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Preface

Most lawyers are called on at some time in their careers to counsel, serve on the board of, or otherwise assist one of a multitude of nonprofit organizations. This practice book will help those lawyers deal with the problems they are most likely to encounter in helping their clients form and operate these entities.

CEB addressed these issues in its first edition of Advising California Nonprofit Corporations in 1984, which was quickly recognized as a leading text in the field, as well as in its second edition of the book in 1998. Since then, nonprofit organizations have become more numerous and more important in our society, issues facing these organizations have become more complex, and knowledge of these issues has become more vital to those in the legal profession.

In this revised and expanded third edition of Advising California Nonprofit Corporations, we have updated the information in the first and second editions. Among other improvements, we have added chapter 21 discussing the complex considerations involved in financial accounting for nonprofits.

The attorneys who served as authors of chapters of this book have given unstintingly of their time and effort. Their names appear on the contents pages and on the first page of the chapter or chapters to which each contributed. Additional biographical information is included in the section "About the Third Edition Authors." To each of them we express our sincere appreciation.

CEB would also like to express its profound gratitude to J. Patrick Whaley, Executive Editor for all three editions of this book. He recruited the superb team of expert authors who wrote this book, while authoring two chapters himself. In addition, his tireless review of drafts of all the material, his peerless editorial eye, and his unparalleled knowledge of tax-exempt organizations law have all made his contributions to this book extraordinary.

CEB Attorney Editor Jean Magistrale and Legal Editors Julie Brook, Nancy N. Lawlor, Sally St. Lawrence, and Kristin Schwaighart contributed to this edition. Administrative support was provided by Deborah Harrison and Nila Kanzaria. Karen Lamoreux handled copyediting and production. Kathryn Te Selle prepared the index. Composition was performed by CEB's Electronic Publishing staff.

CEB plans to supplement this book on a regular basis. We solicit your suggestions and comments to help us keep it accurate and up to date.

April 2010 Update

CEB gratefully acknowledges the invaluable contributions of J. Patrick Whaley, who was the Executive Editor and an author of this update, of Musick, Peeler & Garrett LLP, Los Angeles, as well as the following additional authors of this year's update: Reynolds T. Cafferata and William C. Choi, both of Rodriguez, Horii, Choi & Cafferata LLP, Los Angeles; Gregory L. Colvin, of Adler & Colvin, San Francisco; Kenneth G. Coveney, of Dostart Clapp Gordon & Coveney, LLP, San Diego; Jeffrey D. Davine, of Mitchell Silberberg & Knupp LLP, Los Angeles; Jill S. Dodd, of Manatt, Phelps & Phillips, LLP, San Francisco; Paul J. Dostart, of Dostart Clapp Gordon & Coveney, LLP, San Diego; Cherie L. Evans, of Evans & Rosen LLP, San Francisco; Rosemary E. Fei, of Adler & Colvin, San Francisco; M. Carr Ferguson, of Davis, Polk & Wardwell, New York, New York; Eric K. Gorovitz, of Adler & Colvin, San Francisco; Carol K. Kao, of Luce, Forward, Hamilton & Scripps LLP in San Diego; Pamela S. Kaufmann, of Hanson Bridgett, LLP, San Francisco; Jeff C. Nguyen, of Manatt, Phelps & Phillips, LLP, San Francisco; Lance H. Olson, of Olson Hagel & Fishburn LLP, Sacramento; Shannon M. Paresa, of Rodriguez, Horii, Choi & Cafferata LLP in Los Angeles; Stephanie L. Petit, of Adler & Colvin, San Francisco; Cynthia R. Rowland, of Coblentz, Patch, Duffy & Bass LLP, San Francisco; Lisa A. Runquist of Runquist & Associates, Northridge; Nancy E. Shelmon, of PricewaterhouseCoopers LLP, Los Angeles; Patrick B. Sternal of Runquist & Associates, Northridge; Frederick R. Vandeveer, of Luce, Forward, Hamilton & Scripps LLP, Rancho Santa Fe; Robert A. Wexler, of Adler & Colvin, San Francisco; and Gary L. Wollberg, of Musick, Peeler & Garrett LLP, San Diego.

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for their respective reviews of the employee benefits, insurance, and employment sections of Chapter 13.

CEB Attorney Editor Jean Magistrale and Legal Editors Sally St. Lawrence, Kristin Schwaighart, and Philip Weverka contributed to this title. Administrative support was provided by Kenya Denman and Nila Kanzaria. Dorie Riepe handled copyediting and production. The index was updated by Kathryn Te Selle. Composition was performed by CEB's Electronic Publishing staff.

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Selected Developments

April 2010 Update

The California legislature has enacted AB 1233 (Stats 2009, ch 631), effective January 1, 2010, which revises the law pertaining to governance of nonprofit public benefit corporations, mutual benefit corporations, religious corporations, consumer cooperative corporations, and nonprofit unincorporated associations. The comprehensive revisions concern directors and their titles, election of directors, voting rights, quorum requirements, board committees, third party rights, mergers and dissolutions, and private foundation restrictions. For example, among other provisions, AB 1233 permits nonprofit associations to merge directly with nonprofit or consumer cooperative corporations (Corp C §18360; see §§2.9, 20.42); supplies the gender-neutral term "chair" in the Nonprofits Corporations Code (Corp C 5039.5; see §9.11); clarifies that honorary directors have no authority to act for the corporation unless the articles or bylaws provide otherwise (Corp C §5047; see §9.81); and permits corporations to vote to voluntarily wind up and dissolve, even given lack of a quorum, under certain conditions (Corp C §§6610(c), 8610(c), 9680(b)(3); see §20.86). Relevant discussions throughout the book have been revised to accommodate these and other various provisions of AB 1233.

Revenue and Taxation Code §23701d was amended to provide that an organization exempt under §501(c)(3) by virtue of being part of a group exemption must submit to the Franchise Tax Board the IRS group ruling letter along with evidence that the organization is included in the group. Rev & T C §23701d(c)(1)(B). See §3.71.

New Revenue Procedure 2009-32, 2009-28 Int Rev Bull 142, provides criteria for donor-advised funds and private foundations to use to determine whether a potential grantee is a supporting organization. See §§4.14, 4.46.

The IRS issued proposed regulations regarding the requirements to qualify as a Type III supporting organization operated in connection with one or more supported organizations. See 74 Fed Reg 48672 (2009). See §§4.14, 4.46, 4.63-4.63E, 4.68A.

A Table of Corporations Code Default Provisions has been added to chap 7 which lists Corporations Code sections that may be altered in a corporation's bylaws, articles of incorporation, or both. See §7.2A.

Effective October 11, 2009, a California IRC §501(c)(3) organization is a consumer and not a retailer of tangible personal property sold to its members. Rev & T C 6018.9(a). See §8.57A.

Former Temp Treas Reg §1.6603-6T has been finalized. Treas Reg §1.6033-6. See §12.29.

Humanitarian Law Project v Mukasey (9th Cir 2007) 509 F3d 1122 has been amended and superseded on denial of rehearing en banc. *Humanitarian Law Project v Mukasey* (9th Cir 2009) 552 F3d 916. See §12.70.

Employers sponsoring §403(b) plans that adopted written documents by December 31, 2009, will be able, retroactively and without penalty, to correct any plan failure found later. See §13.41.

A brief discussion of the Federal Trade Commission's Red Flags Rule for identity theft, its requirements, and whether nonprofit organizations are subject to it has been added in chap 13. 16 CFR §681.1. See §13.98.

A city or county may require a license before it authorizes an organization to conduct remote caller bingo. Pen C §326.3(c). See §14.69.

A discussion of the doctrine of merger when an operating charitable trust holds its own endowment has been added to chap 16. See §16.69.

The American Recovery and Reinvestment Act of 2009 (Pub L 111-5, 123 Stat 115) implemented a number of changes to the Internal Revenue Code, including certain changes to the tax exempt bond provisions, which will be important for many IRC §501(c)(3) organizations. IRC §265. See §18.30A.

President Obama has issued an Executive Order imposing limits on interactions between his administration and recently-registered lobbyists. See §19.40A.

The United States Tax Court has determined that an issue-oriented publication, standing alone, did not constitute candidate electioneering. *Catholic Answers, Inc. v U.S.* (SD Cal 2009) 2009-2 USTC ¶50,697, 104 AFTR2d 6894. See §19.64.

The United States Supreme Court has decided *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766, which rescinded provisions of the Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116

Stat 81) such that there is no longer any prohibition regarding corporate expenditures on federal election campaigns. See §19.84.

The form, IRS Publication 4779 (Facts About Terminating or Merging Your Exempt Organization) has been added to chap 20. See §20.5A.

Effective July 1, 2009, the FASB Accounting Standards Codification (FASB ASC) became the single source of authoritative generally accepted accounting principles (GAAP) for periods ending after September 15, 2009. See §§21.3A-21.3B.

FASB Staff Position No. 94-3-1 made several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position 94-3 and the AICPA Accounting Guide to Health Care Organizations. See §21.27A.

Statement of Accounting Standards (SFAS) No. 164 provides guidance on accounting for mergers and acquisitions of not-for-profit organizations, and is applicable to mergers occurring on or after December 15, 2009. See §21.27C.

The discussion of trends in financial accounting and reporting for not-for-profit entities in chap 21 has been updated to reflect events of the past year. See §21.94.

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Attorney's Role During Formation and Operation

Steven J. Chidester

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§1.1 I. SCOPE OF CHAPTER

This chapter addresses the role of the attorney for a nonprofit organization at both the time the organization is established and during its operation. Although many duties of attorneys advising nonprofits are similar to those of attorneys advising for-profit entities, there are differences. Many of these differences arise from the special tax status of most nonprofit entities. Exemption from income tax affects activities of an organization that would not be affected by a mere difference in income tax rates and influences it to act differently from a taxable organization. Thus counsel advising a nonprofit organization on ordinary business matters needs to know the unique area of tax law for nonprofits, which is primarily designed to categorize and to regulate rather than to raise revenue.

Other differences between attorney representation of nonprofit and for-profit organizations occur because many nonprofits start on a shoestring budget and may wish the attorney to work pro bono. In addition, relatively few attorneys practice in this area on a full-time basis, and many attorneys who are asked to advise nonprofits are not experts in the unusual tax and nontax aspects of nonprofits.

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II. ROLE OF ATTORNEY DURING FORMATION OF NONPROFIT ORGANIZATION

§1.2 A. Twelve Basic Questions That Need to Be Answered

The initial attorney-client discussion of a project often occurs before the client has considered many of the basic questions that need to be answered about the proposed entity. Answers to these 12 basic questions will help the client and attorney decide whether to proceed with the formation of a new nonprofit organization. The answer to each of these basic questions depends, in turn, on answers to related questions. In §§1.3-1.14, each major question is discussed and, if appropriate, a related questionnaire is included to help the attorney obtain the facts necessary to analyze the client's situation.

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§1.3 1. Is a New Entity Necessary?

▶ To download **Word** version, right click and choose *Save Target As*

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Questionnaire:

What purpose will be served?

Does a need exist?

What community will be served?

What other organizations, if any, already serve similar purposes?

What is the commitment and staying power of the organizers and participants?

What funds are available?

One of the most valuable services an attorney can render individuals eager to form a new organization is to screen out organizations that do not need to be formed. If the would-be founders find the legal and other costs of properly setting up and advising a new nonprofit entity prohibitive, their perception may be a strong indication that the entity is neither necessary nor viable. However, the mere fact that the entity lacks sufficient resources to pay for its proper establishment at the outset does not automatically dictate that conclusion.

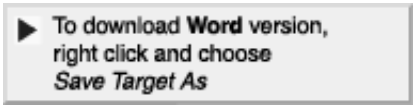
Counsel is helpful to the founder when he or she is familiar with the spectrum of existing nonprofit entities and can, when appropriate, refer the founder to one or more of them. For example, if an existing organization is engaged in similar activities, the attorney might suggest that the founder approach that organization to join forces with it. Or, for example, if the organization's principal activity will be restricted to making grants, the attorney might point out to the founder that this objective can sometimes be satisfied by creating an advised fund with a community foundation, rather than a new private foundation.

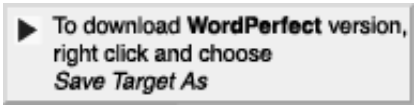
The corporate landscape is littered with derelict suspended nonprofit corporations that should never have been established and were abandoned owing to lack of commitment of the organizers and participants or lack of sufficient funds, even for a proper liquidation. By exercising some independent judgment, responsible attorneys can avoid contributing to this phenomenon.

NOTE: In some areas, "incubator" organizations have sprung up. These organizations foster new projects, enabling them to test their viability without first setting up a new entity. If the activity proves viable, its proponents then leave the shelter of the incubator and establish a new entity. If not, the project dies a quiet death without ever having existed as a separate entity. Examples of such organizations are Community Partners in Los Angeles and The Tides Center in San Francisco.

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§1.4 2. Is There a Sound Business Plan and Is the New Entity Financially Viable?





Questionnaire:

Is there a business plan?

Who will administer the enterprise on a daily basis?

Are qualified and interested directors available?

Are the directors willing to make the commitment necessary for a successful enterprise?

What is the projected budget?

How will the necessary resources be raised?

What are the long-range plans for financing the enterprise?

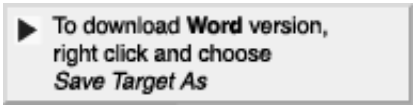
Good intentions and enthusiasm do not guarantee financial success. Frequently, the attorney needs to provide an encounter with reality for would-be founders who do not ask tough questions about costs and sources of revenue. If inexperienced in fundraising, the founders may have unrealistic expectations for their fundraising efforts and no business plan. They may not even have prepared a budget for the first year or two of operation.

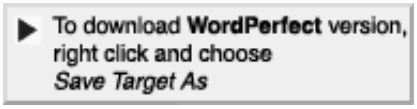
The attorney should point out that the federal exemption application requires a detailed description of the organization's proposed activities and governance. If the enterprise has been in existence for less than a year, it must make a budget, projecting revenues and expenses for the 2 years following the current year, to accompany the federal exemption application IRS Form 1023 (see §§3.60-3.69) and Form 1024 (see §3.70). Counsel may also be able to refer the organizers to resources that could help them formulate a business plan.

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Source: Business Law/Advising California Nonprofit Corporations/1 Attorney's Role During Formation and Operation/ §1.5 3. Should the Organization Be a Nonprofit and What are the Circumstances to Consider?

§1.5 3. Should the Organization Be a Nonprofit and What are the Circumstances to Consider?





Questionnaire:

Are the founders willing to allow the organization to be operated under the direction of a board of directors that may take the organization in a direction the founders would not approve of and maybe even remove the founders entirely?

Is nonprofit status important for obtaining special treatment in a particular area? For example, will it be important for the organization to qualify for reduced-rate mailing privileges, for exemption from unemployment insurance, and for exemption from federal securities registration?

Will outside funding, such as grants, depend on nonprofit status? Is it important to be able to raise equity capital from investors? If so, what regulations will apply? Who will raise the money?

Will it be important for the organization to obtain tax-exempt status?

Will the tax deductibility of contributions to the organization be important?

Will qualified and motivated directors be more easily attracted to serve if the enterprise is nonprofit? For officers and managers, will a salary be adequate incentive or will stock incentives be important?

Is the client aware that more rigorous investment standards may be applied to a nonprofit enterprise or that the enterprise may be subject to supervision by the Attorney General?

Will it be difficult for the nonprofit enterprise to keep up with the paperwork required by the IRS and the Franchise Tax Board?

Will the rules against distributions by nonprofit corporations and benefits that inure to an individual cause problems?

Does the client anticipate engaging in transactions with related parties that would violate applicable federal tax rules (private foundation self-dealing rules or public charity intermediate sanction rules)?

Will the requirement that the organization serve a public purpose and the prohibition against serving a private purpose create problems?

If a product is to be marketed, will people be more likely to buy from an organization that has nonprofit status?

Will the very limited sales tax differences between profit and nonprofit groups be important?

If technology is to be developed, is exclusive or nonexclusive licensing best suited to the organization?

Will the enterprise later wish to convert to for-profit status?

It will often be clear that the enterprise should be nonprofit, as when it has a manifest charitable, religious, or mutual benefit purpose, or, if tax-exempt status is necessary, to attract funds. Many ventures, however—such as scientific research, private schools, or hospitals—can be carried on by either for-profit or nonprofit entities. Merely because the founders conceive of an organization as nonprofit does not mean that the issue is settled. The attorney should be alert for signals, *e.g.,* clear personal profit motives, that the founders would be better served by a business entity. For analysis of preincorporation considerations, see chaps 2-4.

If technology is to be developed, a nonprofit organization might consider nonexclusive licensing to give the public the maximum benefit, while a business enterprise might want an exclusive license in order to ensure reasonable royalties.

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§1.6 4. Should the Organization Be a Nonprofit and What Special Treatment Is Available?

Among the advantages of nonprofit status are that the enterprise may obtain special treatment in several areas, including the following:

- Social Security (42 USC §410(a)(8)(B));
- Unemployment insurance (IRC §3306(c)(8));
- Minimum wage (see 29 USC §203(r));
- Federal securities regulation (15 USC §77c(a)(4));
- Antitrust (see *Dedication & Everlasting Love to Animals v Humane Soc'y of U.S., Inc.* (9th Cir 1995) 50 F3d 710, 712);
- Unfair competition (15 USC §§44-45; see *California Dental Ass'n v FTC* (1999) 526 US 756, 143 L Ed 2d 935, 119 S Ct 1604; *Community Blood Bank v FTC* (8th Cir 1969) 405 F2d 1011);
- Copyright (17 USC §§110, 111(a)(5), 112(b), 118);
- Postal rates (39 USC §3626);
- Government contracts (see, *e.g.,* 48 CFR §§35.014-35.015);
- Property taxes (Cal Const art XIII, §§3(d)-(f), 4(b), (d); Rev & T C §§202(a)(2), 203, 206-207, 213.7-217.1, 221-222.5, 231, 236-236.5); and
- Sales taxes (Rev & T C §§6359.45, 6360-6361, 6363, 6363.2-6363.8, 6365, 6366.3-6366.5, 6370, 6370.5-6371, 6374-6376.5).

Useful resources for attorneys advising nonprofit corporations include Frey & Overton, Guidebook for Directors of Nonprofit Corporations, ABA Section on Business Law (2d ed 2002); Runquist, The ABCs of Nonprofits (2005), and the California Attorney General's website on charitable trusts (http://www.ag.ca.gov/charities/). For further discussion, see generally 2 Marsh, Finkle & Sonsini, Marsh's California Corporation Law, chap 23 (4th ed 2000).

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§1.7 5. If Nonprofit, What Type of Entity Should It Be?

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Questionnaire:

Is an unincorporated association a good alternative? See §§2.4-2.18.

Will the organization engage in any activities for profit?

Will the organization own any real property?

Is a trust a good alternative? See §§2.20-2.25.

Will active management of money or property be required?

Will the organization have members?

Will the organization's activities involve significant risk of contract, tort, or other type of liability?

Will the organization be divided (geographically or otherwise) into chapters or other groups?

Counsel should not automatically assume that the nonprofit entity should be a nonprofit corporation. Although the more esoteric forms of nonprofit organizations are seldom encountered in most practices, counsel should at least be aware of their existence. Among them are the unincorporated association (Corp C §§18000-24001.5) (rarely used because the law is rudimentary and liability can be a concern), the trust (see Prob C §§15000-19403), and the corporation sole (Corp C §§10000-10015) (available only to religious leaders for handling church affairs and property). The attorney should be familiar with the advantages and disadvantages of each type of entity. See chap 2.

Liability considerations. Members, directors, officers, and agents of nonprofit associations are not individually or personally liable for the association's debts or liabilities on the basis of their relationship with the association. Corp C §18605. Members, directors, officers, and agents are not liable for the association's contractual obligations unless they do one of the following (Corp C §§18610(a), (c)-(e), 18615):

- Expressly, in writing, assume responsibility for the contractual obligation;
- Receive a benefit under the contract; or
- Execute a contract without authority, or without disclosing that they are executing the contract on behalf of the association.

Also, a member who in writing authorizes or ratifies a contract, except when the member is acting as director, officer, or agent of the association, may be liable for the obligations resulting from the contract. Corp C §18610(b).

Notwithstanding unincorporated association law, members may be subject to liability under common law principles governing alter ego liability of corporate shareholders. Corp C §18630. See generally, Organizing Corporations in California, chap 1A (3d ed Cal CEB 2001).

The ability of an unincorporated association to deal with real property may be limited as a practical matter by the title company's need to be satisfied that the person signing an instrument is authorized to do so. See Corp C §§18105-18125.

Trusts as nonprofit entities. Trusts are well suited for the passive management of money or property but are less well suited for active operations, although there are notable exceptions, such as Stanford University. Some attorneys routinely create private family foundations as trusts. Such a trust avoids the arbitrary 49-percent restriction of Corp C §5227(a) that would prevent a board from being composed solely of family members if even one member of the family is to be employed by the foundation. Trusts tend to be less flexible than corporations, however, and are not well suited for membership organizations.

Organizations with special reporting requirements. Certain public benefit corporations and trusts are subject to special reporting requirements under the Nonprofit Integrity Act (Stats 2004, ch 919), which amended and added

sections to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). Charitable corporations, unincorporated associations, and trusts that are required to file reports with the Attorney General under Govt C §12583 and have annual revenue in excess of $2 million must prepare an annual financial statement that is audited by an independent certified public accountant. Govt C §12586(e)(1). In addition, covered charitable corporations (but not trusts) are required to appoint audit committees. Govt C §12586(e)(2). This advantage of a trust is unlikely to be decisive as to the choice of entity, but in the event of formation, *e.g.,* of a private foundation that will meet the revenue threshold, it could be a factor favoring a trust form of entity. For a more detailed discussion of these requirements, see §12.53. For a bylaws provision establishing an audit committee, see §7.82.

Controlling legal relationships among related organizations, *e.g.,* organizations divided geographically into chapters or other groups, is most easily accomplished through the corporate form.

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§1.8 6. In What State or Country Should It Be Organized?

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Questionnaire:

In what state will the entity operate?

What are the consequences of organizing outside California but operating in California?

What is the motive of founders concerned with finding a state with minimal supervision of charitable organizations?

If a California attorney is consulted about forming a new entity, the founder probably intends that the organization will operate in California. Frequently, founders have a misguided notion that by organizing in another state they can avoid some of the more "onerous" California rules, such as active supervision of charities by the California Attorney General.

Counsel should be familiar with the consequences of organizing elsewhere but operating in California. The Nonprofit Public Benefit Corporation Law (Corp C §§5110-6910) and the Nonprofit Mutual Benefit Corporation Law (Corp C §§7110-8910) generally do not apply to foreign charitable nonprofit corporations doing business in California. Instead, except for matters specifically provided for in nonprofit law, general corporation law (except for Corp C §2115) governs foreign charitable corporations. Corp C §§6910, 8910.

EXAMPLE: A foreign nonprofit charitable corporation will be deprived of benefits such as the Corp C §5233 procedure for independent director approval of some types of self-dealing transactions.

The Attorney General's Office has on occasion subjected foreign nonprofit corporations doing business in California to the more stringent law applicable to trusts because such corporations hold assets in charitable trust. See §1.35.

Even if created in other states, charitable corporations and unincorporated associations that are required to file reports with the Attorney General, and that receive gross revenues of $2 million or more, are subject to the accounting requirements of Govt C §12586(e). Govt C §12581. See §12.53.

Attorneys should also be wary of clients and founders who are overly concerned with finding a state with minimal supervision of charitable organizations. This concern can indicate less-than-charitable motives.

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§1.9 7. If a California Nonprofit Corporation, Should It Be Public Benefit, Mutual Benefit, or Religious?

The attorney needs to be familiar with the basic distinctions between the three types of California nonprofit corporations: public benefit, mutual benefit, and religious. See §§2.29-2.30. Some organizations with religious purposes could be incorporated under two or even all three of the separate laws.

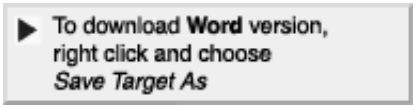
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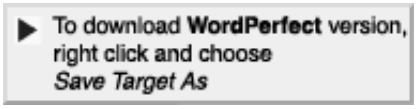
§1.10 8. If a California Nonprofit Corporation, Should It Have Voting Members?

Nonprofit corporation laws permit the creation of a corporation without voting members. See Corp C §§5310, 7310, 9310. If there are no voting members, the directors will be (a) self-perpetuating, (b) appointed or designated, or (c) some combination of the two. Even a corporation with voting members may have some directors who are designated or appointed. The attorney should be familiar with the legal and practical considerations in advising the client on the type of governance most appropriate to its situation. For full discussion, see chap 10.

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§1.11 9. Is Tax Exemption Appropriate and Desirable?





Questionnaire:

What are the benefits of tax-exempt status?

What are the burdens of tax-exempt status?

Many lay persons, including would-be founders of nonprofit organizations, are surprised to learn that nonprofit status and tax exemption are two separate concepts. The attorney should resist the tendency to equate "nonprofit" and "tax-exempt." The essential feature of a nonprofit corporation is that it cannot make distributions of profits to members. A tax-exempt organization can make a profit, and many do. A nonprofit organization may be a taxable entity. Although most founders of nonprofit organizations would prefer that their organizations be exempt from income tax, occasionally an entity will not qualify for tax exemption, or the founder may not wish to be subject to the burdens of tax exemption but may still have sound reasons for establishing a nonprofit corporation. See chap 3. The attorney should familiarize the would-be founders with both the benefits and burdens of nonprofit and tax-exempt status and help them assess their own tolerance for the burdens of that status.

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§1.12 10. If Tax Exemption Is Desirable, Under What Sections of Internal Revenue Code and Revenue and Taxation Code?

Internal Revenue Code §501 and the corresponding section of the Revenue and Taxation Code (see Rev & T C §23701) provide numerous specific categories of exemption. Many organizations obtain an exemption determination under the wrong category, *e.g.,* a youth soccer "club" that has been exempted under IRC §501(c)(7) as a social club might easily have qualified as a charitable organization under IRC §501(c)(3) and thus have been able to receive deductible contributions. The attorney should be familiar with the different types of exemptions and their advantages and disadvantages. See chap 3.

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§1.13 11. If IRC §501(c)(3) Organization, Can It Qualify for Public Charity Classification Under IRC §509(a)?

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Questionnaire:

Will the primary activity be that of a church, school, hospital, or medical research organization operated in conjunction with a hospital?

If not, will the primary source(s) of support be

contributions from the founder and his or her relatives?

contributions from a large number of unrelated people?

gross receipts from the operation of an exempt activity?

Will the differences between the income tax deductibility of contributions to public charities and private foundations be important?

Will the operating restrictions applicable to a private foundation materially interfere with the organization's activities?

Internal Revenue Code §509(a) divides IRC §501(c)(3) organizations into two broad classifications: (a) private foundations and (b) other types of organizations, usually known as public charities. Fairly onerous provisions designed to prevent abuse are applied to private foundations. See §§4.23-4.55. The Treasury Regulations under IRC §509(a) are complex and confusing. Because classification can be crucial to the viability of a proposed organization, it is extremely important that the attorney be able to assess the likely classification of the organization at an early stage. A client will not be pleased to learn, after the entity is organized, that it will not be able to achieve public charity status. If the entity will not qualify as a public charity, its founders may prefer to choose an alternative other than creating a private foundation. For an example of another solution, see §1.15. The attorney should also be familiar with federal "intermediate sanction" rules, which impose penalties on "excess benefit transactions" between the charity and certain related parties. See IRC §4958. For discussion, see 3.15-3.28. This legislation has narrowed the differences in the area of self-dealing between public charities and private foundations.

An attorney asked to create a private foundation usually should acquaint the founder with the alternatives of a donor-advised fund at a community foundation or a supporting organization under IRC §501(c)(3), both of which afford the benefits of public charity status.

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§1.14 12. If Not Qualifiable as Public Charity, Can It Accept Various Restrictions Applicable to Private Foundations?

The attorney must be familiar with the numerous and complex restrictions applicable to private foundations to be able to help the client foresee how those restrictions might impinge on its operations. See §§4.23-4.55.

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§1.15 B. Importance of Having Sufficient Expertise to Resolve Exempt Organization Classification Issues Before Drafting Documents

The attorney should help the client foresee the consequences of its IRC §501(c) and IRC §509(a) classifications. The private foundation rules, in particular, are highly arbitrary and complex; common sense is not a reliable guide to those rules. See §§4.23-4.55.

PRACTICE TIP: The attorney must be able not only to identify problems but also to suggest alternatives that address potential classification problems. For example, the client may be a public charitable organization that either cannot qualify for exemption under IRC §501(c)(3) or would be classified as a private foundation and not be able to function effectively under the highly arbitrary private foundation rules. The solution in that situation might be to suggest establishing two organizations, with the primary operating organization exempt under IRC §501(c)(4) and the ancillary organization exempt under IRC §501(c)(3). Note, however, that the intermediate sanctions law applies to organizations exempt under IRC §501(c)(4) as well as IRC §501(c)(3). See IRC §4958.

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§1.16 C. Feasibility of Commencing Operations Before Obtaining Tax Exemption Determinations

Frequently, individuals seeking to form a new charitable nonprofit organization want to begin operations before receiving determinations of exempt status and private foundation status. The consolidation of federal determinations in one national office in Cincinnati has improved turnaround time, but response still generally takes at least 1 month after the filing, and can take much longer if there are issues preventing a prompt determination. Previously it was possible to expedite an application through the office of a local IRS District Director. It seems that this is no longer possible. Expedited treatment can still be obtained, but any such request needs specific written justification, *e.g.,* pendency of a large gift that must be made by year-end.

The attorney should not acquiesce in the charity's desire to start operating before it receives a determination unless the attorney is very confident of the outcome or the client and any donors to the client are willing to risk an adverse determination. A major concern is the deductibility of contributions made before obtaining determinations. Normally, the determination on a timely filed application will be retroactive to the date of organization. See §3.62. If for some reason, however, it is not retroactive, is not obtained, or is a different determination from the one expected, the question arises how prior contributions will be categorized. It may be possible to condition the contribution on receipt of an appropriate determination in due course with a gift over to a qualified charity if the condition is not satisfied.

Concerning its own income tax liability, the entity will either be taxable or nontaxable, depending on the outcome of the determination. Counsel should so caution the client eager to start operations immediately.

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§1.17 D. Attorney Tasks When Establishing New Nonprofit Organization

In establishing a new nonprofit organization, the attorney must be prepared to do the following:

- **Provide preorganization analysis and advice.** Advising founders who are considering establishing a nonprofit organization requires extensive analysis and advice on tax-exemption qualification and classification issues. Although in a few relatively simple cases counsel with reasonable expertise will not need to do any research, many other cases do require research. There is a growing and unfortunate tendency among clients to regard "research" as something attorneys did before they were "experts." The expert *should* know all the questions and a lot of the answers, but no one can know *all* the answers. In the author's opinion, counsel should recognize this tendency and not fall into the trap of accepting the mistaken assumption that the client should not be billed for necessary research.
- **Draft and file governing instruments.** See chaps 5-7.
- **Prepare, file, and prosecute state and federal exemption applications.** See §§3.60-3.71.
- **Prepare an operating manual for directors, officers, and staff that is tailored to the client's needs.** The operating manual should provide guidance in sufficient depth and detail to enable the client to avoid violating the applicable Corporations Code provisions and tax laws. See §1.18.
- **If the client will have an active fundraising program, provide the client with the necessary forms and advice to ensure compliance with all applicable regulations and to avoid potential liability to donors.** See chaps 12-14.

In rendering advice, the attorney should anticipate that many individuals working in nonprofit organizations tend to think that they need not pay too much attention to technical rules because, in effect, "What could be wrong here? We're doing the work of the Lord" (or the secular equivalent).

Counsel may be able to reduce the cost of this work somewhat by being familiar with the availability and content of boilerplate materials. Such materials must always be used with caution because they rarely completely satisfy the need for advice tailored to the client's situation.

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E. Operating Manual

§1.18 1. Components of Operating Manual for Exempt Organization

The tasks of an attorney engaged to represent a new organization should include preparing a memorandum of guidelines, often called an "operating manual." The manual should be tailored to the organization's particular tax and corporate status, acquainting its managers with the rules with which they must comply. If the client is unwilling to pay for this work, the attorney should either (1) document his or her recommendation that this should be done and the client's refusal to accept that recommendation, or (2) reconsider the wisdom of representing the client. A client who chooses to "fly blind" may try to blame the attorney for not warning of any pitfalls later encountered.

For investment guidelines, the applicable statutes include Corp C §5240 for a corporation; the Uniform Prudent Investor Act (Prob C §§16045-16054) for a trust; and the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob §§18501-18510) for both "institutional funds" and endowment funds. See Silk, *Corporate Scandals and the Governance of Nonprofit Corporations: What Every Director, Officer, and Advisor to Nonprofit Corporations in California Should Know About Corporate Responsibility Rules*, 38 Exempt Org Tax Rev 399 (2002).

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§1.19 2. Form: Suggested Table of Contents for Operating Manual

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I. INTRODUCTION

II. TAX-EXEMPT STATUS

A. Amendments to Articles or Bylaws

B. Significant Changes in Activities

C. Benefiting Private Interests

D. Political and Legislative Activities

III. PUBLIC CHARITY STATUS

_ _[*Add subheadings depending on the basis for public charity status*]_ _

IV. REPORTING REQUIREMENTS

A. Federal Reporting Requirements

B. State Reporting Requirements

C. Municipal Reporting Requirements

V. UNRELATED BUSINESS INCOME

VI. MANAGEMENT STRUCTURE OF CORPORATION

A. Directors

B. Officers

_ _[*C. Members*]_ _

VII. RECORDKEEPING AND CORPORATE FORMALITIES

A. Minutes and Corporate Maintenance

B. Financial Records

VIII. DUTIES AND LIABILITIES OF DIRECTORS AND OTHERS

A. Duty of Care

B. Duty of Obedience

C. Duty of Loyalty

D. Self-Dealing Transactions

E. Intermediate Sanctions

F. Compensation

IX. INVESTMENTS

_ _[*Add subheadings depending on whether the private foundation is a corporation or a trust, or has endowment funds*]_ _

X. PROTECTION AND INDEMNIFICATION OF DIRECTORS

A. Protection Arising From Corporate Form

B. Protection Provided to Volunteer Directors Under California Law

C. Protection Provided to Volunteer Directors Under Federal Law

D. Exceptions to Volunteer Directors' Protection

E. Indemnification

F. Liability Insurance for Directors and Officers

XI. ATTORNEY GENERAL OVERSIGHT

A. Attorney General's Role

B. Remedies Available to Attorney General

XII. SUBSTANTIATION OF CHARITABLE GIFTS

A. Gifts of Less Than $500 in Value ($250 for noncash gifts)

B. Gifts with Value Between $500 ($250 for noncash gifts) and $5000

C. Noncash Gifts With Value Over $5000

D. Quid Pro Quo Contributions

E. Required Filing by Charitable Organization

Comment: The headings above are representative of the subjects that need to be covered in a manual for a charity organized as a public benefit corporation. Many of the headings apply equally well to a mutual benefit corporation, although the content might be different. For example, detailed summaries of member notice, ballot, and meeting procedures are frequently necessary in a mutual benefit manual but not in a public benefit manual. The outline for a religious corporation operating manual may be similar to that of a public benefit corporation, but the content may vary considerably because of the wide variety of religious hierarchies.

If the corporation has voting members, the manual should include a summary of applicable voting, meeting, and notice procedures.

For a private foundation, the operating manual would include all of the above, except that the discussion of public charity status would be replaced by a discussion of private foundation status. The attorney should add another major heading to cover IRC §§4940-4948, which impose a series of excise taxes in the nature of fines on private foundations, their managers, and disqualified persons. See §§4.23-4.55.

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III. ROLE OF ATTORNEY IN REPRESENTING EXISTING TAX-EXEMPT ORGANIZATION

§1.20 A. Checklist: Areas Requiring Review

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- Changes in exempt purpose or activities.
- Introduction of substantial nonexempt activities.
- Unrelated business income tax issues. See chap 17.
- Political and lobbying activities. See chap 19.
- Self-dealing transactions, private benefit, and private inurement. See §§3.15-3.30, 4.25-4.35, 4.76.
- If a public charity, changes in sources of support and "intermediate sanctions" compliance.
- If a public charity, fundraising practices and charitable deduction substantiation compliance; compliance with rules on public availability of documents filed with IRS. See Warning below.
- Timely filing of properly prepared annual returns and reports. See chap 12.
- Corporate housekeeping: notices, quorum, minutes, etc.
- Existence and adequacy of appropriate insurance coverage.
- Personnel practices and compliance; independent contractor versus employee issues.
- Property tax status.
- Officer and director conflict of interest and disclosure policies. See §§9.131-9.150.
- If a membership corporation, compliance with corporate democracy requirements in bylaws and Corporations Code.

When undertaking the general representation of an existing tax-exempt organization, counsel should explain to the client the need for, and obtain the client's consent to conduct, a sufficient legal review of the organization's exempt status and related issues in order to establish a solid foundation for future advice the attorney may be asked to give. The initial exemption determination letter issued years before was based on a then-existing specified set of facts; if material changes in operation have occurred, it is possible that the IRS will not be bound by that letter. See §§3.60-3.69. This checklist covers areas warranting the attorney's review.

WARNING: Governing boards and staffs of charitable organizations seldom understand the full extent to which their cultivation of donors can create duties and even liability to the donors. The attorney should understand, and be prepared to advise the client on, the duties arising from fundraising activities, such as express and implied restrictions on purposes for which charitable gifts can be used and the fiduciary duties arising from planned giving activities (see §§15.59-15.65). Concerning the latter, see *Martin v Ohio State Univ. Found.* (Ohio App 2000) 742 NE2d 1198 (foundation and its treasurer reportedly paid $675,000 to settle this case).

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§1.21 B. Special Considerations for Clients Incorporated in Another State

If a client incorporated in another state does business or has headquarters in California, the attorney should obtain a copy of the nonprofit corporation law of the home state and ascertain whether it has been amended in any significant way that would require changes in the client's governing documents or operations. Counsel should verify that the organization is qualified to do business in California and is filing the appropriate California returns and reports. The attorney should verify that the organization is complying with the rules applicable to the internal affairs of the corporation, usually found in the laws of the home state. See Corp C §2115. See also §§1.8, 1.35. The attorney may also need to consult an attorney in the state of incorporation.

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IV. ATTORNEY COMPENSATION

§1.22 A. The Pro Bono Issue

Attorneys specializing in representing nonprofit organizations are often asked to work for charitable organizations on a pro bono basis. The attorney should establish a policy on such requests. Counsel may have to explain to a client seeking pro bono services that the request does not fall within the attorney's pro bono policy and that to develop and maintain the attorney's nonprofit expertise, he or she cannot afford to offer pro bono services in most instances.

Founders of charities in formative stages often ask the attorney to join the board of directors of their organization. In this area, too, the attorney should have a preestablished policy that takes into account both malpractice insurance issues that might arise under the attorney's policy and the risk of becoming overcommitted. The attorney should try to ascertain whether this is just another way to ask for pro bono advice or reflects a genuine interest in having the attorney's services as a director.

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§1.23 B. Estimating Fees

Once past the Scylla of whether to work *intentionally* without compensation, the attorney must be careful to avoid the Charybdis of *unintentionally* working without compensation. Attorneys should be wary of underestimating fees through a combination of sympathy for the client's worthiness and failure to fully grasp the complexity of applicable laws and what is necessary to complete the job. There is a corresponding risk that the client may not receive all advice necessary to discharge its responsibilities.

In estimating fees, both for organizing and maintaining the entity, counsel should anticipate and educate the client about its need for advice on tax exemption, unrelated business income tax, private foundation classification, compliance with IRC §§4940-4948 and intermediate sanctions rules, corporate governance, fundraising, and other issues. If issues are presented in these areas, fees for the necessary research, analysis, and advice can be substantial. Problems will surely arise if the attorney turns a group of novices loose with an exemption determination letter and no operating manual or understanding that they will need operational legal advice on a regular, or at least an occasional, basis.

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§1.24 C. Getting Paid

An attorney can unintentionally work without compensation by not having an assured source of payment for organizational expenses if the new organization does not succeed or succeeds only minimally. It is entirely appropriate for a new entity to pay its own organizational expenses after it has been formed and has received assets. Counsel, however, may have a chicken-and-egg problem, particularly with a charitable organization. The would-be founders may expect to make or receive charitable contributions to cover their organizational expenses and may ask the attorney to wait to be paid until the contributions arrive. This approach can be highly risky for the attorney, but if counsel is to obtain a fee deposit or retainer, from whom will it come when the organization does not yet exist and has not yet obtained the contributions it expects to receive?

One solution is for the founders to make payments to the attorney's trust account for the benefit of the entity to be established, with the understanding, in writing, that the payments are for organizational expenses and will be treated as contributions to the entity once it has been formed. The entity must ultimately send an appropriately worded deduction substantiation letter. See §§14.3-14.12.

If the founders wish to be reimbursed by the new entity for expenses advanced on its behalf, they may be. However, the attorney should document beforehand that such advances on the new entity's behalf are to be treated as loans rather than contributions, and after formation the board of directors should authorize repayment. Usually such advances are without interest; if interest is desired, counsel will need to verify whether payment is permissible under the Internal Revenue Code and applicable tax laws. For private foundations, see, *e.g.,* IRS Letter Rulings 8016089, 9015066, 9431054. For public charities and religious corporations, consult the intermediate sanctions rules. See §3.16. For mutual benefit corporations, the tax rules are less of a factor as long as the interest payable is truly interest, not a disguised dividend.

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V. CONFLICTS AND ETHICAL ISSUES

§1.25 A. Attorney's Duties Under Rules of Professional Conduct

Conflicts analysis is best done by starting with the attorney's duties. Counsel is subject to four basic rules that can be involved in conflict of interest situations (which apply even without a potential conflict):

- The duty of undivided loyalty to the client;
- The duty to inform the client;
- The duty to maintain client confidence and secrets; and
- The duty to represent the client competently.

All conflict of interest situations involve conflicting loyalties, either between the interests of the lawyer and the client or between the interests of two or more clients. When the clients' interests conflict, there can be a tension between the duty to maintain the confidentiality and secrets of one client and the duty to inform the other. These problems can, in turn, impair a lawyer's ability to represent a client competently.

The conflict rules in Cal Rules of Prof Cond 3-310 are designed to address situations that inherently strain a lawyer's ability to fulfill these basic duties. The close, friendly relationships that tend to exist between nonprofits and their supporters, employees, and founders often present these situations. It is important to understand the scope of the basic duties and to keep them in mind when analyzing whether a potential or actual conflict exists. An analysis of the attorney's basic duties can also help determine what disclosures are needed to obtain a client's informed consent and how to structure an engagement letter to avoid pitfalls.

California Rules of Professional Conduct 3-110(C) addresses the attorney's duty to practice competently. Although many attorneys have the requisite knowledge to handle routine aspects of representing nonprofits, the tax and corporate issues can easily veer off into areas where only specialists have the expertise to practice without a great deal of research and analysis. In that situation, Rule 3-110(C) requires the attorney either to do what is necessary to acquire the requisite expertise before performing the services (which may not be economically viable if the attorney does not intend to make this area a specialty) or to associate counsel with the necessary expertise.

WARNING: Would-be founders of a nonprofit are often unfamiliar with nonprofit entity considerations and look to an attorney who is experienced with nonprofits to decide how to structure the organization. Such advice often is more in the nature of business advice than legal advice. The attorney may or may not be equipped to provide such advice, depending on the length and nature of his or her experience. Counsel should recognize his or her limitations on the ability to provide such advice and become familiar with appropriate resources, such as other nonprofits or entities that provide services to nonprofits, to which to refer clients for business advice.

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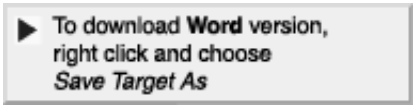
§1.26 B. Who Is the Client When New Entity Is Being Formed?

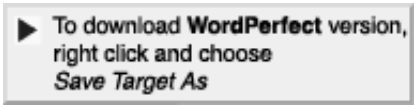
One or more individuals who come to an attorney to form a new nonprofit entity presumably intend that the new entity, once formed, will be the client. These individuals are acting as agents (usually prospective officers and directors) for the proposed entity, which is how attorneys tend to see and treat them. It is recommended that the attorney clarify this assumption with the individuals in writing and clarify whether the attorney represents only the entity or both the entity and one or more of the founders. If the attorney represents only the entity, the founders must understand that the attorney does not represent any of them individually vis-à-vis the organization or each other. For a sample paragraph to include in the attorney's engagement letter, see §1.27.

If one or more of the founders are already clients or also wish to become clients, see §§1.28-1.32.

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§1.27 C. Form: Paragraph in Engagement Letter Confirming That Entity to Be Formed Will Be the Client





You, _ _[*name*]_ _, and _ _[*name*]_ _ have informed us that you have decided to form a nonprofit corporation, to be called _ _[*name of organization*]_ _ (the Foundation), for the primary purpose of _ _[*specify*]_ _. I am pleased that you have selected our firm to represent the Foundation in organizational and tax-exemption matters.

We will (1) provide the necessary advice to you, as founders and as prospective officers and directors acting on behalf of the Foundation, to enable you to make the decisions about the nature and structure of the Foundation, and (2) implement your decisions. In undertaking this work, we will be requesting that you confirm our understanding with you that our client will be and remain the Foundation, and not you, individually or collectively. We have not undertaken representation of you, individually or collectively, and we will not be advising you on your respective relationships with the Foundation or on any other matter unless a further, specific engagement letter for such advice and appropriate conflict waiver letters between you and the Foundation and/or among you are signed.

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D. Specific Conflict of Interest Situations

§1.28 1. Conflict Between Founder and Organization

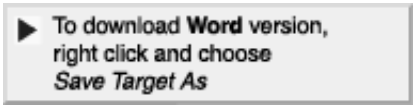
A conflict can occur between the continued representation of an individual client and the representation of a nonprofit organization created for that client, *e.g.,* a private foundation. The obvious mutuality of interest at the outset often does not set off conflict alarms. However, because a conflict could arise, the attorney should obtain a conflict waiver letter from the new entity and from the founder individually if the attorney will continue to represent both. For a form of conflict waiver letter when representing both a foundation and its founder, see §1.30. For a sample paragraph to include in the attorney's engagement letter if the conflict waiver letter is used, see §1.29.

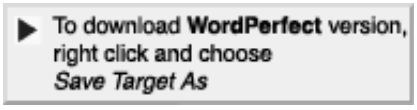
Arguably, the incorporator of the new nonprofit corporation has the authority to execute the conflict waiver letter (and the engagement letter) as part of the incorporator's power to "do whatever is necessary and proper to perfect the organization of the corporation" (Corp C §5134). Some practitioners feel, however, that the corporation cannot officially execute these letters until it has officers and directors, creating a chicken-and-egg problem for the attorney. Either way, the execution of these letters should be ratified in the organizational meeting minutes.

If the nonprofit is a charity, particularly a private foundation, counsel should consider whether the fiduciary duties the directors owe to the public create obligations for the attorney that the organization cannot waive, unlike the duties owed between individual or corporate clients who are on equal footing.

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§1.29 2. Form: Paragraph in Engagement Letter Confirming That Entity to Be Formed Will Be Separate Client





You, _ _[*name*]_ _, and _ _[*name*]_ _ have informed us that you have decided to form a nonprofit corporation, to be called _ _[*name of organization*]_ _ (the Foundation), for the primary purpose of _ _[*specify*]_ _. I am pleased that you have selected our firm to represent the Foundation in organizational and tax-exemption matters.

We will (1) provide the necessary advice to you, as founders and as prospective officers and directors acting on behalf of the Foundation, to enable you to make the decisions about the nature and structure of the Foundation, and (2) implement your decisions. In undertaking this work, we will be requesting that you confirm our understanding with you that our client will be and remain the Foundation with respect to such organizational and tax-exemption matters. Because you, as individuals in other capacities, are clients of _ _[*name of law firm*]_ _ in connection with certain personal and business matters, and _ _[*names of related entities*]_ _ are also clients, I have also enclosed a separate letter that discusses the potential conflicts of interest that may arise from our simultaneously representing the Foundation, you individually, and you in your capacities as trustees of _ _[*name of irrevocable trust*]_ _ and as shareholders and principal officers of _ _[*name of company*]_ _, and also of _ _[*name of company*]_ _ itself. That separate letter requests waivers of any such conflict of interest in our representation of the Foundation.

Comment: The language of the letter is inclusive. Portions of the letter may be deleted if the law firm does not represent any related entities or does not also represent the founders as trustees of a trust or officers of a company. A form of consent to representation and waiver of conflict letter is provided in §1.30.

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§1.30 3. Form: Consent to Representation and Conflict Waiver Letter for Foundation Formed for Existing Client

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

[*Law firm letterhead*]

_ _[*Date*]_ _

_ _[*Name and address of client*]_ _

_ _[*Name and address of foundation*]_ _

Dear _ _[*name of foundation*]_ _:

_ _[*Name of foundation*]_ _ (Foundation) has requested advice and assistance from _ _[*name of law firm*]_ _ in connection with certain organizational and operational matters, including obtaining its tax-exempt status. The Foundation has been created by _ _[*name of client*]_ _, who plans to make significant financial contributions to the Foundation and serve as its _ _[*specify office held*]_ _. _ _[*Name of client*]_ _ is also a client of _ _[*name of law firm*]_ _ for certain personal and business matters. Because of the relationship between the Foundation and _ _[*name of client*]_ _, California law requires us to inform you of potential conflicts of interest that may arise by our simultaneously representing the Foundation and _ _[*name of client*]_ _ and to obtain your respective waivers of such a conflict of interest in our representation of the Foundation.

The first issue that arises in the simultaneous representation of related clients is the issue of confidentiality. Attorneys are prohibited from sharing confidential information received from a client with other clients or with third parties without the consent of the client who divulged the confidential information. By signing this conflict waiver, the Foundation agrees that any information that the Foundation provides our firm in connection with its legal matters may be shared with _ _[*name of client*]_ _. Of course, confidential information provided to us by the Foundation will remain confidential regarding all other parties.

Attorneys are also subject to duties of disclosure regarding information that may be material to the legal matters of their clients. We will endeavor to apprise each client of any information we learn in the course of our concurrent representation that is, in our reasonable judgment, material to them. However, it is not feasible for us to affirmatively disclose each and every fact we learn to each client; we are asking you to acknowledge this fact by signing below. Of course, we will respond fully to any specific inquiries either client may make about information we may have received from the other client, except as provided below. (This point is somewhat moot because of the multiple roles of _ _[*name of client*]_ _.)

Notwithstanding the foregoing, information that _ _[*name of client*]_ _ has provided us in the past, or may provide us in the future in connection with personal legal matters, will remain confidential and may not be disclosed to representatives of the Foundation or to anyone else without proper authorization. For example, if _ _[*name of client*]_ _ should request our assistance in changing _ _[*his/her/their*]_ _ estate plan in a manner that reduces or eliminates gifts or bequests to the Foundation, we would have a duty not to disclose this fact to the Foundation.

In addition to confidentiality issues, a potential conflict of interest exists between the Foundation and _ _[*name of client*]_ _. Currently, the Foundation and _ _[*name of client*]_ _ have consistent wishes and expectations about the Foundation's operation. However, over the course of our representation of the Foundation, the Foundation and _ _[*name of client*]_ _ may, for example, develop a difference of opinion on the management of the Foundation, the application of Foundation funds, or the selection of officers or professional advisers. There are many other ways in which the interests of the Foundation and _ _[*name of client*]_ _ could become adverse during our representation. As attorneys for both the Foundation and _ _[*name of client*]_ _, we cannot be an advocate for either against the other if a conflict arises between you. It is important to note that, if an actual conflict of interest arises between the Foundation and _ _[*name of client*]_ _, _ _[*name of law firm*]_ _

may need to withdraw from representing either of you unless we obtain further consent to the representation at that time.

Finally, we should point out that each of you has the right to seek independent advice from a separate attorney in connection with matters concerning the Foundation. For the time being, however, you have chosen not to do so and have asked us to continue to represent both the Foundation and _ _[*name of client*]_ _. We will therefore continue to represent both of you if you sign this consent unless a conflict of interest arises between you that, in our judgment, prohibits us from doing so.

If our simultaneous representation of both of you with the above understandings is acceptable, please sign and return the enclosed copy of this letter.

Very truly yours,

__[*Signature of attorney*]__
_ _[*Typed name*]_ _
of _ _[*name of law firm*]_ _

The foregoing is accepted and agreed to by:

_ _[*Name of foundation*]_ _**, a California nonprofit public benefit corporation**

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**
By: __[*Signature of foundation officer*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _

By: __[*Signature of client*]__
_ _[*Typed name*]_ _

Comment: The first paragraph of the letter may be adapted as necessary if the law firm also represents any related entities.

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§1.31 4. Conflicts With Existing Clients

Several situations can arise, particularly in the charitable arena, that involve existing clients of the attorney. Some of the most common are the following:

- **When a new entity is designed to benefit or complement activities of an existing nonprofit client.** Occasionally, an attorney will be asked to form a nonprofit entity, usually a foundation, intended to benefit or complement the activities of an existing nonprofit client, which may or may not be a charity. This situation probably does not present an actual conflict, because by definition the two clients have mutual goals. But because it is conceivable that the new entity may wish at some point to shift the focus of its attention away from the existing client, the attorney should consider whether to address that possibility at the outset.
- **When a new entity will compete with the existing nonprofit client for customers, patrons, or contributions.** If the new entity is quite similar to an existing nonprofit client, the attorney would be wise, from a client relations standpoint, to acquaint both clients with that fact and verify in writing that his or her acceptance of the engagement does not violate the duty to either.
- **When the attorney represents both the existing nonprofit client or new entity client that solicits charitable gifts and a wealthy individual client who will make charitable gifts to the nonprofit client.** The attorney can be presented with a conflict of interest when a charitable client and an individual client propose, for example, a split-interest gift transaction (such as creating a charitable remainder trust) and the transaction will involve an active participation, such as serving as trustee, by the charitable client. On split-interest gifts, see §§15.47-15.65.

WARNING: The last situation is most likely to produce exposure to liability for the attorney. Litigation may ensue when the individual contributor becomes unhappy with the split-interest gift transaction, the trusteeship of the charitable beneficiary, or both. An attorney may be sued for breach of the duty of loyalty if there is no written conflict waiver and the attorney fails to adequately disclose the consequences of the transaction to the individual client. Self-dealing transactions between an individual client and a charitable client that the individual client controls could create exposure for the attorney if the attorney is aware of them. In such situations, the attorney would be well advised to represent only one party, with a conflict waiver from both, and to have the other party represented by separate counsel.

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§1.32 E. Choices for Attorney in Potential Conflict Situation

For the attorney faced with a potential conflict of interest, there are essentially three choices:

- Represent both parties and obtain a written waiver and consent. For a sample letter of representation of both a foundation and its founder, see §1.30.
- If both parties have provided confidential information, represent only one party and obtain a waiver.
- Represent neither party.

For an attorney representing conflicting interests in the nonprofit arena, disqualification is a real possibility. However, in one case involving vicarious disqualification of an entire nonprofit law firm, the California Supreme Court held that the firm's representation of successive dependency clients with conflicting interests warranted disqualification only if client confidences could not be protected through effective screening. *In re Charlisse C* (2008) 45 C4th 145, 84 CR3d 597.

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§1.33 F. Duty to Practice Competently Requires Familiarity With Applicable Laws

As discussed in §1.25, an attorney has a duty under Cal Rules of Prof Cond 3-110(C) to practice competently. In fulfilling this duty, an attorney for a nonprofit corporation needs to be familiar with a wide variety of applicable laws. The most important of these are discussed in §§1.34-1.37. Other laws that might be significant are discussed in §1.38.

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§1.34 1. Nonprofit Corporation Law

An attorney representing a nonprofit corporation needs to be thoroughly familiar with California's Nonprofit Corporation Law (Corp C §§5000-10841). The law contains three separate, free-standing sets of laws governing the three types of nonprofit corporations: the Nonprofit Public Benefit Corporation Law (Corp C §§5110-6910), the Nonprofit Mutual Benefit Corporation Law (Corp C §§7110-8910), and the Nonprofit Religious Corporation Law (Corp C §§9110-9690). See §§2.29-2.30.

The law contains a number of specific and nonintuitive provisions regulating certain transactions with directors and officers, such as self-dealing transactions (Corp C §5233), unreasonable compensation (Corp C §5235), and loans to officers or directors (Corp C §5236). The prominence of federal tax laws in these areas sometimes leads clients and attorneys to overlook California corporate law requirements. Interested-party transactions must pass muster under both state corporate laws and federal tax laws.

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§1.35 2. Trust Law

California's Trust Law (Prob C §§15000-19403) applies to charitable trusts that are subject to the jurisdiction of the Attorney General, as long the trust law provisions do not conflict with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). Prob C §15004.

Under *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 755, 40 CR 244, "responsible individuals" such as trustees may sue to enforce a charitable trust. *San Diego County Council, Boy Scouts of Am. v City of Escondido* (1971) 14 CA3d 189, 195, 92 CR 186. See also *L.B. Research & Educ. Found. v UCLA Found*. (2005) 130 CA4th 171, 180, 29 CR3d 710. The Attorney General must be notified and may intervene in an action brought to enforce the trust. Corp C §5142.

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§1.36 3. Tax Laws

- **Federal.** The attorney needs to be familiar with the laws on exemption from income tax (IRC §§501-509), the laws regulating private foundations (IRC §§4940-4948), the laws regulating related-party transactions of public charities ("intermediate sanctions rules") (IRC §4958), the laws governing unrelated business income tax (IRC §§511-515), and the laws on charitable gift deductions (IRC §§170, 2055, 2522). An attorney representing nonprofit corporations should also be familiar with the general income tax laws applicable to individuals, corporations, and partnerships, and with capital gains taxes, all of which will come into play to some extent in the course of advising an organization, regarding both its own operations and its receipt of charitable contributions.
- **State.** The attorney will need to be familiar with the Revenue and Taxation Code. In general, California law follows the federal law and in some areas, such as public charities and private foundations, the California law defers to federal law. There are, however, some notable areas of nonconformity between federal and California law that can affect charitable corporations and their donors. See chaps 14-15.
- **Local property tax.** The attorney should also be familiar with the property tax exemption that is available to some charitable corporations. See, *e.g.,* Rev & T C §214. If representing an organization conducting a planned giving program, the attorney should be familiar with the rules and exemptions on "change of ownership," such as Rev & T C §62.

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§1.37 4. Securities Laws

Although nonprofit corporations cannot issue stock in California, they can issue bonds and, if they do, they must comply with applicable state and federal securities laws. See, *e.g.,* Corp C §25110. A mutual benefit corporation selling memberships, such as a country club, must comply with the California securities law. See 10 Cal Code Regs §260.105.20. See also §§10.12-10.20. In addition, certain securities issues arise in the context of planned giving, such as issuing gift annuities or marketing pooled income funds.

NOTE: The Philanthropy Protection Act of 1995 (Pub L 104-62, 109 Stat 682) was enacted to relieve charities of the obligation of complying with the federal securities laws with respect to certain kinds of fundraising vehicles involving assets that are commingled for investment purposes.

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§1.38 5. Miscellaneous Laws

- **The Nonprofit Integrity Act (Stats 2004, ch 919)**, which amended and added sections to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). See §12.53.
- **The Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7).** This law governs reporting to and supervision by the Charitable Trust Division of the California Attorney General's Office for organizations holding assets for charitable purposes. See §12.57.
- **Laws regulating investment management.** In addition to Corp C §5420, applicable to public benefit corporations, and the Uniform Prudent Investor Act (Prob C §§16045-16054), the attorney should be familiar with the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob §§18501-18510). UPMIFA applies to "institutional funds," meaning most investment funds, and has special provisions regulating the management of endowment funds. Although UPMIFA is found in the Trust Law, its investment provisions primarily apply to public benefit corporations and probably do not apply to most charitable trusts. See §§16.11-16.17.
- **Laws regulating fundraising.** Counsel who represents clients that engage in public solicitation of contributions should know about the various laws regulating this activity. See chap 14.
- **Postal regulations.** Special postal privileges can apply to the mailings of nonprofit organizations. See §13.52.
- **Trademark, copyright, and patent laws.** Frequently, charities create trademarks, service marks, or other intellectual property that can be copyrighted. Charities may also receive a charitable gift of a copyright or a patent. The attorney needs to have sufficient familiarity with the rules in these areas to recognize these issues and refer them to an appropriate specialist if he or she does not have the necessary expertise to deal with them. See §§13.79-13.99.
- **Deferred compensation and retirement plan laws.** Several special laws deal with the retirement benefits available to employees of nonprofit corporations. See, *e.g.,* IRC §§403(b), 409A, 457. Internal Revenue Code §§409A and 457 severely limit the types of deferred compensation agreements available to exempt organizations. See §13.41.
- **Antitrust laws.** Certain kinds of nonprofit organizations, such as trade associations, need to be concerned about possible antitrust issues. An attorney representing this type of organization must be sufficiently familiar with federal and state antitrust laws to at least recognize issues in this area and refer the client to an appropriate specialist if the attorney does not have sufficient expertise.
- **Charitable gift antitrust laws.** For clients that issue gift annuities, the attorney should be familiar with the Charitable Donation Antitrust Immunity Act of 1997 (15 USC §§37-37a) as well as the Insurance Code requirements for qualification to issue gift annuities in California (Ins C §§11520-11524). For more information, see the American Council of Gift Annuities' website at http://www.acga-web.org.
- **Officers' and directors' liability laws.** In addition to the Corporations Code provisions, the attorney should be familiar with the Volunteer Protection Act of 1997 (42 USC §§14501-14505). On officer and director liability, see chap 9.

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§1.39 VI. ADVICE MEMORANDUM TO DIRECTORS AND OFFICERS

Frequently, the officers and directors of nonprofit corporations have little or no experience with the laws governing their rights and duties, nor are they likely to read the bylaws carefully, patiently, and with adequate comprehension. Nonetheless, it is important that they be acquainted with their rights and duties and applicable limitations on the corporation. It is almost always advisable to provide the officers and directors with a memorandum acquainting them with a summary in lay terms of the relevant provisions of the bylaws and the applicable corporate law. Typical topics include the following:

- Election or appointment of directors and officers;
- Composition of the board of directors;
- Limits on delegation of authority;
- Annual reports;
- Duties of care and loyalty;
- Loans and guaranties;
- Indemnification and insurance;
- Limitations on liability of uncompensated directors and officers; and
- Compensation of directors and officers.

See chap 9. See generally Frey & Overton, Guidebook for Directors of Nonprofit Corporations, ABA Section on Business Law (2d ed 2002).

Frequently, nonprofit clients ask the attorney for an opinion about the "permissible" levels of compensation for officers and directors. Compensation is a sensitive area, especially for charitable clients, raising potential issues of self-dealing, inurement, and private benefit, and may lead to intermediate sanctions under the tax laws and the Corporations Code. See §§9.21-9.24. The attorney should not offer opinions that he or she is not qualified to give. Several organizations, *e.g.,* the Council on Foundations (http://www.cof.org) and the American Society of Association Executives (http://www.asaecenter.org), conduct annual surveys of nonprofit compensation that can be useful benchmarks. However, regulations under IRC §4958 discourage reliance on "general" surveys. In addition, there are consulting firms that specialize in advising nonprofits about executive compensation. See §1.42.

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VII. INTERACTIONS WITH OTHER PROFESSIONALS

§1.40 A. Accountants

An attorney for a nonprofit organization must often interact with the organization's accountant. The attorney should consider recommending that the client hire an accountant with the expertise necessary to handle both accounting and tax return preparation. In the accounting area, there are several special Financial Accounting Standards Board (FASB) rules that require nonprofits to account differently from business entities. See Statement of Financial Accounting Standards (SFAS) Nos. 116-117. The returns filed by nonprofit organizations bear no resemblance to returns filed by taxable entities. It is generally advisable to have an accountant prepare the tax returns and have the attorney review them before filing. The return forms contain sensitive questions that can easily be answered incorrectly by an accountant lacking expertise in preparing such returns.

The client should clearly allocate responsibilities between the attorney and the accountant. For example, in an organization that derives its public charity status from being publicly supported, schedules on the federal return (IRS Form 990) should lead the organization to review each year the question of whether it continues to meet the public support requirements. If the attorney is not responsible for advising the client on this issue, the responsibility should belong to the accountant and the client. The client is best served by a good working relationship among its advisers.

NOTE: The IRS has expanded Form 990, the annual information return for most tax-exempt organizations, starting with returns filed for the 2008 tax year. In addition to financial information, the redesigned form includes formal schedules and requires detailed disclosures and textual discussion of activities and governance practices. See §§12.3-12.21.

On financial and accounting matters, including SFAS Nos. 116-117, see chap 21. See also Gross, McCarthy & Shelmon, Financial and Accounting Guide for Not-for-Profit Organizations (7th ed 2005).

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§1.41 B. Fundraising and Marketing Consultants

Although fundraising consultants often have considerable expertise in the rules of fundraising, the attorney should be informed of the fundraising activities proposed by the consultants to be sure that compliance issues do not arise.

Organizations that derive part of their revenue from admissions or other sales of goods or services may engage marketing consultants. The attorney should review the activities they propose to ensure that they are not inappropriate or described inappropriately. Particularly if the organization has business overtones, the marketing consultant should avoid techniques and terminology that appear overly commercial. Hopkins, The Law of Tax-Exempt Organizations, chap 25 (9th ed 2007).

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§1.42 C. Compensation Consultants

Regulations under IRC §4958 ("intermediate sanctions rules") tend to increase the extent to which public charities desire to rely on information and opinions about reasonable compensation for their highly compensated employees. Treas Reg §§53.4958-0—53.4958-8. The examples set forth in Treas Reg §53.4958-6 discourage the use of data from general surveys. See §§3.16-3.28.

Reasonable compensation issues arise less frequently for private foundations. The regulations under IRC §4941 enable private foundation directors to rely on reasoned opinions of counsel as to self-dealing issues. Nonetheless, there can also be situations in which a consultant's opinion may be advisable.

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§1.43 VIII. OPINION LETTERS AND AUDIT STATEMENTS

Occasionally, an attorney may be asked to render an opinion on the tax-exempt status of a charitable client. This situation usually arises in connection with financing transactions, such as the issuance of bonds that are intended to be exempt from state and federal taxes. On tax-exempt financing, see chap 18. When asked to opine on exempt status, the attorney must conduct the necessary due diligence review and analysis to ensure that the organization has not engaged in any activities that contravene or vary materially from those on which the original exemption determination was based or has not otherwise violated the rules of the Internal Revenue Code in a fashion that could jeopardize its exempt status.

The attorney may also be asked for an opinion on whether the persons who constitute the board of directors were duly elected, for which the attorney may need to trace the "lineage" of the board of directors back through the minute book. Corporations Code §§5527 and 7527 can be helpful in this regard because they provide a relatively brief statute of limitations for a challenge to the election of a director.

When responding to a letter from a client requesting the annual letter to the auditing CPA on the client's potential liabilities of which the attorney is aware, counsel will need to consider whether he or she has become aware of any material threat to the client's tax-exempt status that may be asserted to the IRS.

The peculiarities of California law affecting legal opinions and the scope of examination are addressed in a report prepared by the State Bar. It is titled 2005 Report, Corporations Committee, State Bar of California, Business Law Section, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (May 2005, rev'd Oct. 2007), and is available on the State Bar of California, Business Law Section website at http://www.calbar.ca.gov.

For additional discussion on legal opinion letters, see §18.58. See also Drafting Business Contracts: Principles, Techniques & Forms, chap 12 (Cal CEB 1994).

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2

Choice of Entity Considerations

Cherie L. Evans
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§2.1 I. SCOPE OF CHAPTER

This chapter covers the primary organizational forms used by nonprofits in California. See §2.3. It assumes that the decision to form a nonprofit enterprise has already been made (see §2.2), and then presents an overview of the substantive law and addresses the advantages and disadvantages of each. See §§2.4-2.28. The chapter also discusses the types of nonprofit corporations in a bit more detail (see §§2.29-2.35), and includes a table comparing the major aspects of public benefit, mutual benefit, and religious corporations (see §2.30).

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§2.2 II. DECIDING WHETHER TO START A NONPROFIT ENTERPRISE

When a client approaches counsel with questions about starting a nonprofit enterprise, the attorney should first discuss with the client whether there should even be such an enterprise and, if so, whether it should be organized for profit or as a nonprofit enterprise. This initial exploration is discussed in depth in chap 1.

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§2.3 III. BASIC FORMS OF NONPROFIT ENTERPRISES

Organizational structure. Three primary forms of legal organization of nonprofit enterprises are regularly used in California:

- Unincorporated associations (see §§2.4-2.18);
- Trusts (see §§2.20-2.24); and
- Corporations (see §§2.26-2.28).

Further, some nonprofit enterprises may also be conducted using the limited liability company form (see §2.19).

Corporate structure most common. For numerous reasons made clear throughout this chapter, most California nonprofit organizations are corporations. Although the client will ultimately decide which form best suits the needs of the enterprise, the attorney should discuss the key attributes of each of the basic forms of nonprofit enterprises with the client to facilitate an informed decision.

Major factors influencing legal entity choice. Major factors that usually influence the choice of legal entity include ease and cost of formation; flexibility in management and operation; capacity to make contracts, own property, and exercise other legal rights; and limitations on the directors' and members' personal liability. The importance of each factor varies, depending on the organization's intended purposes and activities.

NOTE: The American Law Institute (ALI) is in the process of drafting Principles of the Law of Nonprofit Organizations, which will cover the legal issues raised by the organization, operation, and oversight of nonprofit organizations, with an emphasis on charities. This ALI project aims not only to describe what the law is, but also to set forth optimum principles and, when appropriate, recommendations of good practice. Attorneys considering the appropriate form of nonprofit organization may find these principles helpful. Drafts of chapters completed to date are available on the website of the American Law Institute at http://www.ali.org.

Formation as business corporation rare but not barred. The importance of obtaining tax-exempt status (see chaps 3-4) precludes most nonprofit organizations from being formed as business corporations under the General Corporation Law (Corp C §§100-2319). Any nonprofit organization, however, that is not tax-exempt and does not anticipate the need to become so might consider organizing under this law. Business corporations are not required to operate at a profit, and if no profits are earned, income or franchise taxes are minimal. The main advantage usually is the more liberal standards of conduct afforded under the General Corporation Law.

It should be noted that California has not adopted a benefit corporation (b-corporation) statute or low-profit limited liability company (L3C) statute, which have been adopted recently in a few other states. These new types of business entities are intended to facilitate social entrepreneurial activity. They are not, strictly speaking, forms of nonprofit organizations.

WARNING: A business corporation that holds assets for charitable purposes is, with respect to those assets, subject to supervision by the California Attorney General and the registration requirements under the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §12580-12599.7) (see §12.53). The directors may also be subject to the strict standards of conduct for charitable trustees (see §2.20). Prob C §15004.

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§2.4 A. Unincorporated Associations

Definition. An "unincorporated association" is "an unincorporated group of two or more persons joined by mutual consent for a common lawful purpose, whether organized for profit or not." Corp C §18035(a). A "nonprofit association" is "an unincorporated association with a primary common purpose other than to operate a business for profit." Corp C §18020(a). A nonprofit association may also carry on a business for profit and apply any profit resulting from that business to any activity in which it may lawfully engage. Corp C §18020(b).

Separate legal entity. Unincorporated associations are entitled to general recognition as separate legal entities. See, *e.g., White v Cox* (1971) 17 CA3d 824, 827, 95 CR 259. An unincorporated association may enter into contracts (see Com C §1201(25)-(27)) and may acquire and hold interests in real or personal property (Corp C §18105; see Corp C §§18115, 18120). It may sue and be sued in the name it has assumed or by which it is known. CCP §369.5(a); see also *Barr v United Methodist Church* (1979) 90 CA3d 259, 153 CR 322. Associations are included in the statutory definition of "persons" who may register and protect trademarks and service marks. Bus & P C §14202(e). But see *Lippoldt v Cole* (10th Cir 2006) 468 F3d 1204 (unincorporated association is not "person" under 42 USC §1983).

Diverse use of association structure. Groups using this form of organization are diverse, including labor unions, political parties, social clubs, religious organizations, environmental societies, athletic organizations, condominium owners, lodges, stock exchanges, and veterans groups. Nonprofit corporations that have failed to make requisite filings and lose their corporate status may be treated as unincorporated associations by default.

Distinctions. Although recognized by statute, nonprofit associations, unlike corporations, are not creatures of statute, but rather are established by the "mutual consent for a common lawful purpose" of two or more persons. Corp C §18035(a). Nonprofit associations are not partnerships because they lack the essential partnership attribute of carrying on a business "for profit." Corp C §§16202, 18055.

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§2.5 1. Governing Law

Unincorporated associations are governed by Corp C §§18000-24001.5.

The Corporations Code sections that expressly apply only to nonprofit associations deal primarily with liability issues (Corp C §§18605-18640; see §2.10) and the registration and use of names and insignia (Corp C §§21300-21310; see §2.11).

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§2.6 a. Statutory Mandatory and Default Provisions

Corporations Code §§18300-18420 include mandatory and default provisions for unincorporated associations as to member voting, membership termination and suspension, amending governing documents, merger, and dissolution. They are discussed in §§2.7-2.9, below.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.7 (1) Member Voting

§2.7 (1) Member Voting

Except as otherwise provided by statute or the association's governing principles, voting may be conducted either at a member meeting at which a quorum is present, or by a written ballot in which the number of votes cast equals or exceeds the number required for a quorum. Approval of a matter voted on requires an affirmative majority of the votes cast. Corp C §18330(a). A quorum is one-third the voting power of the association (Corp C §18330(d)), and the association's voting power is the total number of votes that can be cast by members on a particular issue at the time of the vote (Corp C §18330(e)).

NOTE: Notice requirements are discussed in Corp C §18330(b). The notice may not be delivered electronically unless the recipient consented to electronic delivery of the notice. If the vote will be conducted by written ballot, the notice serves as the ballot. Ballot requirements are addressed in Corp C §18330(c).

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.8 (2) Termination of Membership

§2.8 (2) Termination of Membership

Unless otherwise provided by a nonprofit association's governing principles, membership is terminated by any of the following (Corp C §18310(a)):

- Resignation of the member;
- Expiration of the fixed term of the membership unless the membership is renewed before its expiration;
- Expulsion of the member;
- Death of the member; or
- Termination of the legal existence of a member that is not a natural person.

Termination of membership does not relieve a person from an obligation incurred as a member before termination (Corp C §18310(b)) or affect the association's right to enforce an obligation against a person incurred as a member before termination or to obtain damages for breach (Corp C §18310(c)).

NOTE: When a membership in an unincorporated association, other than an association with a religious purpose, includes a property right, or if expulsion or suspension of a member would affect an important, substantial economic interest, the expulsion or suspension must be done in good faith and in a fair and reasonable manner. Corp C §18320(a)-(b). A procedure is fair and reasonable if it satisfies the requirements of Corp C §18320(c). A proceeding to challenge an expulsion or suspension must be instituted within 1 year after its effective date. Corp C §18320(e).

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.9 (3) Merger and Dissolution

§2.9 (3) Merger and Dissolution

Merger. Nonprofit associations may merge into a domestic or foreign corporation, domestic or foreign limited partnership, domestic or foreign general partnership, or domestic or foreign limited liability company, provided that each constituent entity is authorized to effect the merger by the laws under which it was organized. Corp C §18360.

NOTE: Corporations Code §18360 was amended, effective January 1, 2010, to enable nonprofit associations to merge directly with nonprofit or consumer cooperative corporations. Stats 2009, ch 631. In addition, unincorporated nonprofit associations were added to the definition of "other business entity" in Corp C §§5063.5 and 12242.5.

Each constituent party to a merger must approve the merger agreement; the principal terms of the agreement must be approved by the board, the members, and any person whose approval is required by the governing documents. Corp C §18370. After the merger, the separate existence of the disappearing entity ceases and the surviving entity succeeds to the rights and property of the disappearing entity. The surviving entity is subject to all the debts and liabilities of the disappearing entity, including a trust or other obligation governing the property of the disappearing entity, as if incurred by the survivor. Corp C §18380.

Dissolution. If a nonprofit association's governing documents specify a method for dissolution, that method should be followed. Corp C §18410(a). If the association's governing documents do not specify a dissolution procedure, dissolution may be achieved by the affirmative vote of a majority of the association's voting power. Corp C §18410(b).

PRACTICE TIP: The association may amend the governing documents to provide a method for dissolution. See *Holt v Santa Clara County Sheriff's Benefit Ass'n* (1967) 250 CA2d 925, 929, 59 CR 180.

If an association's operations have been discontinued for at least 3 years, the board (or the members of the last preceding incumbent board if no current board) may dissolve the association. Corp C §18410(c). Further, if the association's operations have been discontinued, the association may be dissolved by court order. Corp C §18410(d). After beginning dissolution proceedings, the board or, if none, the members must (Corp C §18420; see Corp C §18130):

- Promptly wind up the association's affairs;
- Pay or provide for its known debts or liabilities;
- Collect any amounts due;
- Take any other necessary or appropriate action for winding up, settling, and liquidating the association's affairs; and
- Properly dispose of its assets.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.10 b. Liability of Members, Directors, Officers, and Agents

§2.10 b. Liability of Members, Directors, Officers, and Agents

Liability issues. The law generally provides for limitation on the liability of members, directors, officers, and agents of nonprofit associations. Corp C §§18605-18640. In particular, a "member, director, or agent of a nonprofit association is not liable for a debt, obligation, or liability of the association solely by reason of being a member, director, officer, or agent." Corp C §18605.

Member liability for contractual obligations. More specifically, a member is not liable for the association's contractual obligation unless he or she (Corp C §18610):

- Expressly assumes personal responsibility for the obligation in a signed writing;
- Expressly authorizes or ratifies the contract, as evidenced by a writing (other than in his or her capacity as a director, officer, or agent of the association);
- Has notice of the contract and received a benefit under it;
- Executes the contract without disclosing that he or she is acting on behalf of the association; or
- Executes the contract without authority to do so.

NOTE: Termination of membership does not relieve a person of an obligation incurred as a member before termination. Corp C §18310(b).

The relatively narrow scope of the statute represents a repudiation of the broader and somewhat vague principle announced in prior court decisions that a member who *impliedly* authorized or ratified the contract could be liable. Comment to Corp C §18610.

NOTE: The common law alter ego doctrine applicable to a corporation and its shareholders also applies to a nonprofit association and "a member or person in control of [the] association." Corp C §18630. None of the statutory liability provisions limits application of the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12). Corp C §18640.

Director, officer, and agent liability for contractual obligations. The Corporations Code contains a corresponding section providing that a director, officer, or agent of a nonprofit association is not liable for the association's contractual obligation unless he or she (Corp C §18615):

- Expressly assumes responsibility for the obligation in a signed writing;
- Executes the contract without disclosing that he or she is acting on behalf of the association; or
- Executes the contract without authority to do so.

Association's tort liability. A member, director, officer, or agent of a nonprofit association is liable for injury, damage, or harm caused by an act or omission of the association (or a director, officer, or agent of the association) if he or she (Corp C §18620(a)):

- Expressly assumes liability for injury, damage, or harm caused by particular conduct and that conduct causes the injury, damage, or harm;
- Engages in tortious conduct that causes the injury, damage, or harm; or
- Is otherwise liable under any other statute.

This list of bases for liability is nonexclusive and does not foreclose any common law grounds for liability. Corp C §18620(b).

An unincorporated association member's personal liability for torts is more uncertain than his or her personal liability for contractual obligations. Even if an association is sued in its own name and faces liability as a separate entity, individual members who consented to or participated in the association's acts or omissions may be personally liable under theories of joint, several, or joint and several liability. See CCP §369.5(b) (requiring service of process on member in individual capacity before liability can be assessed). The precise degree of consent or the kind of

involvement required to expose a member to tort liability is far from clear. For example, *Davert v Larson* (1985) 163 CA3d 407, 209 CR 445, held that tenants in common who delegated control and management of the real property to the owners' association were not immune from common-area tort liability to third parties. Subsequently, however, the legislature provided tenants in common immunity from common-area tort liability as long as the association maintains general liability insurance at a statutorily prescribed level. See CC §1365.9. In contrast to *Davert v Larson*, the court of appeal in *Cody F. v Falletti* (2001) 92 CA4th 1232, 112 CR2d 593, held that members of a subdivision association were not liable for a tort injury on property in which they possessed only a limited access easement interest, not a full ownership interest. In *Steuer v Phelps* (1974) 41 CA3d 468, 472, 116 CR 61, the court held that members of a church association who authorized an individual to drive the association's car may be personally liable for the driver's negligence under the doctrine of respondeat superior.

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§2.11 c. Registering Name With Secretary of State; Recording Interest in Property

Optional registration. Nonprofit associations may, but need not, register their names and insignia with the Secretary of State to prevent registration of any deceptively similar name or insignia or any unauthorized use of the registered name or insignia. Corp C §§21300-21310. See Secretary of State Form LP/UNA 128, available at http://www.sos.ca.gov/business/other/forms/lp-una-128.pdf

Optional recording. An unincorporated association may record a verified and acknowledged statement of authority in any county in which it has an interest in real property. This statement includes the association's name and the names, title, and capacity of its officers and other persons who are authorized to act for the association regarding real property. Corp C §18120(a).

Recordation creates a presumption that a person designated in the statement is authorized to acquire, transfer, or encumber real property on the association's behalf. Corp C §18120(c). This presumption does not apply if, before the transfer, acquisition, or encumbrance, either of the following occurs (Corp C §18120(d)):

- The association revokes the statement of authority (see Corp C §18120(b)); or
- A person claiming to be a member, director, or officer records a verified and acknowledged document in the applicable county stating that the statement of authority is erroneous or unauthorized.

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§2.12 2. Changing to a Nonprofit Corporation

Depending on its purposes, it may be beneficial for an existing nonprofit unincorporated association to become a public benefit corporation (Corp C §5121), mutual benefit corporation (Corp C §7121), or religious corporation (Corp C §9121). Changing to corporate status requires authorization in accordance with the association's rules and procedures. Corp C §§5121(a), 7121(a), 9121(a). For filing requirements and effect of the change, see Corp C §§5121(b)-(g), 7121(b)-(g), 9121(b)-(g). However, even if an unincorporated association has already been recognized as tax-exempt by the IRS, the association will have to refile for exemption on incorporation as a new entity. Rev Rul 67-390, 1967-2 Cum Bull 179.

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§2.13 3. Drafting Governing Documents

The contents of a nonprofit association's governing principles, as embodied in its governing documents, will vary based on the association's purposes, authority, and property. The governing documents should identify persons authorized to act on the association's behalf and other matters concerning the association's internal affairs. For larger associations, the governing documents should also specify the qualifications for board members and officers; the qualifications of members; the requirements for the withdrawal, suspension, and expulsion of members; the liabilities of members for dues and assessments; any classes of membership; the members' property, voting, and other rights, interests, or privileges; the manner of transfer, forfeiture, and termination of memberships; and the manner of amending the governing documents.

NOTE: Because the term "governing documents" includes articles of association, bylaws, and other documents that govern the association's purpose or operations (see Corp C §18008), governance matters may be addressed in either document or both. Therefore, counsel should ensure that no inconsistencies exist among the documents.

PRACTICE TIP: The mandatory and default statutes of CC §§18300-18420 (see §§2.6-2.9) should be consulted when drafting the association's governing document. Some statutes, such as Corp C §18310 (termination and suspension of membership), only apply when the governing documents are silent. Other statutes provide mandatory rules, to standardize relations with other entities (see, *e.g.*, Corp C §§18360-18400 (merger)) or to ensure minimal fairness (see, *e.g.*, Corp C §18320 (expulsion and suspension of members)).

Amending governing documents. If a nonprofit association's governing principles do not specify an amendment procedure, its governing documents may be amended by a vote of the members. Corp C §18340. However, amendments may not ordinarily impair a member's existing contract right without the consent of the members affected by the change. *Hogan v Pacific Endowment League* (1893) 99 C 248, 250, 33 P 924. Amendments adopted in accordance with an association's prescribed procedure bind its members unless the association's governing documents (as in existence when an individual became a member) limit the association amendment authority. *Lawson v Hewell* (1897) 118 C 613, 621, 50 P 763; *Gear v Webster* (1968) 258 CA2d 57, 60, 65 CR 255 (salesman bound by bylaw amended 2 years after joining board).

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§2.14 4. Advantages

The major advantages of the unincorporated association are the relative ease with which it can be organized, the informality with which it can act, and the relatively few statutory formalities. Whether oral or embodied in a constitution or in the bylaws, articles of association, or other documents, these matters, as well as the association's purposes and the rights, obligations, and authority of its members, directors, and officers, are governed by the principles of agency and contract law, by implied and express agreements among the members, and by statute and case law.

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§2.15 5. Disadvantages

There are some disadvantages that make the unincorporated association less than desirable for most nonprofit enterprises. Among them are:

- Some remaining uncertainties concerning the law governing the association and its members (see §2.16);
- The uncertainty about the liability of association members in SLAPP suits (see §2.17); and
- The possibility that the association may be subject to Attorney General supervision (see §2.18).

On the disadvantages of an unincorporated association that intends to operate outside the United States, see §2.25.

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§2.16 a. Remaining Uncertainty in Governing Law

Unincorporated associations face some degree of legal uncertainty in California because of the fact that statutory provisions define some, but not all, of the rights, duties, and liabilities of the association and its members, directors, officers, and agents (see §§2.5-2.12). In addition, case law fails to clarify many of the statutory gaps. This lack of statutory and decisional norms can make it somewhat difficult to draft governing documents for unincorporated associations. See §2.13.

NOTE: The California Supreme Court has established a general policy of abstention from interfering in unincorporated association disputes between (1) members respecting their rights and obligations as members and (2) one member and officials or a governing unit of the association. Courts may nonetheless afford relief in cases presenting exceptional circumstances. See, *e.g.*, *California Dental Ass'n v American Dental Ass'n* (1979) 23 C3d 346, 350, 152 CR 546 (acts clearly contrary to association's bylaws); *Ezekial v Winkley* (1977) 20 C3d 267, 273, 142 CR 418 (arbitrary expulsion).

Lack of standard of care. Existing law does not provide a standard of care for a director of an unincorporated association, which leaves a director unsure of his or her duties and potential liability. For further discussion of director liability, see §2.10.

Lack of express operating authority. Another area of uncertainty stems from the lack of express statutory authority giving officers, directors, or members of an unincorporated association implied or apparent authority to act for it. Under general agency principles, an association's officers and directors must have express or clearly implied authorization or express subsequent ratification of acts performed as agents of the association. This restriction may be a disability when dealing with banks and other organizations that require a clear indication of an agent's authority. This uncertainty has been alleviated to some extent for real property transactions. See Corp C §§18115 (specified officers of unincorporated association may execute acquisition, transfer, or encumbrance in real property), 18120 (unincorporated association may record interest in real property).

NOTE: In response to the uncertainty of common law and state statutes governing nonprofit unincorporated associations throughout the United States, Canada, and Mexico (with the notable exception of California), the National Conference of Commissioners on Uniform State Laws (NCCUSL) completed and presented for adoption in all states the Revised Uniform Unincorporated Nonprofit Association Act (RUUNAA) in 2008, which presents a model act for the treatment of nonprofit unincorporated associations, particularly with regard to tort and contract liability of members, the ownership and conveyance of property, and suits by and against an unincorporated nonprofit association. Because California already has substantial law regarding these entities, California is not expected to adopt the Act in its entirety although some parts of RUUNAA may eventually be adopted in California.

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§2.17 b. Uncertainty Concerning Liability in SLAPP Suits

Members belonging to a nonprofit association that attempts to influence governmental action on issues of public significance, such as environmental and development matters, face the threat of "Strategic Lawsuits Against Public Participation" (SLAPP suits) brought by the people whose activities the association opposes. See generally Pring & Canan, SLAPPs: Getting Sued for Speaking Out (1996). Although California has an anti-SLAPP statute that offers some protection (see CCP §§425.16-425.18; *Briggs v Eden Council for Hope & Opportunity* (1999) 19 C4th 1106, 81 CR2d 471; *Drum v Bleau, Fox & Assocs.* (2003) 107 CA4th 1009, 132 CR2d 602), members of associations suffer more uncertainty about their ultimate liability than do participants in enterprises using the corporate form. For further discussion of member liability, see §2.10.

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§2.18 c. Possible Attorney General Supervision

Because unincorporated associations and other legal entities holding property for charitable purposes are expressly subject to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) (Govt C §12581), an unincorporated association may be deemed a trustee under this Act if the association holds property in trust under a charitable trust (see §§2.20-2.25) or accepts property to be used for a particular charitable purpose distinct from the general purposes of the association. Govt C §12582. Therefore, depending on the nature of their activities, some nonprofit associations may be subject to Attorney General supervision and the reporting requirements and other provisions of the Act. See chap 12.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.19 B. Nonprofit Limited Liability Companies

§2.19 B. Nonprofit Limited Liability Companies

A limited liability company (LLC) may engage in "any lawful business activity, whether or not for profit." An LLC, therefore, may be a nonprofit entity. The LLC form has advantages in the ease of formation and management (see Corp C §§17050-17062) compared to a corporation, while providing for a personal liability shield for its members akin to corporate shareholders. Corp C §17101(a)-(b).

NOTE: A single-member LLC can be disregarded by the IRS for tax purposes, though it will not be disregarded by the Franchise Tax Board (FTB).

A nonprofit LLC may apply for tax-exempt status. However, an LLC will only be recognized as tax exempt by the IRS if its members are exempt organizations themselves, or governmental units, or wholly owned instrumentalities of a state or its political subdivisions. For this reason, nonprofit LLCs are mainly used by exempt organizations for managing subsidiary and joint-venture activities, as well as for holding title to property.

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C. Charitable Trusts

§2.20 1. Definition and Governing Law

A charitable trust is established when one or more persons holds legal title to property, subject to an equitable obligation to use or hold it for the benefit of charitable purposes. See Restatement (Third) of Trusts §2 (2003). In California, a trust may be created for any purpose that is not illegal or against public policy (Prob C §15203); a charitable trust is defined as one that is created for religious, charitable, scientific, literary, educational, or other purposes enumerated in IRC §170(c)(2)(B). Prob C §15205.

NOTE: On drafting charitable trusts, see Drafting California Irrevocable Trusts, chaps 18-18A (3d ed Cal CEB 1997).

California's Trust Law (Prob C §§15000-19403) applies to charitable trusts that are subject to the Attorney General's jurisdiction, to the extent that the Trust Law does not conflict with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). Prob C §15004. Except to the extent modified by statute, the common law of trusts applies. Prob C §15002.

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§2.21 2. Standard of Care

When involved in general activities that do not involve investment or management of trust assets, a trustee must use "reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument." Prob C §16040(a). Under the Uniform Prudent Investor Act (UPIA) (Prob C §§16002(a), 16003, 16045-16054), a more detailed standard of care applies when a trustee is investing or managing trust assets. In the latter case, the trustee is held to the standard of care of a prudent investor, considering the purposes, terms, and distribution requirements and other circumstances of the trust. See Prob C §16047(a), (c). The UPIA also imposes a duty to diversify the investments (Prob C §16048); review the trust assets for compliance with the UPIA's requirements (Prob C §16049); and incur only appropriate and reasonable costs in managing and investing the assets (Prob C §16050). A trustee may delegate management and investment functions as prudent under the circumstances. Prob C §16052. See §16.19.

In addition, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) also applies a standard of care to the trustees of a trust holding funds for charitable purposes. In particular, UPMIFA imposes a duty on "each person responsible for managing and investing an institutional fund" to "manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Prob C §18503(b). On the UPMIFA, see §§16.11-16.18.

NOTE: The statutory duties under the general trust law and UPIA may be modified in the trust instrument. Prob C §§16040(b), 16046(b).

Standard of care for public benefit corporations. For comparison, see, *e.g.,* Corp C §5240, which establishes, for nonprofit public benefit corporations, an investment standard of avoiding speculation, looking to the permanent disposition of the funds, considering probable income and safety of the corporation's capital, and complying with any additional standards imposed in the articles, bylaws, or expressed terms of an instrument or agreement under which the assets were contributed to the corporation.

California's standard for trust investment and management largely follows the Restatement (Third) of Trusts approach, so that a trustee's decisions are "evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Prob C §16047(b); see Restatement (Third) of Trusts: Prudent Investor Rule §§227-229 (1992).

Self-dealing prohibited. A trustee may not use or deal with trust property for the trustee's own profit, and may not take part in any transaction in which the trustee has an interest adverse to the beneficiary. Prob C §16004(a).

WARNING: A trustee's self-dealing is presumed to be a violation of the trustee's fiduciary duties, except when the trustee and the beneficiary agree to the hiring and compensation of the trustee. Prob C §16004(c).

In addition to the specific statutory provisions discussed above, many other Probate Code provisions address trustee duties, powers, and liability to beneficiaries and other persons. See generally Prob C §§16000-16504, 18000-18005.

NOTE: A California nonprofit charitable corporation may be appointed as a trustee if certain statutory requirements are met. Prob C §15604.

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§2.22 3. Limits on Trusts That Are Private Foundations

Despite any provision in the trust instrument or a more permissive California statute, a trust that is a private foundation as defined in IRC §509(a) (see §1.13) must not (see Prob C §§16101-16102):

- Engage in any act of self-dealing as defined in IRC §4941(d);
- Retain any excess business holdings as defined in IRC §4943(c);
- Make any investments in a manner that would subject the trust to tax under IRC §4944;
- Make any taxable expenditure as defined in IRC §4945(d); or
- Fail to distribute its income for each taxable year at a time and in a manner that will not subject the trust property to tax under IRC §4942.

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§2.23 4. Advantages

Favored in law. Charitable trusts are favored in the law. They are not subject to the rule against perpetuities (Prob C §21225(e)) and will not be allowed to fail for lack of a trustee (Restatement (Third) of Trusts §§31, 34 (2003)) or for lack of a detailed plan of execution (*Estate of Butin* (1947) 81 CA2d 76, 183 P2d 304). To qualify for this preferred status, a trust's purposes must be exclusively and clearly charitable, and its beneficiaries must be either the public (or some definite class or part of the public) or institutions devoted to the public welfare. *Estate of Graham* (1923) 63 CA 41, 218 P 84.

Fewer organizational formalities. The major advantage of a charitable trust is that it can be established and operated without having to comply with as many statutorily required formalities as the corporate form of organization. For example, under the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7), although both charitable trusts and charitable corporations that meet a certain revenue threshold must comply with several of the same financial reporting and auditing requirements, trusts are relieved of the obligation to establish and maintain an audit committee. See Govt C §12586(e)(2). Unless contrary to the express terms of the trust agreement, a trust can dissolve without court action or appeal.

Use as family foundation. A common application of the charitable trust form is probably in the context of a family foundation because it may allow the family members to retain control while permitting certain tax benefits. If the grantor intends that the organization's principal activity be investing its endowment and making distributions for charitable purposes, a trust may be preferable to a public benefit corporation.

Ability to name trustees and successors. An important advantage to the charitable trust form is that the trust settlors (founders) can name the trustee, as well as name successor trustees. Because a trust is not subject to the restrictions on interested persons required of corporations (see Corp C §5227), the trustees of a charitable trust may include the settlor, the settlor's spouse, and children, although the stricter fiduciary standards for trustees will apply. The trust instrument should carefully identify successor trustees, to avoid the need to go to court to appoint a successor; allow the grantor to exercise control over the direction of the trust; help maintain continuity of charitable purpose; and inform existing trustees of the consequences of resignation. If a court must someday decide whom to appoint as trustee, successor trustee provisions will guide the court as to the characteristics of trustees the grantor originally intended.

PRACTICE TIP: The trust instrument should give trustees the power, in their absolute discretion, to form a charitable corporation inside or outside of California and to transfer all the assets of the trust to it.

Harder to change trust purpose. An additional advantage to using the trust form over another form of nonprofit entity is that the purpose of a trust is usually harder to change than that of the other types of entities. With a corporation or unincorporated association, there is no way to completely prohibit the purpose from being changed by the board of directors and/or the members.

NOTE: Corporate assets dedicated for charitable purposes remain impressed with the charitable trust of the original charitable purpose. See *Queen of Angels Hosp. v Younger* (1977) 66 CA3d 359, 136 CR 36. In addition, the modification of a charitable purpose set forth in a trust requires the approval of a court and the Attorney General, who must be convinced that the modification is necessary and appropriate. See *In re Estate of Beryl H. Buck* (Marin Super, Aug. 15, 1986, No. 23259), reprinted at 21 USF L Rev 691 (1987).

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§2.24 5. Disadvantages

Registration and supervision. Like all organizations that hold assets for charitable use, charitable trusts must be registered with the Attorney General's Registry of Charitable Trusts and are subject to the Attorney General's continuing supervision. See generally Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7); Attorney General's Guide for Charities (2005); Bell & Bell, *Supervision of Charitable Trusts in California*, 32 Hastings LJ 433 (1980). In a proceeding involving a charitable trust, the Attorney General must be given at least 30 days' notice before a hearing on a petition filed under Prob C §17200. Prob C §17203(a)(3). The Attorney General may file a petition in an action involving a charitable trust under Chapter 3 of the Probate Code (Prob C §§17200-17211) when a trustee's liability for breach of trust is at issue. Prob C §17210.

Inappropriate for certain activities. When a client is considering organizing a nonprofit charitable enterprise, the initial focus should be on the intended activities. A trust may be an appropriate vehicle if the organization is primarily intended to hold, manage, or distribute property, but it is seldom appropriate if the organization intends to engage in other types of activities. If the organization is to have member or community involvement, input from members or the community may be inconsistent with trustee control and duties under the Trust Law (Prob C §§15000-19403) and the Uniform Prudent Investor Act (Prob C §§16002(a), 16003, 16045-16054). A public benefit or religious corporation may be preferable in such a situation.

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§2.25 6. Disadvantages of Charitable Trusts or Unincorporated Associations That Will Operate Outside United States

No governmental filing is necessary to establish either a trust or an unincorporated association. This makes their establishment easier, in so far as the entity is formed by an agreement only between private parties. Further, a nonfiling organization is not required to register to do business in another state. Nevertheless, one issue arises if the organization intends to operate outside of the United States: Numerous countries do not recognize the existence of an unregistered or nonstatutory entity. As a result, if a United States based organization is structured as a trust or an unincorporated association, for liability purposes, the foreign government will look through the organization to whatever person or entity makes up the membership or is the beneficiary. This may result in inadvertent consequences, if it is even possible to operate outside of the United States. Therefore, if the organization intends to have any type of international operations, the use of the trust or unincorporated association form of governance is not recommended.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.26 D. Nonprofit Corporations

§2.26 D. Nonprofit Corporations

Nonprofit corporations are governed by Corp C §§5000-10841. Although the three main types of nonprofit corporations have distinct characteristics, as discussed in §2.29, they share some common features. One or more persons may form a nonprofit corporation by filing articles of incorporation with the Secretary of State and paying a modest filing fee. Corp C §§5120(a), 7120(a), 9120(a); see Govt C §12186(d) (fee). Bylaws must be adopted to customize internal governance (*e.g.,* to specify whether there will be voting members and how the directors will be elected) and to alert directors to the law governing the corporation. See Corp C §§5150-5151, 7150-7151, 9150-9151. Nonprofit corporations generally have no fixed termination date, but may voluntarily decide to dissolve by the required vote of the members, if any, or the directors. Corp C §§6610, 8610, 9680.

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§2.27 1. Advantages

Clear statutory norms. The corporate form of organization offers one major advantage over the alternatives discussed in §§2.4-2.25: It is a recognized and well-understood legal entity governed by relatively clear statutory norms in such important areas as permitted activities, director and member liability, director standards of conduct, indemnification of agents, and internal governance.

The corporate powers enumerated in the Corporations Code, which are not exhaustive, include the right to purchase property, enter into contracts, carry on a business, and issue memberships. Corp C §§5140, 7140, 9140. The board of directors is charged with the ultimate direction of the management of the corporation and of the exercise of corporate powers. Corp C §§5210, 7210, 9210.

Protection from liability. Moreover, several code sections address member, director, and officer liability and indemnification. For example, a member of a corporation is not personally liable for the corporation's debts, liabilities, or obligations. Corp C §§5350(a), 7350(a), 9350(a). Uncompensated directors, officers, and trustees are protected from liability to third parties under certain circumstances. See Corp C §§5047.5, 5239, 7231.5, 9247; see also §§9.115-9.120. A director who performs his or her duties in accordance with the statutory standard of care is not liable for any alleged failure to discharge his or her obligations as a director. Corp C §§5231(c), 7231(c), 9241(d). For an in-depth discussion of director liability, see §§9.103-9.130.

Also, the Corporations Code allows nonprofit corporations to indemnify directors, officers, and other agents against the expenses of litigation if certain statutory conditions are met. See Corp C §§5238, 7237, 9246; see also §§9.156-9.162.

Statutory default and mandatory provisions. The Corporations Code provides default provisions in case certain areas are not adequately addressed in the articles or bylaws, such as the 1-year term for directors (Corp C §§5220(a), 7220(a), 9220(b)), a quorum as a majority of the authorized number of directors (Corp C §§5211(a)(7), 7211(a)(7), 9211(a)(7)), and the 4 days' notice requirement for special meetings of the board (Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2)). The Corporations Code also includes mandatory provisions that cannot be altered by the articles or bylaws. Both the statutory default provisions and the mandatory provisions provide a solid internal governance framework and can assist in resolving controversies among directors, officers, and members.

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§2.28 2. Disadvantages

Potential disadvantages of incorporation include ongoing filing requirements with the Secretary of State (including filings to effectuate amendment of the articles of incorporation, dissolution, and merger); the need to observe corporate formalities; and the burden imposed on directors by statutory standards of conduct (including the interested persons limitation imposed on public benefit corporations). Except for small clubs or similar organizations and passive charitable foundations, these disadvantages are usually outweighed by the substantial advantages of the corporate form.

For more information on the advantages and disadvantages of the corporate form, see Selecting and Forming Business Entities, chaps 2, 8 (2d ed Cal CEB 2007).

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/ IV. CHOOSING THE RIGHT TYPE OF NONPROFIT CORPORATION/ A. Public Benefit, Mutual Benefit, and Religious Corporations/ §2.29 1. Basis for Classification

IV. CHOOSING THE RIGHT TYPE OF NONPROFIT CORPORATION

A. Public Benefit, Mutual Benefit, and Religious Corporations

§2.29 1. Basis for Classification

Most California nonprofit corporations fall within one of three major classifications: public benefit, mutual benefit, or religious. In addition to the Nonprofit Corporation Law's general provisions (Corp C §§5000-5080), each type of nonprofit corporation is governed by a separate, self-contained part of that law, known respectively as the Nonprofit Public Benefit Corporation Law (Corp C §§5110-6910), the Nonprofit Mutual Benefit Corporation Law (Corp C §§7110-8910), and the Nonprofit Religious Corporation Law (Corp C §§9110-9690).

Distinctions. The three types of nonprofit corporations differ from one another primarily in their purposes, the way their assets may be distributed, and the extent to which they are subject to statutory or administrative regulation:

- **Public benefit corporations** may be formed for public or charitable purposes, may not make any distribution of corporate assets to members at any time, and are subject to extensive governmental regulation and supervision.
- **Mutual benefit corporations** may be formed for any lawful purpose, may make distributions of corporate assets to members on dissolution, and are subject to less stringent state regulation and supervision.
- **Religious corporations** may be formed primarily or exclusively for religious purposes, may not make any distribution of corporate assets to members at any time, and are subject to less stringent governmental regulation and supervision.

Classification relates to purposes. A corporation's classification often relates to its purposes. Incorporated charitable organizations such as foundations, community chests, and hospitals are often organized as public benefit corporations. Social clubs, fraternal orders, trade and homeowners' associations, and similar organizations conducted for their members' benefit are often organized as mutual benefit corporations. Churches, seminaries, and other religious organizations are often organized as religious corporations. If the organization's purpose is religious, then it can be a religious corporation, even if it is a hospital, school, or other organization that could also be formed as a public benefit corporation. In fact, many nonprofit hospitals were formed by churches and continue to be religious organizations. Foundations may also be either religious or public benefit corporations, depending on their purpose.

PRACTICE TIP: To be a religious organization, the organization must have a religious purpose, even if the purpose is evidenced by activities that are also commonly carried on by public benefit corporations. For example, a private school that has as its purpose raising children in a particular faith and inculcating religious values would qualify as a religious organization; a school that has no statement of faith and focused only on education would not.

Overlap. Some overlap occurs among the three main types of nonprofit corporations. For example, a corporation with religious purposes could organize as a public benefit corporation, although it would be unlikely to do so because public benefit corporations have less freedom in the management of their affairs and face more extensive Attorney General supervision than religious corporations. See *McKeon v Mercy Healthcare Sacramento* (1998) 19 C4th 321, 329, 79 CR2d 319, superseded by statute as stated in *Silo v CHW Med. Found.* (2002) 27 C4th 1097, 1110, 119 CR2d 698. Similarly, a corporation with public or charitable purposes seeking to avoid the relatively strict standards of a public benefit corporation could be formed as a mutual benefit corporation if its assets were not irrevocably dedicated to charitable, religious, or public purposes—if, *e.g.,* the articles of incorporation permitted distribution of the assets to members on dissolution or if the articles did not provide for distribution. This is also unlikely to occur because the corporation would be ineligible for tax exemption under IRC §501(c)(3), and, as to any assets held in charitable trust, it would be regulated much as if it were a public benefit corporation. Corp C §§7238, 7240.

PRACTICE TIP 1: Some religious groups may wish to consider forming a corporation sole (Corp C §§10000-10015) as an alternative to a religious corporation. See §2.33.

PRACTICE TIP 2: An advantage to incorporating as a religious corporation (or religious corporation sole) rather than as a public benefit corporation is that a claim for punitive or exemplary damages can be pleaded against a religious corporation only by permission of the court on the basis of a finding that the plaintiff has established evidence substantiating that the plaintiff will meet the clear and convincing standard of proof under CC §3294. CCP §425.14.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.30 2. Table: Comparison of Some Aspects of Public Benefit, Mutual Benefit, and Religious Corporations

§2.30 2. Table: Comparison of Some Aspects of Public Benefit, Mutual Benefit, and Religious Corporations

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The attributes of public benefit, mutual benefit, and religious corporations are discussed in detail in later chapters of this book. The following table provides a quick-reference summary and comparison of the three types of nonprofit corporations in a few key areas.

TABLE: COMPARISON OF PUBLIC BENEFIT, MUTUAL BENEFIT, AND RELIGIOUS CORPORATIONS

	PUBLIC BENEFIT CORPORATION	MUTUAL BENEFIT CORPORATION	RELIGIOUS CORPORATION
1. Purposes	Any public or charitable purpose. Corp C §5111.	Any lawful purpose; however, if all corporation's assets are irrevocably dedicated to charitable, public, or religious purposes and if it must distribute its assets to an organization carrying on a charitable, public, or religious purpose on dissolution, it cannot be a mutual benefit corporation. Corp C §7111.	Any primarily or exclusively religious purpose. Corp C §9111.
2. Members	Corporation may, but need not, have one or more classes of statutory members and may refer to others as "members" if desired. Corporation may specify qualifications for membership (including fees), rights of members, and transferability of memberships. Corp C §§5310-5354.	Same as public benefit corporation except that memberships may be transferred for value if permitted by articles or bylaws. Corp C §§7310-7354.	Same as public benefit corporation except there are no statutory due process requirements for termination. Corp C §§9310-9353.

3. Distributions to Members	No distribution may be made to members. Corp C §5410. Creditors, directors, members, or Attorney General (AG) may sue to recover improper distributions on behalf of corporation. Corp C §5420.	Distributions to members are permitted only on dissolution or, subject to limitations, in connection with repurchase or redemption of memberships. Corp C §§7410-7414. Nonconsenting creditors may recover improper distributions from recipients who had knowledge of facts indicating impropriety on corporation's behalf. Corp C §7420.	No distributions may be made to members. Creditors, directors, or specified minimum number of members may sue to recover improper distributions on corporation's behalf. Corp C §9610.
4. Officers	Any number of offices may be held by same person unless articles or bylaws provide otherwise; except secretary, chief financial officer, or treasurer may not serve concurrently as president or board chair. Corp C §5213(a).	Any number of offices may be held by same person unless articles or bylaws provide otherwise. Corp C §7213(a).	Same as public benefit corporation. Corp C §9213.
5. Directors			
a. Selection and Term	If corporation has members, directors are elected for terms of up to 4 years. If corporation has no members, directors may be elected for terms up to 6 years by board vote or any other means specified in articles or bylaws. Class voting and staggered terms are permissible. Corp C §5220. See Corp C §5224 for when and how directors	If corporation has members, directors are elected for terms of up to 4 years. If corporation has no members, directors may be elected for terms up to 6 years by board vote or any other means specified in articles or bylaws. Class voting and staggered terms are permissible. Corp C §7220. See Corp C §7224 for when and how directors and members may fill	Articles or bylaws may provide for tenure, election, selection, designation, removal, and resignation of directors. Corp C §9220. See Corp C §9224 on when and how directors and members may fill board vacancies. In corporation without members, if all directors resign, die, or become incompetent, superior court may

	and members may fill board vacancies. In corporation without members, if all directors resign, die, or become incompetent, superior court may appoint directors. Corp C §5220(e).	board vacancies. In corporation without members, if all directors resign, die, or become incompetent, superior court may appoint directors. Corp C §7220(e).	appoint directors. Corp C §9220(d).
b. "Interested Persons" Limitation	No more than 49% of directors may be "interested persons." Corp C §5227.	No "interested persons" limitation.	No "interested persons" limitation.
c. Transactions Between Corporations With Interlocking Directorships	May be void or voidable unless (1) material facts as to transaction are fully disclosed or known and transaction is approved by sufficient number of directors without common directors, or (2) transaction is just and reasonable as to corporation. Corp C §5234.	Same as public benefit corporation. Corp C §7233(b).	Same as public benefit corporation except that for (2) transaction is just and reasonable as to the corporation, taking into account its religious purposes, or is in furtherance of its religious purposes. Corp C §9244.
6. Directors' Standards of Conduct, Liability			
a. Duty of Care	Directors must act in good faith, in a manner believed to be in corporation's best interests, and with the care of an ordinarily prudent person in like position under similar circumstances; may rely on reliable and competent officers, employees, outside experts, and certain committees. Corp	Same as public benefit corporation. Corp C §7231.	Directors must act in good faith, in a manner believed to be in corporation's best interests, and with care appropriate in circumstances; may rely on reliable and competent officers, employees, outside experts, certain committees, and religious authorities. Corp C §9241.

	C §5231.		
b. Investment Standards	Special standards of care, in addition to general standard of care, apply to investments. Corp C §5240.	No special standards for investments beyond general standard of care. See Corp C §7231.	General standard of care applies to investments. Corp C §9250.
c. Duty of Loyalty ("Self-Dealing")	Interested directors may be liable for "self-dealing" transaction unless it is (1) approved by AG or court, or (2) approved in advance by disinterested directors, who find that it is for benefit of and fair and reasonable to corporation and that no better arrangement is available. Corp C §5233.	"Self-dealing" transaction is not void or voidable if (1) it is approved by members, (2) it is approved by disinterested directors and is just and reasonable to the corporation, or (3) it was just and reasonable to the corporation. Corp C §7233.	Generally same as public benefit corporation except that for transactions approved in advance by disinterested directors, they must find that it is for benefit of corporation or religious organization and fair and reasonable to corporation or in furtherance of corporation's religious purposes and that no better arrangement is available or it is in furtherance of corporation's religious purposes. Corp C §9243.
d. Volunteers	In some circumstances, uncompensated directors and officers may be protected from liability to third parties under Corp C §§5047.5, 5239; CCP §425.15; CC §1365.7; and 42 USC §§14501-14505.	In some circumstances, uncompensated directors and officers may be protected from liability to third parties under Corp C §§5047.5, 7231.5; CCP §425.15, CC §1365.7; and 42 USC §§14501-14505.	In some circumstances, uncompensated directors and officers may be protected from liability to third parties under Corp C §§5047.5, 9247; CCP §425.15; CC §1365.7; and 42 USC §§14501-14505.
e. Loans and Guaranties	Unless falling within statutory exception, loans and guaranties to officers and directors prohibited; directors may be	Loans and guaranties to officers and directors not prohibited if statutory standards are met; directors may be liable for	Loans and guaranties to officers and directors governed by directors' general duty of care; directors may be liable for

	liable for approving improper loans and guaranties. Corp C §§5236-5237.	approving improper loans and guaranties. Corp C §§7235-7236.	approving improper loans and guaranties. Corp C §§9241, 9245.
f. Indemnification	Indemnification of directors' litigation expenses permitted, required, or prohibited depending on satisfaction of statutory conditions. Corp C §5238.	Same as public benefit corporation. Corp C §7237.	Same as public benefit corporation except that standard for indemnification is changed from "person reasonably believed" to less stringent "person believed" to be in the best interests of the corporation. Corp C §9246.
g. Insurance	Insurance permissible except with respect to "self-dealing" transactions. Corp C §5238(i).	Insurance permissible. Corp C §7237(i).	Same as public benefit corporation. Corp C §9246(i).
h. Special Rules	Public benefit corporations that are private foundations as defined in IRC §509(a) must comply with IRC §§4941-4945. Corp C §5260.	Standards of Public Benefit Corporation Law apply to directors' conduct as to assets held in charitable trust. Corp C §7238.	Same as public benefit corporation. Corp C §9260. Churches are automatically not private foundations.
7. Attorney General Supervision			
a. Filing, Registration, and Reporting	Initial and annual filings with AG required. Audit committee and audited financial statements are required if corporation has $2,000,000 or more in gross revenue. Board or board committee must review and approve compensation of CEO and CFO. Corp C §6324(a); Govt C §§12586(e), (g); see generally	Filing, registration, and reporting provisions of Govt C §§12580-12599.7 apply to assets held in charitable trust. Corp C §8324(a).	Filing, registration, and reporting provisions of Govt C §§12580-12599.7 do not apply. Govt C §12583.

	Govt C §§12580-12599.7. These provisions do not apply to certain corporations, such as educational institutions and hospitals.		
b. Investigation	AG may examine corporation at any time to ascertain condition of its affairs, and compliance with its purposes and trusts it has assumed. Corp C §5250; Govt C §12588.	No AG powers except as to assets held in charitable trust, to which public benefit corporation rules apply. Corp C §§7142, 7238, 7240, 8324(a); Govt C §12588.	AG has no powers in noncriminal matters except as expressly empowered by statute (see d. below). Corp C §9230(a).
c. Power to Revoke Registration	AG may refuse to register or may revoke or suspend registration of corporation if AG finds violation of Govt C §§12580-12599.7. Govt C §12598(e).	AG may refuse to register or may revoke or suspend registration of corporation if AG finds violation of Govt C §§12580-12599.7. Govt C §12598(e).	
d. Power to Bring Suit			
(1) Against the Corporation	AG may bring or intervene in action to correct departure from corporate purposes or failure to comply with trust assumed by corporation (Corp C §5250; Govt C §12591); to appoint provisional directors (Corp C §5225); to compel corporation to hold membership meeting or conduct written ballot (Corp C §§5510, 5515); for failure to comply with statutes (Corp C §6216);	No specific power except for assets held in charitable trust to which public benefit corporation rules apply. See Corp C §7142; Govt C §12591. AG may file complaint for involuntary dissolution. Corp C §8511. AG may bring quo warranto action (CCP §803) to challenge unlawful acts or usurpation of powers by corporation or its directors.	AG may bring quo warranto action (CCP §803) to challenge classification as religious corporation. Corp C §9230(b). AG may represent state agencies empowered to challenge status or regulate type of activities engaged in. Corp C §9230(c). AG may bring action to enforce specific charitable purposes for which property was solicited from general public (Corp C §9230(d)) and to

	and to seek corporation's involuntary dissolution (Corp C §§6510(a)(5), 6511). AG may bring quo warranto action (CCP §803) to challenge unlawful acts or usurpation of powers by corporation or its directors.		compel compliance with reporting requirements. Corp C §9660.
(2) Against Directors			
(a) Challenging Election	AG may intervene in action challenging director's election or appointment. Corp C §5617.	AG, if assets held in charitable trust, may intervene in action challenging director's election or appointment. Corp C §7616.	
(b) Breach of Duty	AG may initiate or intervene in action against director for breach of standards of conduct. Corp C §§5223, 5237(c)(3).	If assets held in charitable trust, AG may initiate or intervene in action to remove director for breach of standards of conduct. Corp C §7223.	AG may initiate or intervene in action to remove director for fraudulent acts. Corp C §9223.
(3) To Recover Improper Distributions	AG may initiate or intervene in action to recover improper distributions. Corp C §§5420, 6719, 6721.	AG has no specific power to initiate or intervene in action to recover improper distributions.	AG has no specific power to initiate or intervene in action to recover improper distributions.
e. Major Corporation Changes—Notice or Consent Required	Notice to or consent of AG required for change of status (Corp C §5813.5) or disposition of substantially all assets (Corp C §5913). For health facilities, consent of AG required for disposition of material amount of assets or transfer of control to for-profit, mutual benefit, or another nonprofit corporation or	Notice to or consent of AG required for disposition of any assets held in charitable trust. Corp C §7913. On special rules for health facilities, see §20.21. Prior consent of AG required for merger with a public benefit or religious corporation. Corp C §8010. Notice to AG required for involuntary dissolution of	Notice to or consent of AG required for disposition of substantially all assets. Corp C §9633. Special rules for health facilities; see §20.21. Prior consent of AG required for mergers other than with religious, public benefit, or foreign nonprofit corporation whose articles provide

	entity. Corp C §§5914-5925. Prior consent of AG required for mergers other than with public benefit, religious, or foreign nonprofit corporation whose articles provide that its assets are irrevocably dedicated to charitable, religious, or public purposes. Corp C §6010. Notice of election to AG required for voluntary dissolution unless unanimous (Corp C §§6611, 6617) and waiver of objections by AG required (unless court order obtained) (Corp C §6716).	corporation holding assets in charitable trust. Corp C §8510(e). Same requirements as public benefit corporation for voluntary dissolution of corporation that holds assets in charitable trust or that has a charitable dissolution clause. Corp C §§8611(a), 8613(c), 8716(c).	that its assets are irrevocably dedicated to charitable, religious, or public purposes. Corp C §9640(b). Same requirements as public benefit corporation for voluntary dissolution. Corp C §9680.
f. Other Notice Requirements	AG must be given notice of any proceedings in which AG may intervene or which AG could have initiated (d. above). See, *e.g.,* Corp C §5223(b).	Same as public benefit corporation. See, *e.g.,* Corp C §7223(c).	Same as public benefit corporation. See, *e.g.,* Corp C §9223(b).

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.31 B. Other Types of Nonprofit Corporations

§2.31 B. Other Types of Nonprofit Corporations

In addition to the three major types of nonprofit corporations recognized in California (see §§2.29-2.30), several minor types of nonprofit corporations are recognized under California law for special purposes (see §§2.31-2.35). It is also possible to operate a foreign nonprofit corporation in California (see §2.35). The following sections briefly discuss some of these other types of nonprofit corporations.

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§2.32 1. Cooperative Corporations

A cooperative corporation (Corp C §§12200-12704) is a special type of corporation that may be formed for any lawful purpose, but it must be organized and must conduct its business primarily for the mutual benefit of its members as patrons of the corporation. Corp C §12201. The law authorizing these corporations is primarily intended to apply to consumer cooperatives and cooperatives formed for the purpose of recycling or treating hazardous waste, but it also applies to other cooperatives that elect to incorporate under it. Corp C §12200. The corporate earnings, savings, or benefits must be used for the members' general welfare or must be proportionately and equitably distributed to them, based on their patronage of the corporation. Corp C §§12201, 12451.

NOTE: If the client wants to offer the members limited patronage refunds or dividends during operations, the cooperative corporation may be the best choice. On most other points, the law is similar or identical to the law governing mutual benefit corporations.

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§2.33 2. Corporations Sole

The corporation sole is a special nonprofit corporation that can be formed by the presiding officer of a religious denomination, society, or church to manage its affairs. This type of corporation is governed by Corp C §§10000-10015. Examples of corporations sole are some dioceses of the Catholic Church and the Episcopal Church. See *Berry v Society of St. Pius X* (1999) 69 CA4th 354, 81 CR2d 574 (discussing origination and purposes of corporations sole and requirements for amending their articles of incorporation).

For a religious group whose ruling authority is centralized in one individual, the corporation sole may be preferable to the religious corporation because it is subject to fewer governmental controls. Compare Corp C §§10000-10015 with Corp C §§9110-9690.

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Source: Business Law/Advising California Nonprofit Corporations/2 Choice of Entity Considerations/§2.34 3. Other Special Purpose Corporations

§2.34 3. Other Special Purpose Corporations

Except where noted, the following special purpose corporations are governed by the Nonprofit Corporation Law and, in some cases, governed in part by special statutory provisions:

- **Societies for the prevention of cruelty to children or animals** are subject to the Nonprofit Public Benefit Corporation Law as well as special provisions on formation (*e.g.,* the articles of incorporation must be endorsed by the Department of Justice or by a judge of the superior court) and operation. Corp C §§10400-10406, 14500-14503.
- **Port and terminal protection and development corporations** are subject to the Nonprofit Mutual Benefit Corporation Law as well as special provisions on participation by public agencies. Corp C §§10700-10703.
- **Nonprofit medical, hospital, or legal services corporations** are subject to the Nonprofit Public Benefit Corporation Law or the Nonprofit Mutual Benefit Corporation Law, depending on the corporation's purposes, as well as special provisions on formation (including for medical services that at least one-fourth of all licentiates of the particular profession residing in California become members (Corp C §10810(a)) and operation. Corp C §§10810-10841.
- **Chambers of commerce, boards of trade, mechanics' institutes, and similar organizations,** if organized with capital stock, are subject to the General Corporation Law; if organized without capital stock, they are subject to the Nonprofit Mutual Benefit Corporation Law. Corp C §12000.
- **Fish marketing associations and corporations,** which are subject to the Fish Marketing Act (Corp C §§13200-13356), even though deemed to be nonprofit (Corp C §13203), are governed by the General Corporation Law except when inconsistent with the express provisions of the Fish Marketing Act. Corp C §13204. The Act's purpose is to promote the intelligent and orderly marketing of fish and fishery products, to eliminate speculation and waste, to improve distribution, and to stabilize the marketing of fish and fishery products. Corp C §13201.
- **Small business development corporations** that come under the California Small Business Financial Development Corporation Law (Corp C §§14000-14091) are subject to special provisions of that law on purpose, formation, and operation, and are subject to the Nonprofit Public Benefit Corporation Law except when inconsistent with the express provisions of the Small Business Financial Development Corporation Law. Corp C §14051.
- **Mutual water companies** may be formed under either the Nonprofit Mutual Benefit Corporation Law or the General Corporation Law. If formed under the General Corporation Law, they are subject to special provisions on quorum requirements and cumulative voting. Corp C §§602(a), 708(d). In either case, they are subject to special provisions on scope of operation and transfer and assessment of shares. Corp C §§14300-14303.
- **Corporations for charitable or eleemosynary purposes** are subject to the Nonprofit Public Benefit Corporation Law or the Nonprofit Religious Corporation Law, depending on whether the purpose is charitable or primarily or exclusively religious. Corp C §10200 (limited in application to corporations in existence on December 31, 1979).
- **Agricultural nonprofit cooperative associations** are provided for in Food & A C §§54001-54294. They are subject to the General Corporation Law, rather than the Nonprofit Corporation Law, except when inconsistent with the relevant provisions in the Food and Agricultural Code. Food & A C §54040. Three or more natural persons may form such an association to market the products of its members, to supply machinery to its members, or to finance these activities. Food & A C §54061. The association may then enter into marketing contracts that require the members to sell products exclusively through the association. Food & A C §54261. See generally McTigue-Floyd, *Agricultural Cooperative Law: A Selective Bibliography*, 10 San Joaquin Agricultural L Rev 53 (2000).

The foregoing list is not exhaustive. See, *e.g.,* Ins C §§10970-11165 (fraternal benefit societies), Ins C §§11400-11407 (firemen's, policemen's, and peace officers' benefit and relief associations).

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§2.35 4. Foreign Nonprofit Corporations

Exempt from General Corporation Law. Foreign corporations are expressly exempt from the statute making sections of California's General Corporation Law applicable to foreign business corporations having activities and shareholders in California. Corp C §§6910, 8910; see Corp C §2115. Therefore, a foreign nonprofit corporation must apparently look to the law of the state in which it is organized for rules on management, standards of conduct, distributions, and similar matters. This exemption seems to suggest that some of the rigors of complying with California's Nonprofit Corporation Law (*e.g.,* the director "self-dealing" provisions) could be avoided by incorporating in another state, but as a rule this is probably not the case.

PRACTICE TIP: One provision of California's Nonprofit Corporation Law that might be avoided is the limitation on "interested persons" in Corp C §5227, as no similar provision in California law applies to foreign nonprofit corporations.

Regulation by Attorney General. If a foreign corporation does any business or holds any property in California for charitable or eleemosynary purposes (other than religious purposes), it is subject to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). The Act requires that reports be periodically filed with the California Attorney General and authorizes the Attorney General to investigate the corporation's affairs to verify compliance with its stated purposes and with the terms of any charitable trusts it has assumed. This authority is sufficiently broad to allow the Attorney General to prosecute for violations of applicable fiduciary standards. The fiduciary standards applied would probably be the strict California standards for charitable trustees. See Prob C §§16000-16105. Although these standards have been expressly made inapplicable to directors of California nonprofit corporations (Corp C §§5230(b), 7230(b), 9240(b)), directors of foreign nonprofit corporations have not been exempted.

NOTE: The Act expressly excludes from its coverage a charitable corporation organized and operated primarily as a religious organization, educational institution, or hospital, or a health care service plan licensed under Health & S C §1349. Govt C §12583.

Qualification to do business. Foreign nonprofit corporations transacting intrastate business must qualify to do business and designate an agent for service of process in California in the same manner as foreign business corporations. Corp C §§6910, 8910; see Corp C §§2100-2117.1. A fee applies for filing the statement and designation of agent for service of process of "a foreign, nonprofit, nonstock corporation, and of a foreign corporation organized for educational, religious, scientific, or charitable purposes, and not issuing shares." Govt C §12186(e).

A foreign nonprofit corporation must also establish tax-exempt status with the Franchise Tax Board.

NOTE: There are few advantages (other than avoidance of Corp C §5227 as noted in the Practice Tip above) and there may be several disadvantages (including additional filing and compliance requirements) for a California organization that chooses to incorporate in another state as a nonprofit corporation.

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3

Planning for, Obtaining, and Maintaining Tax-Exempt Status

Robert A. Wexler

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§3.1 I. SCOPE

This chapter focuses primarily on tax issues concerning organizations described in IRC §501(c)(3) and the parallel California statute, Rev & T C §23701d. See §§3.2-3.46. The chapter also discusses organizations qualifying for exemption under IRC §501(c)(4), (6), and (7). See §§3.47-3.50. In addition, the chapter briefly discusses California franchise, property, and sales taxes, as well as California tax deductions. See §§3.56-3.59. California sales and use taxes are discussed in more detail in chap 8.

This chapter also briefly addresses the unrelated business income and federal tax deductions. See §§3.51-3.55. The unrelated business income tax is discussed in detail in chap 17. The chapter discusses how to apply for §501(c)(3) status and how to complete IRS Form 1023. See §§3.60-3.69. Finally, it discusses the federal tax exemptions under other provisions of §501(c) and the exemptions from California income and franchise taxes. See §§3.70-3.71. For discussion of private foundations, see chap 4.

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II. FEDERAL TAX ISSUES

A. Tax-Exempt Organizations

§3.2 1. Advantages and Disadvantages of Tax-Exempt Status

"Nonprofit" versus "tax-exempt." Being "nonprofit" is not synonymous with being "tax-exempt." Most California nonprofit public benefit, mutual benefit, and religious corporations will find it advantageous to obtain and maintain tax-exempt status under California and federal law. But practitioners may occasionally encounter examples of certain businesses operated by religious organizations, health maintenance and service organizations, and other entities that choose the nonprofit form even though they are not eligible for tax-exempt status. Most nonprofit corporations, however, are eligible for tax-exempt status and should be encouraged to so qualify.

Exemption categories. There are 28 different tax-exemption categories under IRC §501(c) and somewhat fewer under Rev & T C §23701. The most frequently encountered categories are charitable organizations (IRC §501(c)(3)), social welfare/lobbying organizations (IRC §501(c)(4)), labor unions (IRC §501(c)(5)), trade associations and business leagues (IRC §501(c)(6)), social clubs (IRC §501(c)(7)), and veterans' organizations (IRC §501(c)(19)). These organizations are generally exempt from tax on the income and gifts they receive; a few, most notably IRC §501(c)(3) organizations, are able to offer their donors charitable tax deductions for their contributions. The table in §3.3 summarizes the exemption categories and shows which contributions are potentially deductible as charitable contributions under IRC §170.

Costs of obtaining tax-exempt status. A client who wishes to qualify as a tax-exempt organization should be informed, before beginning the application process, of the potential costs and other burdens of exempt operation. Applying for tax-exempt status alone can be costly and time-consuming. In addition, exempt organizations must prepare periodic filings and reports for various government agencies, which are subject to public inspection. Exempt organizations may be audited by tax and other governmental authorities, and, of particular concern in this chapter, exempt corporations face restrictions on their activities, management, control, and sources and disposition of assets and income.

Alternatives. Practitioners should be aware of the alternatives to setting up a new nonprofit corporation and applying for exemption. For some clients, the cost and administrative burden of operating a separate organization may outweigh the benefits. With individual donors, for example, it may sometimes be more prudent to establish a donor-advised fund at a local community foundation or with one of the commercially available funds rather than a stand-alone private foundation. See chap 4.

With small operating charities, it may sometimes be more prudent to establish a fiscal sponsorship relationship with a local community foundation or another established public charity. The new charitable endeavor can be structured as a project of an established charity that can provide the requisite infrastructure, including bookkeeping, payroll, and legal compliance. This approach enables a smaller project to focus on its charitable mission without the expense of setting up a new entity and with the benefit of another organization's administrative structure.

NOTE: A properly structured fiscal sponsorship arrangement can be used as a temporary measure until a charity is substantial enough to set up its own corporation and seek its own tax-exempt status, or on a more long-term basis.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.3 2. Table: Federal and State Tax Exemptions

§3.3 2. Table: Federal and State Tax Exemptions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.3-3.55.

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Federal and State Tax Exemptions

DESCRIPTION	FEDERAL EXEMPTION (IRC §)	STATE EXEMPTION (Rev & T C §)	Charitable Contribution Deduction?
Corporation formed and granted exemption by Act of Congress	501(c)(1)	None required	Yes, if for exclusively public purposes
Corporation that holds title to property for another exempt organization	501(c)(2)	23701h	No
Organizations organized and operated exclusively for purposes that are charitable, religious, scientific, testing for public safety, literary, educational, fostering amateur sports competition, or preventing cruelty to children or animals	501(c)(3)	23701d	Yes
Social welfare organizations (includes organizations that lobby substantially); local associations of employees	501(c)(4)	23701f	No
Labor, agricultural, or horticultural organizations	501(c)(5)	23701a	No
Business leagues, chambers of commerce, real estate boards, trade associations, and professional football leagues	501(c)(6)	23701e	No
Social clubs	501(c)(7)	23701g	No
Fraternal societies that provide insurance or similar benefits to members	501(c)(8)	23701b	Yes, if limited to charitable purposes
Voluntary employees' beneficiary associations (VEBAs)	501(c)(9)	23701i	No
Fraternal societies that do not provide insurance to members	501(c)(10)	23701l	Yes, if limited to charitable purposes
Teachers' retirement fund associations	501(c)(11)	23701j	No

Local benevolent life insurance associations, mutual ditch or irrigation companies, and cooperative telephone companies	501(c)(12)	None[2]	No
Cemetery companies	501(c)(13)	23701c	Yes
Credit unions and mutual insurance funds	501(c)(14)	23701y[1]	No
Certain small insurance companies	501(c)(15)	23701z[1]	No
Corporations that provide crop financing	501(c)(16)	None	No
Supplemental unemployment benefit trusts	501(c)(17)	23701n	No
Certain pre-1959 employee funded pension plans	501(c)(18)	23701s	No
Veterans' organizations	501(c)(19)	23701w	Yes, in certain cases
Group legal services plans	501(c)(20)	None	No
Black lung benefit trusts	501(c)(21)	None	No
Certain ERISA trusts	501(c)(22)	None	No
Certain organizations that provide insurance to veterans	501(c)(23)	None	No
Certain ERISA trusts	501(c)(24)	None	No
Certain title-holding corporations	501(c)(25)	23701x	No
Membership organizations that provide medical insurance for the difficult to insure	501(c)(26)	None	No
Certain state-formed workers' compensation organizations	501(c)(27)	None	No
National Railroad Retirement Investment Trust established under 45 USC §231n(j)	501(c)(28)	None	No
Religious or apostolic corporations	501(d)	23701k	No
Political organizations	527	23701r	No
Homeowners associations	528	23701t	No

[1] Revenue and Taxation Code §23701y and IRC §501(c)(14) provide exemptions for credit unions. Practitioners should review the definitions in these sections carefully before advising clients. Revenue and Taxation Code §23701z, like IRC §501(c)(15), provides an exemption for certain *self-insured pools*, but the definitions of this phrase are quite different.

[2] Although there is no Revenue and Taxation Code section equivalent to IRC §501(c)(12), California does provide special exemption, or deductions, for certain income in a membership corporation. See, *e.g.,* Rev & T C §24405.

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§3.4 3. State and Political Subdivision Exemption

Income accruing to state or subdivision excluded. The source of the federal income tax exemption for states and political subdivisions is IRC §115, which excludes from taxation income "accruing" to states and political subdivisions that is "derived" from the "exercise of any essential governmental function." Whether an activity is an "essential government function" is decided on a case-by-case basis. Rev Rul 90-74, 1990-2 Cum Bull 34. Income earned by a state, its political subdivisions, or an "integral part" of a state and its political subdivisions is generally not taxable unless there is specific statutory authorization for taxing the income. Rev Rul 87-2, 1987-1 Cum Bull 18. For example, income to the University of California is generally exempt under §115. However, the unrelated business taxable income of colleges and universities that are state agencies or instrumentalities, like UC, is taxable under IRC §511(a)(2)(B).

Contributions deductible. Contributions to states and political subdivisions are generally tax deductible under IRC §170(a)(1) and IRC §170(c)(1) if the contribution is "made for exclusively public purposes." Nonetheless, because donors are often confused about their ability to make a charitable contribution to the government or for other reasons, many states, cities, and government agencies that are seeking contributions will form a separate corporation or trust, exempt under IRC §501(c)(3), to receive contributions for the benefit of the agency in question. It is for this reason that there are numerous "friends of" organizations affiliated with local governments.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.5 B. Qualifying for and Maintaining Status as Tax-Exempt Organization Under IRC §501(c)(3)

§3.5 B. Qualifying for and Maintaining Status as Tax-Exempt Organization Under IRC §501(c)(3)

Internal Revenue Code §501(c)(3) offers the most advantageous basis for exemption because IRC §501(c)(3) organizations do not, with a few exceptions, pay taxes on donations, grants, earned income, or passive income, such as interest, rents, and royalties. In addition, they are able to offer their donors very favorable tax deductions. Because IRC §501(c)(3) organizations are so advantageous, they face the greatest hurdles in applying for and maintaining tax-exempt status, and they are the most heavily regulated of tax-exempt entities.

"Tax-exempt organization" defined. Section 501(c)(3) defines tax-exempt charitable organizations in language that can fairly be described as obscure:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

The first clause of IRC §501(c)(3) purports to list the types of entities that can qualify for exemption. In that clause, only the "corporation" is a generally recognized form of legal entity in California. The terms "community chest," "fund," and "foundation" are descriptive of the function served by a nonprofit entity, but they are not types of legal entities themselves. However, §501(c)(3) also applies to certain unincorporated associations, trusts, and in some cases limited liability companies, none of which is directly mentioned in the subsection.

Five tests. A nonprofit corporation will qualify as a tax-exempt charitable organization if it satisfies five tests, each of which is found within the single 133-word sentence that is IRC §501(c)(3):

(1) It must be organized exclusively for exempt purposes;
(2) It must be operated primarily for exempt purposes;
(3) It must refrain from inurement;
(4) It must avoid electioneering; and
(5) It may not engage in substantial lobbying.

NOTE: The IRS website (http://www.irs.gov/charities) contains some excellent materials that can help guide the practitioner or the organization through these complex rules.

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§3.6 1. Organizational Test

Governing document must limit purpose. The organization's governing document—whether articles of incorporation, articles of association, a trust agreement or, in some situations, an LLC agreement—must meet certain requirements to satisfy the organizational test. The document must limit the charity's purposes to one or more of the purposes listed in IRC §501(c)(3). It must not "expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes." Treas Reg §1.501(c)(3)-1(b)(1)(i)(*b*). In practice, the charity must include in its governing document an affirmation that it will not engage in prohibited political activities. Finally, the governing document must provide that the charity's assets are irrevocably dedicated to one or more exempt purposes. Chapter 6 provides examples of articles of incorporation that contain all of the provisions necessary to secure tax-exempt status.

Purpose may be broad or narrow. One of the key decision points in drafting articles of incorporation or other governing documents is to identify the organization's exempt purposes. Sometimes the articles will recite only broad exempt purposes (*e.g.,* charitable, educational, scientific, or religious), and sometimes they will recite fairly narrow and specific purposes. For example, of two organizations with identical charitable activities, one organization's articles might legitimately recite the broadest possible charitable and educational purposes, while the articles of the other might equally legitimately limit the purpose to "protecting and preserving the environment" or to "relief of the poor," both of which are recognized charitable purposes.

NOTE: A broad statement of purpose will be advantageous in most situations because the organization will be able to change activities, or add new activities in the future, without having to amend its articles of incorporation to restate its purposes. Nonetheless, a more narrow statement of charitable purposes may sometimes be necessary to satisfy potential grantors or donors, or because of an affiliation with a government agency or with another charity or group of charities.

Dissolution clause. A second key decision point is the wording of the dissolution clause. Most organizations permit their assets to be transferred to any other IRC §501(c)(3) entity on dissolution. However, organizations with a special relationship to another charity may want to name a particular organization or organizations as distributees on dissolution.

Despite these decision points, it is relatively simple to satisfy the organizational test under IRC §501(c)(3) simply by including the right language in the articles.

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§3.7 2. Operational Test

It is one thing to be organized for tax-exempt purposes—largely a question of legal drafting. It is quite another to operate for tax-exempt purposes. The operational test raises at least three issues:

(1) The meaning of "operating exclusively for exempt purposes" (see §3.8);
(2) The private benefit doctrine (see §3.9); and
(3) What activities further exempt purposes (see §3.10).

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§3.8 a. Operated Exclusively for Exempt Purposes

What does is it mean to be operated "exclusively" for exempt purposes? Taken literally, IRC §501(c)(3) requires an organization to be operated *exclusively* for exempt purposes. The United States Supreme Court stated that "the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption." *Better Business Bureau v U.S.* (1945) 326 US 279, 283, 90 L Ed 67, 71, 66 S Ct 112. After that decision, the regulations were revised to make it clear that a charity may qualify as such if it is operated *primarily* for exempt purposes. Thus, an "insubstantial part" of the charity's activities may be devoted to nonexempt purposes. Treas Reg §1.501(c)(3)-1(c)(1). Accordingly, a charity may operate a trade or a business whose operation is unrelated to its exempt purposes without losing its charitable status. A charity may, however, be subject to the unrelated business income tax on these activities. Treas Reg §1.501(c)(3)-1(e)(2). See IRC §§511-515. See also chap 17.

NOTE: An activity is "insubstantial" if it is "indirect or unintentional" or "a necessary concomitant of the activity which benefits the public at large," which means that the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. IRS Letter Ruling 200737044. For example, a charity may pay a contractor cost-plus-profits to build a museum, as long as the profit is reasonable. Even though the contractor benefits, it is necessary to pay some contractor to build a museum for the public good. Alternatively, if a charity builds and maintains a park or other green space for the benefit of the community, the landowners who live adjacent to the park may benefit by an increase in the value of their property, but that benefit is necessary to the overall public good. See Rev Rul 70-186, 1970-1 Cum Bull 129.

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§3.9 b. May Private Interests Benefit From Charity?

May private interests benefit from a charity? The operational test leaves some room for private interests to benefit from the charity's activities if that benefit is an unavoidable incident of the charity's otherwise proper activities. However, the operational test requires a charity to "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests." Treas Reg §1.501(c)(3)-1(d)(1)(ii). This test is known as the "private benefit" test.

NOTE: Although they are sometimes blurred, the private benefit test is different from the private inurement test. See §3.15. The private inurement test prohibits insiders, the founders, directors, officers, donors, and key employees from receiving a share of the profits or income of the charity. The private benefit test, which is not separately articulated in IRC §501(c)(3), is part of the operational test. It looks to whether the charity is actually serving a public interest rather than a private interest (whether of insiders or not) in the conduct of its activities. A charity can forfeit its tax-exempt status if it engages in any private inurement transaction, but charities may provide some level of benefit to individuals. In GCM 37789 (Dec. 18, 1978), the IRS confirmed that a charity will only lose its exemption if the private benefit is quantitatively or qualitatively substantial rather than insubstantial or incidental.

Sufficiently broad class of recipients. Some charities do not qualify for exemption because the charitable class they serve is too narrow, either in size or scope, so that only a private benefit is being served. In *American Campaign Academy* (1989) 92 TC 1053, the tax court held that an organization established to educate and train individuals for careers in political campaigns was not operated for exempt purposes. Almost all of the graduates went to work for Republican candidates, and therefore, the court found that the primary beneficiary of the academy was the Republican party, not the public. Similarly, charities established to benefit a single family or entity will fail the private benefit test. Even though a child suffering from cancer may be a valid member of a charitable class and eligible for charitable assistance, a charity set up to benefit only that one child will not qualify for exemption.

Joint ventures. The IRS becomes particularly concerned about private benefit when a charity engages in joint venture transaction involving both for-profit and nonprofit entities. Most of the cases and rulings focus on whole entity joint ventures, when a charity takes all of its activities and contributes them to a new LLC or partnership and a for-profit investor contributes cash and expertise. For a discussion of these issues, see *Redlands Surgical Servs.* (1999) 113 TC 47, aff'd (9th Cir 2001) 242 F3d 904; *Plumstead Theatre Soc'y, Inc.* (1980) 74 TC 1324, aff'd (9th Cir 1982) 675 F2d 244; Rev Rul 98-15, 1998-1 Cum Bull 718; see also *St. David's Health Care Sys. v U.S.* (5th Cir 2003) 349 F3d 232. Revenue Ruling 2004-51, 2004-1 Cum Bull 974 illustrates the tax consequences of an ancillary joint venture, in which a nonprofit organization sought to enter into a joint venture with a for-profit organization for an insubstantial part of its overall activity.

PRACTICE TIP: In the author's opinion, the private benefit doctrine is not a coherent doctrine that is consistently applied. Most exempt organizations will never face a private benefit issue. However, practitioners should be alert to this issue when:

- An organization plans to enter into a joint venture;
- The charitable class served by the organization seems narrow; or
- There is a particular financial transaction that will provide a substantial benefit to a private party.

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§3.10 c. What Activities Further Exempt Purposes?

When do particular activities further exempt purposes? The operational test looks at the specific activities that the organization actually conducts or proposes to conduct and whether those activities further one or more exempt purposes set forth in IRC §501(c)(3). The operational test is applied on a facts-and-circumstances basis in each situation, and no law, regulation, case, or ruling articulates a clear standard that applies to all situations.

Regulations, cases, and rulings have established tests that will help an organization and its counsel determine whether the organization's proposed activities properly further exempt purposes. The rules governing one type of activity, however, do not necessarily apply to another. For example, very different rules determine whether a hospital will operate for exempt purposes than those that apply to a low-income housing organization.

Sections 3.11-3.14 cover some of the more common types of tax-exempt activities that further the four major exempt purposes set forth in IRC §501(c)(3)—charitable, educational, scientific, and religious purposes. However, this discussion is by no means exhaustive.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.11 d. Charitable Activities

§3.11 d. Charitable Activities

Broad scope. The traditional common law definition of "charity" focuses on relief of the poor and the distressed. The regulations extend the term to include the advancement of education, religion, or science (even though education, religion, and science are each separate exempt purposes in their own right); erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; and promoting social welfare; or activities that are designed "(i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency." Treas Reg §1.501(c)(3)-1(d)(2). Organizations that operate food banks and soup kitchens or that otherwise provide free services to the poor or disadvantaged will normally easily qualify for exemption.

Fee-for-service organizations. Organizations that charge fees for goods or services present more complex operational issues. Practitioners looking for specific guidance on organizations that do generate some fees for their efforts might consider the following commentary on charitable activities:

Promoting health. Promoting health for the benefit of the community has historically been recognized under common law as a valid charitable activity. The IRS formally recognized it as such in Rev Rul 69-545, 1969-2 Cum Bull 117, as amplified by Rev Rul 83-157, 1983-2 Cum Bull 94. Promoting health includes, but is not limited to, the operation of hospitals, medical clinics, and medical research organizations. The term "hospital" is not defined in the Internal Revenue Code; however, Schedule C to IRS Form 1023 sets forth the relevant factors. Schedule C is available on the IRS website at http://www.irs.gov/formspubs.

NOTE: Because health care is also provided on a taxable, for-profit basis, it is important for practitioners representing health care organizations to understand the community benefit doctrine and other factors that permit a health care organization to operate for exempt purposes.

Low-income housing. The IRS recognizes providing low-income housing as a valid charitable activity. Revenue Procedure 96-32, 1996-1 Cum Bull 717, sets forth a safe harbor for organizations that provide low-income housing. The safe harbor considers the percentage of housing units that are provided to low and very low income residents. It also provides a facts-and-circumstances test and refers to a series of other revenue rulings that provide related alternatives for exemption. Many low-income housing organizations also participate in limited partnerships or LLCs that offer low-income housing tax credits under IRC §42 to for-profit investors.

Senior housing. Revenue Ruling 72-124, 1972-1 Cum Bull 145, and Revenue Ruling 79-18, 1979-1 Cum Bull 194, provide guidance on relief of distress of the elderly, including the provision of senior housing. Revenue Ruling 79-19, 1979-1 Cum Bull 195, provides guidance on relief of distress of the physically handicapped.

Combating community deterioration. A variety of activities are designed to combat community deterioration. An organization that combats community deterioration must (1) operate in an area with actual or potential deterioration, and (2) directly prevent or relieve that deterioration. See, for example, the situations described in Rev Rul 68-17, 1968-1 Cum Bull 247; Rev Rul 68-655, 1968-2 Cum Bull 213; Rev Rul 70-585, 1970-2 Cum Bull 115; and Rev Rul 76-147, 1976-1 Cum Bull 151.

Lessening the burdens of government. Organizations that lessen the burdens of government may often be able to engage in activities that might not otherwise be considered charitable under any other theory. For example, recent letter rulings suggest that it is charitable for an organization to construct and operate a civic sports arena when doing so would have normally been a government function. See IRS Letter Ruling 200832034, IRS Letter Ruling 200634036. See also Rev Rul 85-1, 1985-1 Cum Bull 178; Rev Rul 85-2, 1985-1 Cum Bull 178. An organization lessens the burdens of government if:

- The governmental unit objectively manifests that it considers the activities of the organization to be the government's burdens; and
- The organization actually lessens the government's burdens.

Elimination of discrimination and prejudice. Any activity designed to eliminate prejudice or discrimination may be charitable. See Rev Rul 68-655, 1968-2 Cum Bull 213; Rev Rul 70-585, 1970-2 Cum Bull 115. These rulings describe organizations that further charitable purposes by assisting persons in specific racial groups to acquire housing for the purpose of stabilizing neighborhoods or reducing racial imbalances.

Job skills and training. The IRS recognizes that a charity can further an exempt activity by being organized and operated to help a disadvantaged class of individuals learn how to perform a job skill. The disadvantaged class could be based on poverty, a physical or mental disability, or other factors. In *Aid to Artisans, Inc.* (1978) 71 TC 202, the tax court considered the exemption of a charity that purchased and sold handicrafts from disadvantaged craftspeople. The charity in that case sold the handicrafts to museums and other nonprofit shops and agencies. The court found that the sale of these items was related to the exempt purpose of the organization because the activity alleviated economic deficiencies in communities of disadvantaged artisans, and the crafts themselves served to educate the public in the artistry, history, and cultural significance of handicrafts from these communities. A similar conclusion was reached in *Industrial Aid for the Blind* (1979) 73 TC 96, in which the corporation purchased products manufactured by blind individuals and sold them to various purchasers. In Rev Rul 73-128, 1973-1 Cum Bull 222, the IRS determined that a business conducted for the primary purpose of providing skills training to the disadvantaged was operated for charitable purposes. In Rev Rul 75-472, 1975-2 Cum Bull 208, a charity directly employed disadvantaged persons in its business. That business involved the production and sale of furniture made by residents of the corporation's halfway house for alcoholics.

Legal services. Public interest law firms may be eligible for tax-exempt status if they advance issues of importance to the public. Because of the direct competition with for-profit law firms, these organizations are carefully scrutinized over their fee structures and their mission. For more details, see Rev Proc 92-59, 1992-2 Cum Bull 411.

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§3.12 e. Educational Purposes

Educational purposes. "Educational" includes both instructing individuals to improve their abilities or develop their capabilities and instructing the public "on subjects useful to the individual and beneficial to the community." Treas Reg §1.501(c)(3)-1(d)(3)(i). The broad scope of this definition embraces conventional classroom instruction, the publication and distribution of written or recorded materials, public television, and more.

Full and fair exposition required. Before looking at specific educational activities, it is important to know that much of the discussion about whether an activity is educational or not has focused on the neutrality of the message being taught. The broad language of Treas Reg §1.501(c)(3)-1(d)(3)(i)(*b*) makes it clear that neutrality is not required:

> An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

Courts have criticized the "full and fair exposition" standard, finding it to be overly vague. See, *e.g., Big Mama Rag, Inc. v U.S.* (DC Cir 1980) 631 F2d 1030, disapproved as stated in *Board of Trustees of Leland Stanford Jr. Univ. v Sullivan* (1991) 773 F Supp 472. In response, the IRS issued Rev Proc 86-43, 1986-2 Cum Bull 729, which focuses not on content but on methodology. To qualify as educational, an organization must "provide a factual foundation for the viewpoint or position being advocated" or "provide a development from the relevant facts that would materially aid a listener or reader in a learning process." See also *National Alliance v U.S.* (DC Cir 1983) 710 F2d 868; *Nationalist Movement* (1994) 102 TC 558, aff'd (5th Cir 1994) 37 F3d 216.

Specific educational activities include the following (see Treas Reg §1.501(c)(3)-1(d)(3)(ii)):

Schools. A school is an organization, such as a primary or secondary school, a college, or a professional or trade school, that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on. Treas Reg §1.501(c)(3)-1(d)(3)(ii), Example 1. Schools must also demonstrate that they operate in a nondiscriminatory manner. See Form 1023, Schedule B, available on the IRS website at http://www.irs.gov/formspubs.

Public forums. Public forum activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. These programs may be on radio or television. Treas Reg §1.501(c)(3)-1(d)(3)(ii), Example 2.

Seminars and other instruction. An organization that is not a school per se, but that presents a course of instruction by means of correspondence or through the use of television or radio, is considered educational. Treas Reg §1.501(c)(3)-1(d)(3)(ii), Example 3. Presumably, courses presented over the Internet will qualify as educational.

Museums. Museums, zoos, planetariums, symphony orchestras, and other similar organizations are educational. Treas Reg §1.501(c)(3)-1(d)(3)(ii), Example 4.

Publishing. Publishing may also be exempt it if is carried out in a "noncommercial" manner, as described in Rev Rul 67-4, 1967-1 Cum Bull 121. This ruling and Rev Rul 66-147, 1966-1 Cum Bull 137, suggest a four-part test. An organization engaged in publishing may qualify for exemption under the following circumstances:

- The content of the publication is educational;
- The preparation of material follows methods generally accepted as "educational" in character;
- The distribution of the materials is necessary or valuable in achieving the organization's educational and scientific purposes; and
- The manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

In Rev Rul 77-4, 1977-1 Cum Bull 141, the IRS reviewed the publication of an ethnic newspaper. It found that a nonprofit organization, whose only activities were preparing and publishing a newspaper of local, national, and international news articles with an ethnic emphasis and soliciting advertising and selling subscriptions to that newspaper in a manner indistinguishable from ordinary commercial publishing practices, was not operated exclusively for charitable

and educational purposes and did not qualify for exemption.

In the seminal case of *Presbyterian and Reformed Publ'g Co. v Commissioner* (3d Cir 1984) 743 F2d 148, the Third Circuit reversed a tax court decision in favor of the IRS and held that a religious publishing house, an informal affiliate of a church, qualified for exemption.

Technical assistance and training. Some exempt organizations have been established to provide technical assistance to other exempt organizations on the theory that such assistance is educational in nature. In *BSW Group, Inc.* (1978) 70 TC 352, an organization provided consulting services to a small number of organizations for a fee. The court found that even though the fee was below market, it was above cost and, therefore, was not sufficient to establish the charitable nature. See also *At Cost Servs.,* TC Memo 2000-329, where job training and placement fees equal to cost were not considered to be charitable.

PRACTICE TIP: The IRS takes the position that one-on-one technical assistance must be provided at "substantially below cost." Practitioners advising clients providing technical assistance must consider what costs are appropriate to include in this calculation and what is meant by substantially below. At different times the IRS has taken the position that substantially below cost can mean anything from 15 percent of cost to 85 percent of cost. See Rev Rul 71-529, 1971-2 Cum Bull 234; IRS Letter Ruling 9347036.

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§3.13 f. Scientific Purposes

An organization has a scientific purpose if its research is in the public interest and in furtherance of a scientific purpose. See Treas Reg §1.501(c)(3)-1(d)(5)(i); *Midwest Research Inst. v U.S.* (WD Mo 1983) 554 F Supp 1379, aff'd (8th Cir 1984) 744 F2d 635. Questions of ownership, public access, and acceptable categories of licensing arrangements are discussed in Treas Reg §1.501(c)(3)-1(d)(5). Charities may make money from developing marketable patents or actual goods that result from scientific research. Scientific research will be regarded as carried on in the public interest if (Treas Reg §1.501(c)(3)-1(d)(5)(iii)):

- The results of the research (including any patents, copyrights, processes, or formulas resulting from that research) are made available to the public on a nondiscriminatory basis;
- The research is performed for the United States, or any of its agencies or instrumentalities, or for a state or any of its political subdivisions; or
- The research is directed toward benefiting the public.

The regulations further provide examples of research that is directed toward benefiting the public and therefore exempt in nature, including scientific research carried on for the purpose of (Treas Reg §1.501(c)(3)-1(d)(5)(iii)(*c*)):

- Aiding in the scientific education of college or university students;
- Obtaining scientific information that is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public;
- Discovering a cure for a disease; or
- Aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.

Scientific research described above will be regarded as carried on in the public interest even though the research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulas resulting from that research. Treas Reg §1.501(c)(3)-1(d)(5)(iii)(*c*).

On the other hand, the regulations state that an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, thus, will not qualify under IRC §501(c)(3) as a scientific organization if the organization (Treas Reg §1.501(c)(3)-1(d)(5)(iv)):

- Will perform research only for persons that are (directly or indirectly) its creators and that are not described in IRC §501(c)(3); or
- Retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulas resulting from its research and does not make those patents, copyrights, processes, or formulas available to the public.

A patent, copyright, process, or formula is considered "made available to the public" if the patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, this intellectual property will be considered as made available to the public if the granting of the exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be used to benefit the public. Treas Reg §1.501(c)(3)-1(d)(5)(iv)(*b*).

NOTE: The fact that any organization (including a college, university, or hospital) carries on research that is not in furtherance of an exempt purpose does not preclude that organization from qualifying as a §501(c)(3) organization, provided that the organization meets the organizational test (see §3.6) and is not operated for the primary purpose of carrying on the non-qualifying research (see Treas Reg §1.501(c)(3)-1(e) (organizations carrying on a trade or business)). See Treas Reg §1.501(c)(3)-1(d)(5)(v).

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§3.14 g. Religious Purposes

The term "religious" is not defined in the regulations, but it is most commonly associated with the operation of some type of church, synagogue, mosque, or similar institution. See §3.33. The term "religious" also includes, however, any other activities that involve the study or promotion of religion, including, for example, conducting religious seminars or retreats and religious publishing.

NOTE: The IRS rarely questions whether or not an activity promotes religion because of the First Amendment protections for religion.

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§3.15 3. Prohibition on Inurement

Private inurement involves an inappropriate payment to an insider. Internal Revenue Code §501(c)(3) specifically requires that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual." Unlike the private benefit doctrine discussed in §3.9, the prohibition on private inurement is strict and the consequences more severe. The IRS General Counsel's office has written that (GCM 38459 (July 31, 1980))

> [i]nurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes.

In audits, the IRS typically takes the position that any sharing of net profits between an insider and a charity is per se private inurement. If no net profits have been shared, the IRS usually will look to the fairness of the arrangement between the organization and the insider. However, practitioners should recognize that the IRS is not always consistent in its application of this inherently subjective test.

If the IRS finds that inurement has occurred, the charity's tax-exempt status is subject to revocation. Because this harsh consequence is not always appropriate, IRC §4958 imposes punishments (sometimes called intermediate sanctions) on persons who benefited from the inurement.

NOTE: Congress enacted IRC §4958 precisely because the IRS, which was reluctant to revoke exempt status for private inurement, sought some other means to penalize exempt organizations. The Internal Revenue Code already contained, and continues to contain, an excise tax for private foundations engaging in self-dealing. See the discussion of IRC §4941 in §§4.26-4.34. However, because IRC §4941 does not pertain to IRC §501(c)(3) organizations that are not private foundations, IRC §4958 was enacted.

The IRS has issued regulations with examples that help clarify when it will seek to revoke exempt status in situations of private inurement or private benefit, as opposed to, or in addition to, looking for the remedies afforded by IRC §4958. See Treas Reg §1.501(c)(3)-1(f).

PRACTICE TIP: In tax planning for charities, practitioners are better advised to study IRC §4958, rather than trying to piece together the miscellaneous cases and rulings that examine the private inurement doctrine. Several of the questions on the Form 1023 tax exemption application are directed at whether the organization has complied, and intends to comply, with IRC §4958.

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§3.16 a. Excess Benefits Under IRC §4958; Intermediate Sanction Rules

Internal Revenue Code §4958 permits the IRS to impose excise taxes on certain insiders (disqualified persons) of IRC §501(c)(3) public charities and IRC §501(c)(4) organizations that obtain excessive benefits from the organization. The IRS may also impose excise taxes on any managers of these organizations who knowingly approve an abusive transaction. However, IRC §501(c) organizations other than public charities (see §3.31) and social welfare organizations are not subject to IRC §4958.

For a transaction to be subject to IRC §4958, there must be a direct or indirect transaction between an applicable tax-exempt organization (a §501(c)(3) public charity or a §501(c)(4) organization) and a disqualified person, in which the disqualified person receives an excess benefit.

NOTE: The availability of the intermediate sanctions of IRC §4958 does not preclude the IRS from seeking a revocation of exempt status. Treas Reg §53.4958-8(a).

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.17 b. Definition of Disqualified Person

§3.17 b. Definition of Disqualified Person

A "disqualified person" under IRC §4958 is any of the following with regard to a transaction (IRC §4958(f)(1)):

- A person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization, or a member of that person's family (see IRC §4958(f)(4));
- A 35-percent controlled entity (see IRC §4958(f)(3));
- Any person who is described above with respect to an IRC §509(a)(3) organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, the applicable tax-exempt organization;
- Any person who is described as a donor or donor advisor (see IRC §4958(f)(7)) with respect to a donor-advised fund (see IRC §4966(d)(2)); and
- Any person who is described as an investment advisor (see IRC §4958(f)(8)) with respect to a sponsoring organization (see IRC §4966(d)(1).

Under Treas Reg §53.4958-3, a disqualified person is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the 5-year period ending on the date of the transaction in question. Treas Reg §53.4958-3(a)(1). There are four categories of people and organizations that are deemed to have substantial influence (Treas Reg §53.4958-3(c)):

- Voting members of the organization's governing body;
- Persons having the responsibilities of the president, chief executive officer, or chief operating officer (*e.g.,* the ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization), regardless of the actual title of the person; and
- Persons having the responsibilities of treasurer or chief financial officer of an organization (*e.g.,* the ultimate responsibility for managing the organization's finances), regardless of the actual title of the person; and
- Persons with a material financial interest in a provider-sponsored organization in which a participating hospital is an applicable tax-exempt organization.

"Substantial influence" defined. Individuals and entities that do not fall into any of the above categories may nevertheless be disqualified persons if the facts and circumstances show that they are in a position to exercise substantial influence. Factors tending to show substantial influence include the following (Treas Reg §53.4958-3(e)(2)):

- The person founded the organization;
- The person is a substantial contributor (see IRC §507(d)(2)(A)) but only taking into account contributions received during the current tax year of the organization and the 4 preceding years;
- The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls;
- The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or employee compensation.
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's activities, income, assets, or expenses.
- The person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.
- The person is a nonstock organization controlled, directly or indirectly, by one or more disqualified persons.

No substantial influence. The regulations also provide some categories of persons and entities that are deemed *not* to have substantial influence. This category includes all IRC §501(c)(3) organizations and certain IRC §501(c)(4) organizations. Treas Reg §53.4958-3(d)(1)-(2). In addition, full-time or part-time employees of the applicable tax-exempt organization are deemed not to have substantial influence if (1) they are not "highly compensated" (see IRC

§414(q)(1)(B)(i)); (2) they are not related to any disqualified person; (3) they are not officers or directors; and (4) they are not substantial contributors (see IRC §507(d)(2)(A)); Treas Reg §53.4958-3(d)(3)).

WARNING: Practitioners will find, therefore, that if an employee's economic benefit from the organization (including salary, taxable and nontaxable benefits, and other sources of income) is below the IRC §414 amount and the person is not a board member or otherwise subject to a conflict of interest, the employee and the organization need not concern themselves with IRC §4958. This does not mean, however, that compensation below the IRC §414 level is automatically appropriate for all purposes and will not be questioned under any circumstances.

In addition, the regulations list the following factors tending to show that a person does not have substantial influence:

- The person has taken a bona fide vow of poverty as an employee, agent, or on behalf of a religious organization;
- The person is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) about transactions from which the contractor will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);
- The person's direct supervisor is not a disqualified person;
- The person does not participate in management decisions affecting the organization as a whole, or a discrete segment of the organization that represents a substantial portion of the organization's income, expenses, or activities; and
- Any preferential treatment the person receives based on the size of a donation is also offered to anyone else making a comparable donation as part of a solicitation intended to attract a substantial number of contributions.

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§3.18 c. Definition of Excess Benefit Transaction

Excess benefit transactions. Treasury Regulation §53.4958-4 describes transactions that are considered to be excess benefit transactions. The regulation emphasizes that, if an organization has directly or indirectly conferred an economic benefit on a disqualified person that exceeds the value of what the organization received in return, an excess benefit transaction has occurred. See Treas Reg §53.4958-4(a)(1). Transactions involving compensation and property transfers are likely to be the most common excess benefits.

NOTE: The regulations help the practitioner understand how to evaluate compensation, what types of compensation to take into account, and when to evaluate compensation.

Sometimes an individual receives compensation both from a tax-exempt entity and from for-profit or tax-exempt subsidiaries of that entity. The regulations discuss when to take into account compensation paid by certain controlled entities. Treas Reg §53.4958-4(a)(2). Generally, the IRS will consider the reasonableness of the combined compensation that an employee receives from an exempt entity and all exempt and nonexempt entities that it controls.

Initial contract rule. The regulations also provide an initial contract or "first bite" rule. See Treas Reg §53.4958-4(a)(3). When a person who is not already a disqualified person enters into a contract with an applicable tax-exempt organization that involves a fixed payment (as defined in the regulations), the transaction is not subject to IRC §4958, even if the compensation or other form of payment is excessive. This means, for example, that the first time an exempt organization hires a new CEO, who is not otherwise a disqualified person, the organization does not have to consider IRC §4958 when entering into the contract. This rule helps organizations avoid the awkwardness of having to treat a new hire as an "insider" for purposes of IRC §4958. Of course, for other reasons of legal compliance, the organization must still only enter into contracts that are reasonable. See Treas Reg §53.4958-4(a).

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§3.19 d. Presumption of Reasonableness

Burden of proof. Ordinarily, the taxpayer has the burden of proving that the IRS erred in imposing taxes. Under IRC §4958, however, the organization can shift the burden of proof to the IRS if the following three requirements are satisfied (Treas Reg §53.4958-6(a)):

(1) The transaction is approved in advance by the organization's authorizing body, or a committee of the authorizing body, in either case composed entirely of people who do not have a conflict of interest with respect to the transaction;

(2) The authorizing body or committee obtains and relies on appropriate data as to comparability before approving the transaction; and

(3) The authorizing body or committee adequately documents the basis for its determination concurrently with making that determination. See §§3.24-3.25.

"Appropriate data" is information that is sufficient for the authorizing body or committee members to determine, under the standards set forth in Treas Reg §53.4958-4(b), that the compensation arrangement in its entirety is reasonable or that the property transfer is at fair market value. Treas Reg §53.4958-6(c)(2)(i). The following examples, though not exclusive, constitute relevant information:

- Compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
- Information regarding whether similar services are available in the organization's geographic area;
- Independent compensation surveys compiled by independent firms;
- Actual written job offers from similar institutions competing for the person in question; and
- Independent appraisals of the value of property involved in the transaction, as well as offers received as part of an open and competitive bidding process.

NOTE: Many organizations will not be able to qualify for the rebuttable presumption of reasonableness. Fortunately, the fact that a transaction does not qualify for the presumption does not create any inference that the transaction is an excess benefit transaction. Treas Reg §53.4958-6(e).

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§3.20 (1) Interested Directors

The regulations recognize that a board is likely to include persons with a conflict of interest and that corporate law in some states, such as California, may effectively require board approval of particular transactions in order to avoid self-dealing. If a director with a conflict of interest regarding a particular transaction meets with the other directors only to answer questions, and otherwise leaves the room and does not participate in the debate or vote on the transaction, the regulations exclude that director from the membership of the authorizing body for purposes of the first of these requirements. Treas Reg §53.4958-6(c)(1)(ii). Thus, a board with one or more interested directors may invoke the presumption of reasonableness by following this procedure.

NOTE: The regulations are stricter than California law, which only requires that the interested director abstain; it does not expressly require the director to leave the room during the debate and the vote. Corp C §§5233, 7233, 9243. See chap 9. At the same time, California law requires that the board make findings to avoid self-dealing that are not required under tax law. Under California law, the board would need to determine that there is not a better deal possible under the circumstances. Internal Revenue Code §4958 does not require such a finding.

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§3.21 (2) Safe Harbor for Small Organizations

The board or committee of an organization with annual gross receipts of less than $1 million will be considered to have obtained appropriate data if it gathers compensation data from "three comparable organizations in the same or similar communities for similar services." Treas Reg §53.4958-6(c)(2)(ii). This safe harbor allows the organization to avoid the significant expense of commissioning an independent salary survey. However, not all organizations can take advantage of this safe harbor. For example, small organizations that are affiliated with larger organizations are not permitted to invoke this rule. Treas Reg §53.4958-6(c)(2)(iii); see Treas Reg §53.4958-4(a)(2)(ii)(B). Nevertheless, the regulations do clarify that larger organizations may, when appropriate, compile their own data without the need to obtain an expensive independent salary survey.

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§3.22 (3) Rebutting the Presumption

If the criteria for presumption of reasonableness are satisfied, the IRS may impose penalty excise taxes only if it develops sufficient contrary evidence to rebut the evidence put forth by the parties to the transaction. For example, the IRS could establish that the compensation data relied on by the parties was not for functionally comparable positions, or that the disqualified person did not substantially perform the responsibilities of his or her position. A similar rebuttable presumption arises with respect to the reasonableness of the valuation of property sold, purchased, or otherwise transferred by an organization to or from a disqualified person, if the sale, purchase, or transfer is approved by an independent board that uses appropriate comparability data and adequately documents its determination.

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§3.23 (4) Reasonable Compensation

As a rule, compensation for the performance of services is reasonable only if it is an amount that would ordinarily be paid for like services by like enterprises under like circumstances. IRC §4958(c); Treas Reg §53.4958-4. Ordinarily, reasonableness is measured by looking at the circumstances existing on the date when the contract for services was made. If reasonableness of compensation cannot be determined based on circumstances existing at the date when the contract for services was made, then that determination is made based on all facts and circumstances existing up to and including the date of payment.

Compensation includes all items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services by a disqualified person, including but not limited to salary, fees, bonuses, and severance payments paid and all forms of deferred compensation that are earned and vested, whether or not funded. The regulation discusses in detail what items are and are not included in compensation. See Treas Reg §53.4958-4(b)(1)(ii)(B).

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.24 e. Adequate Documentation

§3.24 e. Adequate Documentation

To take advantage of the presumption of reasonableness discussed in §§3.19-3.23, the records of a board or committee must include the following (Treas Reg §53.4958-6(c)(3)):

- The terms of the approved transaction;
- The date on which it was approved;
- The members of the board or committee present during the debate on the transaction;
- The members of the board or committee who voted on the transaction;
- The comparability data that the board or committee relied on and how it was obtained;
- The actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body or committee but who had a conflict of interest with respect to the transaction or arrangement; and
- If the board or committee determines that a reasonable transaction would involve economic benefits higher or lower than the comparability data would indicate, the reasons for this determination.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.25 f. Deadline for Drafting Minutes

§3.25 f. Deadline for Drafting Minutes

To benefit from the presumption of reasonableness discussed in §§3.19-3.23, the organization must document its decision concurrently. It must prepare records by the later of 60 days or the next meeting of the approving body after the meeting at which final action was taken. The body must review and approve the records as reasonable, accurate, and complete within a reasonable time period after the final actions. Treas Reg §53.4958-6(c)(3)(ii).

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.26 g. Questionnaire: Creating Rebuttable Presumption of Reasonableness of Compensation

§3.26 g. Questionnaire: Creating Rebuttable Presumption of Reasonableness of Compensation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.3-3.55.

▶ To download **Word** version, right click and choose *Save Target As*

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1. Name of disqualified person:_____
2. Position under consideration:_____
3. Duration of contract (*e.g.,* 1 year, 3 years):_____
4. Proposed compensation:

   Salary:_____

   Bonus:_____

   Deferred compensation:_____

   Fringe benefits (list, excluding IRC §132 fringes):

   _____

   _____

   Liability insurance premiums:_____

   Foregone interest on loans:_____

   Other:_____
5. Description of types of comparability data relied on (*e.g*., association survey, phone inquiries):

   a._____

   b._____

   c._____

   d._____
6. Sources and amounts of comparability data:

   Salaries:_____

   Bonuses:_____

   Deferred compensation:_____

   Fringe benefits (list, excluding IRC §132 fringes):

   _____

   _____

   Liability insurance premiums:_____

   Foregone interest on loans:_____
7. Office or file where comparability data kept:_____
8. Total proposed compensation:_____
9. Maximum total compensation per comparability data:_____
10. Compensation package approved by authorized body:

    Salary:_____

    Bonus:_____

    Fringe benefits (list, excluding IRC §132 fringes):

_____

_____

Deferred compensation:_____

Liability insurance premiums:_____

Foregone interest on loans:_____

Other:_____

11. Date compensation approved by authorized body:_____

12. Members of the authorized body present (indicate with X if voted in favor):

_____

_____

_____

_____

_____

13. Comparability data relied on by approving body and how data was obtained:

_____

_____

14. Names of and actions (if any) by members of authorized body having conflict of interest:

_____

_____

15. Date of preparation of this documentation (must be prepared by the later of next meeting of authorized body or 60 days after authorized body approved compensation):_____

16. Date of approval of this documentation by board (must be within reasonable time after preparation of documentation above):

_____

Comment: This questionnaire is based on the IRS requirements for meeting the rebuttable presumption of reasonable compensation. See §§3.19-3.23.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.27 h. Penalties

§3.27 h. Penalties

The penalty structure of IRC §4958 is, in substance, both a penalty and a prohibition because it requires the recipient of the excess benefit not only to pay a penalty but to promptly return the excess amount to the organization. The statute imposes an initial excise tax directly on the disqualified person of 25 percent of the amount of the excess benefit. IRC §4958(a)(1). If the transaction is not corrected promptly (as by repayment of excessive compensation), the insider must pay a second tax of 200 percent of the excess benefit. IRC §4958(b). To "correct" a transaction, the parties must unwind the transaction to the extent possible and make restitution.

Organization managers may be taxed at 10 percent of the excess benefit, up to $20,000, if they knew that the transaction involved an excess benefit. IRC §4958(a)(2), (d)(2). There is no second-tier tax on organization managers. Managers subject to the tax include officers, directors, or trustees of the organization, or individuals with similar powers or responsibilities. IRC §4958(f)(2). The legislative history of IRC §4958 suggests that a person who regularly exercises general authority to make administrative or policy decisions on behalf of the organization will be considered an organization manager, despite his or her title. If more than one person is liable for a penalty excise tax, then all are jointly and severally liable. IRC §4958(d)(1).

NOTE: In particular, the regulations emphasize that a manager must *knowingly* engage in the transaction in order to be liable for a penalty, and that the manager may rely on a written, reasoned opinion of legal counsel, a qualified CPA, or other experts appropriate to the particular transaction. Treas Reg §53.4958-1(d)(4).

The IRS may abate the IRC §4958 first-tier penalty excise tax under IRC §4962 if the manager or the disqualified person shows that his or her participation was due to reasonable cause and not willful neglect and the transaction was corrected within 90 days of a notice of deficiency as provided in IRC §4963(e). Treas Reg §53.4958-1(c)(2)(iii).

NOTE: The IRS will consider compensation paid to a disqualified person that is not reported as compensation on the IRS Form 990 as an automatic excess benefit, subject to penalties.

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§3.28 i. Special Rules for Donor-Advised Funds and Supporting Organizations

The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) made significant changes to the excess benefits rules for both donor-advised funds and supporting organizations. Effectively, these rules prohibit a donor-advised fund from providing *any* financial benefit to a donor or an advisor to the fund. IRC §4958(c)(2), (f)(7)-(8). The PPA also prohibits any transactions between a supporting organization and a substantial contributor to the supporting organization, as well as any loan to any disqualified person of a supporting organization. IRC §4958(c)(3). For guidance on who are disqualified persons under these rules, see Notice 2006-109, 2006-51 Int Rev Bull 1121. Practitioners should expect additional regulations to be issued to clarify some of the other nuances of these new sections. For more detailed discussion, see chap 4.

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§3.29 4. Prohibition on Electioneering

A charity may neither support nor oppose candidates for public office. The IRS considers this prohibition absolute. The Chief Counsel's office has stated that "an organization described in IRC §501(c)(3) is precluded from engaging in *any* political campaign activities." (Emphasis added.) GCM 39694 (Jan. 21, 1988). Some activities that initially appear overly political may not, however, constitute prohibited electioneering. For example, when students in a political science course were required to participate in a political campaign of their choice as part of their course work, or when the college provided facilities and faculty advisers for a student newspaper that published student-written editorials on political matters, the IRS ruled that the college itself was not breaking the rules against supporting or opposing candidates. Rev Rul 72-512, 1972-2 Cum Bull 246; Rev Rul 72-513, 1972-2 Cum Bull 246. A charity is also allowed to register voters, to urge registered voters to vote, and to educate voters as long as its activities are nonpartisan. IRC §4945(f); Treas Reg §53.4945-3(b); Rev Rul 80-282, 1980-2 Cum Bull 178, amplifying Rev Rul 78-248, 1978-1 Cum Bull 154. In Rev Rul 2007-41, 2007-1 Cum Bull 1421, the IRS determined whether 21 different situations involved electioneering. For further discussion of electioneering, see chap 19.

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§3.30 5. Prohibition on Substantial Lobbying

A charity may not devote a substantial part of its activities to attempting to influence legislation. Alternatively, charities that are neither churches nor private foundations may elect to take advantage of IRC §501(h). Internal Revenue Code §501(h) defines the amount of lobbying that is permissible with reference to a charity's expenditures on lobbying; IRC §4911 imposes a 25-percent tax on excess lobbying expenditures.

Much advocacy commonly conducted by charities does not rise to the level of lobbying. A charity can attempt to influence the actions of government officials aside from legislative decisions, advocate its views through public interest litigation, convene conferences on public policy issues even when the issues are controversial, and express its views through advertising, all without engaging in "lobbying" as the IRS defines the term.

These issues are discussed in more detail in chap 19.

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C. Qualifying as Public Charity

§3.31 1. Public Charity Status Must Be Proved

Federal tax law divides charities into two categories: public charities and private foundations. Ordinarily, a charity is assigned to one of these categories when it applies for a determination of its tax-exempt status. Because private foundations (but not public charities) are subject to extensive regulations, and because donors to public charities may claim more generous tax benefits than can donors to most private foundations, an organization that has been classified as a public charity is well advised to monitor its operations to ensure that it retains its favored status. It is possible to regain public charity status after being reclassified as a private foundation, but it can be time-consuming and costly.

Under IRC §509(a), a charity is presumed to be a private foundation unless it can prove that it is a public charity. This preferred status may be attained as set forth in §§3.32-3.36.

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§3.32 2. Qualification Based on Activities

If a charity is described in IRC §170(b)(1)(A)(i)-(v), it is a public charity as a matter of law, based on the nature of its activities. The most frequently encountered charities of this type are churches, schools, hospitals, medical research organizations, and governmental units. IRC §170(b)(1)(A)(i)-(iii), (v).

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§3.33 a. Churches

The church category includes a convention or association of churches, and refers to synagogues, mosques, and similar congregations. Among the advantages of being in this category are that churches need not file the annual return required of other charities (such as IRS Form 990 or IRS Form 990-PF (see chap 12)), and it is more difficult for the IRS to audit a church. Not surprisingly, gaining initial classification as a church (when a church chooses to seek an IRS determination letter) can be a rigorous process because it may be the IRS's only opportunity to ensure that the organization is not a sham. Churches are also distinct from other charitable organizations in that they need not file a formal application for tax-exempt status in order to be exempt from tax. Treas Reg §1.508-1(a)(3)(i)(*a*). It is not unusual for churches, synagogues, and the like not to have a formal determination letter from the IRS, but they must file an exemption application with the Franchise Tax Board.

At least some of the following factors must be present if an organization is to qualify as a church for tax purposes: a distinct legal existence; a recognized creed and form of worship; an internal ecclesiastical government; a formal code of doctrine; a distinct religious history; a membership not affiliated with another church or denomination; ordained spiritual leaders who have completed a prescribed course of study; a literature of its own; a congregation that meets regularly; regularly held religious services; a program of religious instruction for young people; an established place of worship; schools for the preparation of ministers. An organization is not required to demonstrate all of these factors, however, and no single factor is determinative. The IRS looks at all the facts and circumstances in deciding whether an organization qualifies as a church. See IRS Pub 1828, Tax Guide for Churches and Religious Organizations.

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§3.34 b. Schools

Not all organizations with educational purposes can qualify as schools for purposes of public charity status. A "school" is defined in IRC §170(b)(1)(A)(ii) as "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." This definition is not limited to conventional educational institutions. See also Treas Reg §1.170A-9(c)(1). The IRS has granted school status to outdoor education programs, childbirth education programs, and others. Rev Rul 73-434, 1973-2 Cum Bull 71; Rev Rul 73-543, 1973-2 Cum Bull 343. Schools also must comply with certain nondiscrimination requirements described in Rev Proc 75-50, 1975-2 Cum Bull 587.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.35 c. Hospitals and Medical Research Organizations

§3.35 c. Hospitals and Medical Research Organizations

A charity whose principal purpose is providing medical or hospital care, medical education, or medical research can qualify as a public charity. IRC §170(b)(1)(A)(iii). The hospital category includes outpatient clinics, community mental health or drug treatment centers, and the like. Treas Reg §1.170A-9(d)(1). It is restricted to caring for humans; free clinics for animals do not qualify as public charities under this statute. Rev Rul 74-572, 1974-2 Cum Bull 82. The medical research category includes organizations that are "primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital" and that satisfy either an assets test or an endowment test. Treas Reg §1.170A-9(d)(2).

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§3.36 3. Qualification Based on Public Support Under IRC §§170(b)(1)(A)(vi) and 509(a)(1)

A charity will qualify as a public charity under IRC §§170(b)(1)(A)(vi) and 509(a)(1) if it receives financial support from a sufficiently broad base of donors. The charity must satisfy one of two mathematical public support tests, both of which measure public support as a fraction of total support. See table in §3.43. Charities that depend on income from the performance of their exempt functions (*e.g.,* income from the sale of educational materials, admission fees for musical or theatrical performances, and the like) for a significant proportion of their revenues will probably not find either IRC §170(b)(1)(A)(vi) test appropriate and should look instead to the public support test of IRC §509(a)(2), discussed in §3.40.

A publicly supported charity described in IRC §§170(b)(1)(A)(vi) and 509(a)(1) must provide information each year on its tax return, IRS Form 990, Schedule A, to demonstrate that it has satisfied the mathematical public support test. A new organization will not be judged on its public support percentage for its first five years. In its sixth year, it will be evaluated based on support received in its second through sixth years and, failing that, on support received in its first through fifth years. If it fails based on both years two through six and one through five, it will be reclassified as a private foundation. Treas Reg §§1.509(a)-3T(d), 1.170A-9T(f)(4).

For an established charity that has been in existence for more than 6 years, the public support test continues to apply on the basis of a 5-year rolling average. Treas Reg §§1.509(a)-3T(c), 1.170A-9T(f)(4). If an organization qualifies as publicly supported during any 5-year period, it qualifies as a public charity for the 2 years including the fifth year of the 5-year measuring period and the following year. For example, the year 2009 tax return would show the public support information for the years 2009-2005. If the organization satisfies the support test for the years 2009-2005, then it is considered a public charity for both 2009 and 2010.

WARNING: The public support test rules and measuring periods changed dramatically in 2008. Practitioners who have not reviewed the rules recently should read the Temporary Regulation that IRS issued on September 9, 2008: Treas Reg §§1.170A-9T(f). This Regulation eliminates what used to be known as the "advance ruling period," and also clarifies provisions of the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780). For organizations that already have advance ruling letters from the IRS, the new rules apply to organizations whose advance ruling periods expire after June 8, 2008. These organizations can effectively consider their advance ruling letters to be final determination letters.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.37 a. Calculating Public Support Test

§3.37 a. Calculating Public Support Test

The public support test itself is a fraction, the denominator of which is total support during the measuring period (a 5-year rolling period) and the numerator of which is public support. Total support consists of all gifts, grants, donations, membership fees, gross investment income (but not capital gains), taxable income from unrelated business activities (less the amount of tax imposed on that income), and most other types of revenue. Total support does not include gross receipts from exempt-function activities. IRC §509(d); Treas Reg §1.170A-9T(f)(7). Public support (*i.e.,* the numerator of the fraction) is more narrowly defined. Government grants are included in full, but government contracts are considered exempt function income and are excluded from both the numerator and the denominator. Treas Reg §1.170A-9T(f)(8). Gifts, grants, contributions, and membership fees from other public charities described in IRC §§170(b)(1)(A)(vi) and 509(a)(1) are counted in full. As for gifts, grants, contributions, and membership fees from all other sources, the charity must multiply its total support during the period by 2 percent to calculate how much may be counted from each source toward public support. Gifts, grants, contributions, and membership fees from each source are computed in the aggregate during the period in question. Treas Reg §1.170A-9T(f)(6).

Amounts from certain related family members, and from businesses and their major owners, are combined and ordinarily treated as coming from one source. However, if a donor and the donor's family foundation both make gifts to a public charity, the gifts are treated as coming from different sources. Treas Reg §1.170A-9T(f)(6)(i). If funds received from a particular source during the period add up to 2 percent or less of total support, funds from that source may be counted in the numerator in full. Larger gifts, grants, contributions, and membership fees may be included in the numerator as public support up to the 2-percent figure, but the excess does not count as public support. For purposes of the 2-percent limitation, unusual grants may be excluded from both the numerator and the denominator. Treas Reg §1.170A-9T(f)(6)(ii).

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§3.38 b. The One-Third Test

If the computation results in a public support fraction of one-third or more, the charity automatically qualifies as a public charity. Treas Reg §1.170A-9(e)(2).

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§3.39 c. The Facts and Circumstances Test

If the public support fraction is less than one-third, the charity can still qualify as a public charity if the fraction is at least one-tenth and the charity satisfies a facts and circumstances test. Treas Reg §1.170A-9T(f)(3). Thus, it is possible for a charity to derive a substantial portion—indeed, up to 90 percent—from a single source and still qualify as a public charity if the facts and circumstances indicate that the charity looks and functions more like a public charity than a private foundation. Some of the key facts and circumstances, no one of which is dispositive, include maintaining a continuous and bona fide program to attract public support, maintaining a governing body that is broadly representative of the public interest, having a large number of donors even if they contribute small amounts, maintaining a public support percentage that is closer to one-third than one-tenth, and offering programs and services that are visible and available to the public.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/ 4. Qualification Under IRC §509(a)(2)/§3.40 a. Qualification Based on Public Support

4. Qualification Under IRC §509(a)(2)

§3.40 a. Qualification Based on Public Support

A charity may qualify as a public charity under IRC §509(a)(2) if (1) it derives at least one-third of its total support from sufficiently diverse sources, including donors and consumers of its exempt-purpose goods or services, and (2) it derives no more than one-third of its total support from investment income. Both tests must be satisfied for the corporation to qualify as a public charity. IRC §509(a)(2).

Calculating investment income test. As in the donative public charity support tests described in §3.36, the first step is to calculate the denominator, *i.e.,* the amount of total support for the period. For public charities qualifying under IRC §509(a)(2), the denominator is defined differently. It includes not only donative income, investment income, unrelated business income, and the value of governmental services and facilities above those normally provided to the public, but also includes gross receipts from admissions, merchandise sold, services performed, facilities furnished, or other income-generating activities related to the charity's exempt purposes. IRC §509(d). The sum of these items for the period in question is the denominator of the fraction for each of the two IRC §509(a)(2) tests. See table at §3.41.

To satisfy the IRC §509(a)(2) investment income test, a charity must normally receive no more than one-third of its total support from gross investment income (other than capital gains) and unrelated business taxable income (less the tax on that income). "Normally," under Treas Reg §1.509(a)-3T(c)(1)(i), means that "the aggregate amount of the support received from [investment income and unrelated business taxable income] is not more than one-third, of the total support of the organization for such 5-year period." Thus, it is possible to exceed the one-third ceiling on investment in 1 year during the period and still pass the test if the fraction, computed over the aggregate measuring period, is still less than one-third. Because investment income is subject to a strict ceiling and gross receipts must reach a specified floor, it is important to categorize receipts accurately. Under Treas Reg §1.509(a)-3(m), interest received under a loan program serving a charitable class of borrowers by making credit available at below-market interest rates should be treated as gross receipts from a related activity, not as investment income.

NOTE: To summarize: At the end of each measuring period, the charity must compute a fraction whose denominator is total support and whose numerator is non-capital-gain gross investment income and unrelated business taxable income net of tax. If this fraction is more than one-third, the charity does not qualify as a public charity under IRC §509(a)(2) even if it meets the public support test of that statute.

Test as threshold. The public support test of §509(a)(2) is not a ceiling, but a threshold. The charity must derive at least one-third of its total support from donations, membership fees, and gross receipts from the performance of its exempt functions. Although all such revenues in the measuring period must be included in the denominator, the amount that may be included in the numerator depends on the source and amount of funds, as shown in the tables in §3.41.

Lack of flexibility. Unlike the public support test for charities that rely primarily on donative income and investment income, there is no flexibility in IRC §509(a)(2). Facts and circumstances are not considered; the tests are strictly mathematical. It is thus essential for public charities using this test to monitor their receipts regularly for compliance with the investment income ceiling and the public support minimum requirements. In addition, charities that receive grants from governmental agencies or from IRC §509(a)(1) public charities should bear in mind that grants from these organizations are counted in full as public support, while fees for services or products are subject to the $5000/1-percent annual ceiling. The line between grants and gross receipts is not always clear, especially if the charity is producing a service or a product at the funder's request. The fundamental questions are: What is the charity providing in return for the payment, and who is receiving the product? If the charity provides the payor organization with a service or a product that primarily benefits the public rather than primarily benefiting the funder, the IRS is more likely to treat the payment as a grant.

Many practitioners, including exempt organization specialists, find these public support tests to be both illogical and cumbersome, and they have argued for simplifying the tests and perhaps eliminating the separate IRC §509(a)(2) test

altogether.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.41 b. Tables: Ascertaining Numerator of Public Support Fraction

§3.41 b. Tables: Ascertaining Numerator of Public Support Fraction

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Gifts, Grants, Bequests, Memberships: How Much Is Included in Numerator of IRC §509(a)(2) Public Support Fraction?

Source	Includable Amount
A governmental bureau or unit	100%
An IRC §509(a)(1) public charity	100%
A disqualified person as defined in IRC §4946	None
Individuals and entities that have not become disqualified persons by the end of the measuring period	100%

Gross Receipts From Performing Tax-Exempt Functions: How Much Is Included in Numerator of IRC §509(a)(2) Public Support Fraction?

Source	Includable Amount
A governmental bureau or unit	Amounts received in a taxable year up to the greater of $5000 or 1% of the total support received by the charity in that taxable year
An IRC §509(a)(1) public charity	Amounts received in a taxable year up to the greater of $5000 or 1% of the total support received by the charity in that taxable year
A disqualified person as defined in IRC §4946	None
Individuals and entities that have not become disqualified persons as of the end of the taxable year	Amounts received in a taxable year up to the greater of $5000 or 1% of the total support received by the charity in that taxable year

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5. Mathematical Public Support Tests

§3.42 a. Differences Between Tests

The public support test of IRC §509(a)(2), with its ceiling on investment income and its treatment of large donors and contractors (see §3.40), is less flexible than that of IRC §§170(b)(1)(A)(vi) and 509(a)(1). A charity that derives most of its receipts from exempt function income, however, may be able to qualify as a public charity under IRC §509(a)(2). Because §509(a)(2) has no facts and circumstances test to fall back on, charities within its scope should monitor their receipts with great care. Indeed, any organization that qualifies as a public charity under one of the mathematical public support tests should analyze its receipts well before the end of the applicable tax period. The charity may then increase or reduce receipts in appropriate categories to retain its public charity status. The table in §3.43 compares the items of income included in the numerator and denominator of each mathematical public support test.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.43 b. Table: Comparison of Mathematical Public Support Tests

§3.43 b. Table: Comparison of Mathematical Public Support Tests

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Comparison of Mathematical Public Support Tests

	Included Under IRC §509(a)(2)?		**Included Under IRC §§170(b)(1)(A)(vi) and 509(a)(1)?**	
	Numerator	**Denominator**	**Numerator**	**Denominator**
Grants from governmental units	Yes	Yes	Yes	Yes
Membership fees	Yes	Yes	Yes	Yes
Grants or contributions from entities described in IRC §§170(b)(1)(A)(i)-(v)	Yes	Yes	See Notes 1, 2	Yes
Grants or contributions from entities described in IRC §170(b)(1)(A)(vi)	Yes	Yes	Yes	Yes
Grants or contributions from individuals, trusts, private foundations, or public charities described in IRC §509(a)(2) or (3) that are not disqualified persons	Yes	Yes	See Note 1	Yes
Grants or contributions from above sources that are disqualified persons	No	Yes	See Note 1	Yes
Exempt function income up to greater of $5000 or 1% of total support from each permitted	Yes	Yes	No	No

source				
Exempt function income over the limit from permitted sources or any amount from other sources	No	Yes	No	No
Investment income	No	Yes	No	Yes
Unrelated business income	No	Yes	No	Yes
Benefit from tax revenues	Yes	Yes	Yes	Yes
Value of services or facilities furnished by government without charge (other than what is normally available)	Yes	Yes	Yes	Yes
Capital gains, loans, unusual grants, and value of tax exemption	No	No	No	No

Note 1: Amount of contribution from any one contributor (excluding unusual grants) includable as public support may not exceed 2 percent of organization's total support for applicable period (excluding unusual grants).

Note 2: Two-percent limit does not apply to contributions from contributors that meet public support test of IRC §170(b)(1)(A)(vi) even if they also qualify under IRC §170(b)(1)(A)(i)-(v). See Rev Rul 76-416, 1976-2 Cum Bull 57, made obsolete in part by Rev Rul 88-85, 1988-2 Cum Bull 333; Rev Rul 78-95, 1978-1 Cum Bull 71.

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§3.44 6. Qualification Based on Affiliation Under IRC §509(a)(3)

A charity may qualify as a public charity under IRC §509(a)(3) by virtue of its relationship with one or more other public charities that it is organized and operated to support. Such a supporting organization public charity ("SO charity") does not need to monitor the sources of its financial support as do public charities that base their status on the mathematical tests described in §3.42. Donors who are contemplating the formation of private foundations should consider the supporting organization as an alternative, particularly if the donor wishes to give appreciated assets or otherwise benefit from giving to a public charity.

WARNING: Practitioners, particularly those who may already have formed IRC §509(a)(3) organizations in the past, need to review the rules carefully in light of changes made by the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780). Treasury Regulations under IRC §509 have not been completely updated to reflect the changes in the PPA, although some guidance has been issued. See, *e.g.,* proposed regulations, REG-155929-06, 74 Fed Reg 48672 (2009) and IRS Notice 2006-109, 2006-51 Int Rev Bull 1121, superseded in part by Rev Proc 2009-32, 2009-28 Int Rev Bull 142. In addition to the changes to the definitions in IRC §509, practitioners should be aware of changes to IRC §§4942 and 4945, which limit the ability of a private foundation to make qualifying distributions to certain types of SOs and which require that such grants be expenditure responsibility grants. See §4.44. In addition, certain SOs are now subject to the excess business holding rules under IRC §4943, which previously affected only private foundations. See §4.41.

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D. Private Foundations

§3.45 1. Default Classification

If a charity does not qualify as a public charity under any of the tests discussed above, it is classified by default as a private foundation. The typical private foundation is a family foundation or company foundation that depends for its revenues on the income from its endowment, current contributions from the family or business, or both. It is very important from a tax planning standpoint to determine before the first contribution is made whether the organization is likely to qualify as public charity or as a private foundation. Certain donations to private foundations receive less favorable tax treatment. See §15.27. In addition, private foundations are subject to more rigorous operating restrictions. See §§4.24-4.46.

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§3.46 2. General Governing Statutes

All private foundations are subject to the technical rules of IRC §§4940-4948. Some of these restrictions are modified for private operating foundations and exempt operating foundations. Practitioners should exercise extreme caution in providing advice on these highly technical, and often counterintuitive, private foundation rules because the specific penalties for violating any of them can be severe.

Practitioners who have worked with private foundations in the past should be aware that many of the excise taxes were significantly increased in 2006 as part of the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780). For a detailed discussion of the rules affecting private foundations, see §§4.23-4.55.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.47 E. Other Tax-Exempt Organizations

§3.47 E. Other Tax-Exempt Organizations

The bulk of this chapter discusses IRC §501(c)(3) organizations. The table in §3.3 describes the other types of exempt organizations under IRC §501(c). In most situations, contributions to these other organizations are not tax-deductible as charitable contributions, but the organization itself is exempt from income tax, with certain modifications. Several of these other categories of exemption are worth exploring in more detail. See §§3.48-3.50.

NOTE: Organizations seeking an exemption under IRC §501(c) other than under IRC §501(c)(3) complete a different exemption application form—IRS Form 1024, not IRS Form 1023. Form 1024 is available on the IRS website at http://www.irs.gov/formspubs.

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§3.48 1. Social Welfare Organizations and Civic Leagues (IRC §501(c)(4))

Primarily engaged in promoting social welfare. Nonprofits that are organized and operated exclusively to promote social welfare are exempt under IRC §501(c)(4). As with IRC §501(c)(3), "exclusively" really means "primarily." Donors to these organizations ordinarily do not receive a charitable or other tax deduction, and in some cases, donations may arguably be subject to gift tax. See, *e.g.,* Rev Rul 82-216, 1982-2 Cum Bull 220.

An organization is considered to promote social welfare if it is "primarily engaged in promoting in some way the common good and general welfare of the people of the community." A social welfare organization typically works to bring about tangible or intangible "civic betterments and social improvements." The term "social welfare" can include activities that also might qualify as charitable under IRC §501(c)(3). Treas Reg §1.501(c)(4)-1(a)(2)(i).

PRACTICE TIP: Practitioners should keep in mind that IRC §501(c)(4) organizations are still subject to IRC §4958 (see §3.16) as well as limitations on commercial activity and unrelated business taxable income (see chap 17).

Section 501(c)(4) organizations in California are normally set up as nonprofit public benefit corporations under Corp C §§5110-6910. These organizations often are formed to engage in activities that are designed to influence legislation (lobbying). Section 501(c)(4) organizations also are permitted to devote some of their efforts toward taking positions in support of or opposition to candidates for office, as long as candidate activity is not the primary purpose. For a detailed discussion of lobbying and political activities, see chap 19.

Local employee associations. Associations of employees may qualify for exemption under IRC §501(c)(4). To qualify (Treas Reg §1.501(c)(4)-1(b)):

- The membership of the organization must be limited to the employees of a designated person or persons in a particular municipality; and
- The net earnings of the association must be devoted to charitable, educational, or recreational purposes.

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§3.49 2. Business Leagues and Trade Associations (IRC §501(c)(6))

Internal Revenue Code §501(c)(6) provides an exemption for business leagues, chambers of commerce, and trade associations. The terms "business league" and "trade association" are used interchangeably in analysis of IRC §501(c)(6). Section 501(c)(6) organizations in California are typically established as nonprofit mutual benefit corporations under Corp C §§7110-8910, with voting members.

Promoting line of business. To qualify for exemption under IRC §501(c)(6), a business league or trade association must be established to promote a particular line of business, which can be broadly defined, such as all attorneys in a particular city or all U.S. toy manufacturers; or narrowly defined, such as independent booksellers in a particular geographic region. In *National Muffler Dealers Ass'n, Inc. v U.S.* (1979) 440 US 472, 59 L Ed 2d 519, 99 S Ct 1304, the Court held that an association of Midas Muffler franchisees was not fully representative of an entire line of business and therefore not exempt under IRC §501(c)(6). More recently, the IRS denied exempt status to a purported §501(c)(6) business league in *Bluetooth SIG v U.S.* (WD Wash, Feb 1, 2008, No. C05-1778-JCC) 2008 US Dist Lexis 7576.

No private inurement. No part of a §501(c)(6) organization's net earnings can inure to the benefit of any private individual. See discussion of private inurement in §3.15.

NOTE: A member of an IRC §501(c)(6) organization usually claims a business deduction under IRC §162, because membership in the organization is intended to further the business interests of the contributor.

Trade associations are permitted to operate trade shows and conferences for their members and the public; they often publish periodicals, have an informational website, and engage in other activities that promote their line of business. They are permitted to engage in some lobbying and political activity. See chap 19. They are also subject to the tax on unrelated business taxable income. For example, some of the income from a trade show may be taxable. IRC §513(d)(3); Treas Reg §1.513-3(c)(2). See chap 17.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.50 3. Social Clubs (IRC §501(c)(7))

§3.50 3. Social Clubs (IRC §501(c)(7))

Internal Revenue Code §501(c)(7) exempts clubs that are organized and operated exclusively for pleasure, recreation, and other related nonprofit purposes and if no part of the net earnings inures to the benefit of any private person. Treas Reg §1.501(c)(7)-1. The IRS will likely deny exemption to a club, such as an automobile club, that is organized for purposes other than recreational and social purposes. See, *e.g., Chattanooga Auto. Club v Commissioner* (6th Cir 1950) 182 F2d 551; *Keystone Auto. Club v Commissioner* (3d Cir 1950) 181 F2d 402. These clubs in California are typically organized as nonprofit mutual benefit corporations under Corp C §§7110-8910, with either voting or nonvoting members.

Income limitations. A social club operates under somewhat different, and more complex, rules from other IRC §501(c) organizations in regard to how much income it may receive from different sources and still maintain its exemption. The IRS has developed standards based on a reading of the legislative history. The IRS maintains that a club is assumed to receive most of its income from member dues and fees. It may receive up to 35 percent of its gross receipts, including investment income, from sources outside of its membership without losing its exempt status. Of that 35 percent, not more than 15 percent may be derived from the use of the club's facilities or services by the general public or from activities not furthering the social or recreational purposes of the members. S Rep No. 94-1318, 94th Cong, 2d Sess (1976), reprinted in 1976-2 Cum Bull 597; *Skillman Family Reunion Fund, Inc. v U.S.* (ND Ohio 2002) 196 F Supp 2d 543.

NOTE: All club income other than exempt-function income from members and member dues is treated as unrelated taxable business income. Therefore, unlike other exempt organizations, clubs pay taxes on investment income and other income from unrelated business activities. There are many nuances to these income rules, and any organization forming a club would be advised to review these rules closely.

Discrimination prohibited. Social clubs may not discriminate on the basis of race, color, or religion. However, an exception applies for organizations that do not discriminate on the basis of race or color but that are designed to further the teachings or principles of a particular religion. IRC §501(i).

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§3.51 F. Unrelated Business Income

At the planning stage, it is essential to consider whether part or all of the income that might be generated by the organization's activities will be taxable as unrelated business income. If the organization will generate significant taxable income, it should consider, from the outset, whether it is actually carrying out any legitimate exempt purpose. If it is, and will therefore qualify for tax exemption, the organization should consider whether its purposes would be better served by moving those taxable activities into a for-profit subsidiary or a separately owned corporation.

For a more detailed discussion of unrelated business income, see chap 17.

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§3.52 G. Federal Tax Deductions

The tax treatment of donors must be considered in the forming and planning stages because the availability of tax deductions substantially shapes decisions about what type of entity to form. Very different rules apply to limit the tax deductions available to corporate and individual donors. Similarly, individuals may receive a very different tax deduction, depending on the tax status of the charity and whether the contribution takes the form of cash, real estate, tangible personal property, or intangible personal property.

For example, if a donor intends to contribute highly appreciated real estate to a new organization and expects to take a charitable tax deduction, it may not be prudent to establish a private foundation because the donor's tax deduction will be limited to his or her basis in the real estate. IRC §170(e)(1). In that event, one should consider whether the foundation might qualify as a private operating foundation and, if not, whether it might somehow qualify as a public charity, such as an IRC §509(a)(3) supporting organization.

For a more detailed discussion of the tax treatment of charitable contributions, see chap 15.

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§3.53 1. Individual Donors

An individual donor may ordinarily deduct contributions made to public charities on terms more favorable than for those made to private foundations. In analyzing the deductibility of any contribution, one must ask four questions:

- What is being contributed: money, real estate, tangible personal property, or intangible personal property?
- Is the recipient charity a standard private foundation, on the one hand, or a public charity, private operating foundation, pass-through foundation, or common fund, on the other?
- If property, rather than money, is being contributed, is the property intended to be used in a way that is related to the organization's exempt purpose (*e.g.,* a painting that is contributed to a museum)?
- If property, rather than money, is being contributed, what is the character of the property in the hands of the donor: inventory, long-term capital gain property, or short-term capital gain property?

Deduction limits. An individual's deduction is limited in two ways: First, depending on the answers to the preceding questions, the donor's deduction will be based on either the fair market value of the cash or property being contributed or the donor's tax basis in the property. IRC §170(c), (e). Second, again depending on the answers to the preceding questions, the donor will be able to claim a deduction for the year of contribution equal to a maximum of either 50, 30, or 20 percent of the donor's adjusted gross income for the year, with unused amounts being carried forward for up to 5 years. IRC §170(b)(1).

NOTE: These limitations on deductions apply only to income tax deductions for inter vivos gifts. Bequests are governed by the estate tax laws. See California Will Drafting, chaps 13-14 (3d ed Cal CEB 1992).

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§3.54 2. Corporate Donors

Like an individual donor, a corporate donor may deduct only its cost or other basis, rather than fair market value (FMV), in certain types of property, as reflected in the table in §3.55. Also, corporate donors are subject to different percentage limits: They may deduct no more than 10 percent of their taxable income in any one year, with a 5-year carryforward. IRC §170(b)(2)(A), (d)(2). The corporate donor's limitation to 10 percent of taxable income is not affected by whether the donee is a public charity or a private foundation.

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Charitable Contribution Deductions for Individuals

Form of Gift	**Amount of Deduction for Gifts to Public Charities or Private Operating Foundations IRC §170(e)[1]**	**Percent Limitation on Gifts to Public Charities or Private Operating Foundations IRC §170(b)[2]**	**Amount of Deduction for Gifts to Private Foundations IRC §170(e)[1]**	**Percent Limitation on Gifts to Private Foundations IRC §170(b)[2]**
Cash	Face value	50%	Face value	30%
Intangible Property[3] (*e.g.,* securities)				
Qualified appreciated stock[4]	FMV[5]	30%	FMV	20%
Long-term capital gains	FMV[5]	30%	Basis[6]	20%
Short-term capital gains	Basis[7]	50%	Basis[6]	30%
Real Estate				
Long-term capital gain property	FMV[5,9]	30%[5.10]	Basis[6]	20%
Short-term capital gain property	Basis[7]	50%	Basis[6]	30%
Tangible Personal Property[8]				
Unrelated use, long-term capital gains	Basis[6]	50%	Basis[6]	20%
Unrelated use—short-term capital	Basis[6]	50%	Basis[6]	30%

gains				
Related use —long-term capital gains	FMV[5]	30%	Basis[6]	20%
Related use —short-term capital gains	Basis[7]	50%	Basis[6]	30%
Ordinary[11] income property—inventory	Basis [7]	50%	Basis[6]	30%

[1] The "Amount of Deduction" is determined at the date of the gift. The Amount of Deduction can be used to offset a percentage of the donor's Adjusted Gross Income in the year of the gift, up to the amount set forth in the "Percentage Limitation" columns. The Amount of Deduction not used in the year of the gift can be carried forward for 5 years. No deduction is allowed unless the gift is substantiated as required by the IRS regulations.

[2] If the property is given "for the use of" instead of "to" the charity, the deduction will be limited to 20 percent of the donor's Adjusted Gross Income (whether the gift is made to a private foundation or a public charity). The phrase "for the use of" refers to indirect contributions made in trust. For example, if a donor creates a nongrantor charitable lead trust, or a charitable remainder trust where the charity does not receive an outright distribution at the death of the income beneficiaries, the gift qualifies as being made "for the use of" the beneficiary charity. (A gift to a charitable remainder trust is considered "to" the beneficiary charity if the charity gets a lump-sum distribution at the termination of the trust, and not just an income interest.)

[3] Contributions of patents, copyrights, and some other intellectual property assets receive special treatment. Gifts of partnership interests also raise additional issues.

[4] Qualified appreciated stock is certain unrestricted, publicly traded stock held for more than 1 year. See IRC §170(e)(5). Qualified appreciated stock donated to a private foundation is treated differently from other intangible long-term capital gains property.

[5] The amount of the deduction is the gift's FMV, and the percentage limitation is 30 percent. Alternatively, the donor may elect to have the amount of the deduction limited to the donor's basis (or FMV if lower, see Note 6), and have the percentage limitation increased to 50 percent.

[6] The deduction is FMV minus the amount of ordinary income or long- or short-term capital gain that would be realized if the asset were sold, which results in a deduction equal to basis, provided that if the basis exceeds FMV, the deduction is limited to FMV.

[7] The deduction is FMV minus the amount of ordinary income or short-term capital gain that would be realized if the asset were sold, resulting in a deduction equal to basis; however, if the basis exceeds FMV, the deduction is limited to FMV.

[8] Special rules limit the deductibility of vehicle donations. For vehicles donated to a charity for an unrelated use, the deduction is limited to the gross sales price the charity receives for the vehicle.

[9] The amount of the deduction is reduced by any ordinary income that would be realized if the property were sold (for example, if there would be income from depreciation recapture on sale).

[10] Qualified conservation contributions are deductible up to 50% of AGI (100% for qualified ranchers or farmers), and

the excess may be carried forward for 15 years.

[11] There are a variety of special deduction rules for some types of inventory.

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III. CALIFORNIA TAX ISSUES

A. Tax Exemptions

§3.56 1. Franchise Tax

California imposes a franchise tax, similar to an income tax, on any corporation that does not otherwise qualify for exemption. In some states, a corporation is automatically exempt from state income tax by filing for and obtaining an IRS determination letter. Until January 1, 2008, California required corporations to file separately for tax-exempt status, although most of the requirements for exemption are the same as the federal requirements. As of January 1, 2008, corporations that have received an IRS determination letter under IRC §501(c)(3) are not required to file a complex application in California. They simply provide a copy of the IRS letter along with a new short-form application, FTB Form 3500A, for automatic state exemption. Rev & T C §23701d(c)(1). Form 3500A is available on the Franchise Tax Board website at http://www.ftb.ca.gov/forms/index.shtml.

NOTE: Non-§501(c)(3) organizations still must file for exemption in California.

The table in §3.3 shows the sections of the Revenue and Taxation Code that correspond to the IRC sections. Most corporations that are eligible for federal tax exemption under IRC §501(c)(3) are also eligible for California tax exemption under Rev & T C §23701d.

NOTE: If an organization's federal tax-exempt status under IRC §501(c)(3) is suspended or revoked, the organization must notify the Franchise Tax Board. On notification, the FTB will suspend or revoke, as applicable, for state income tax purposes, the organization's automatic tax-exempt status. Rev & T C §23701d(c)(2).

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§3.57 2. Property Tax

California taxes the real and personal property of all businesses. Some property held by an exempt organization is exempt from taxation. This is particularly significant for organizations holding valuable real estate.

For an organization with educational purposes, certain language may be specifically required in the articles of incorporation for the organization to qualify for a property tax exemption. Absent precise language, county assessors often refuse to grant property tax exemptions. For examples of appropriate language, see §§11.10-11.11.

The property tax exemption does not precisely match the income or franchise tax exemption. As a result, it is not unusual to find a charitable organization that qualifies for the income tax exemption, but not for the property tax exemption. Property taxes are discussed in more detail in chap 11.

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§3.58 3. Sales Tax

As a general rule, nonprofit organizations, like any commercial vendor, pay sales tax on sales of tangible personal property. For example, if a nonprofit corporation plans to sell tee shirts or compact discs, even if they are directly related to the organization's exempt activity, the organization will likely be required to pay sales tax. For discussion of the specific and very limited exceptions to this general rule, see §§8.31-8.57.

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§3.59 B. California Tax Deductions

For the most part, California's tax deductions mirror the federal tax deductions discussed in chap 15. Practitioners should not forget, however, to consider California tax statutes in evaluating the deductibility of particular gifts, particularly if the federal provision in question is newly enacted or provides a transitional window.

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IV. THE APPLICATION PROCESS

A. Federal Exemption Under IRC §501(c)(3)—IRS Form 1023

§3.60 1. Who Must File?

Most organizations seeking exemption under IRC §501(c)(3) must prepare and file a tax-exemption application on IRS Form 1023. IRC §508. Form 1023 is available on the IRS website at http://www.irs.gov/formspubs. Otherwise, the organization, even if it otherwise qualifies under IRC §501(c)(3), will not be treated as tax-exempt and will not be eligible to receive tax-deductible charitable contributions. IRS Publication 557 provides a good discussion of the issues involved in completing the exemption application, and the instructions to both IRS Form 1023 and IRS Form 990 will prove helpful as well.

If an exempt organization intends to be the parent in a group of exempt organizations, it might consider obtaining a group tax exemption. The procedures for obtaining a group tax exemption are described in IRS Publication 4573 and set forth in Rev Proc 80-27, 1980-1 Cum Bull 677, as modified by Rev Proc 93-23, 1993-1 Cum Bull 538, and Rev Proc 96-40, 1996-2 Cum Bull 301.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.61 2. Exceptions to Filing Requirement

§3.61 2. Exceptions to Filing Requirement

Some organizations are not required to file IRS Form 1023. These organizations include (IRC §508(c); Treas Reg §1.508-1(a)(3)(i)-(ii)):

- Subordinate organizations covered by a group exemption letter;
- Churches, their integrated auxiliaries, such as religious schools and youth groups, and conventions or associations of churches; and
- Organizations, other than private foundations, with annual gross receipts that do not normally exceed $5000.

Small organizations and churches may nevertheless find it advantageous to file because it may be difficult to convince potential donors to make contributions without having the IRS determination letter in hand.

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§3.62 3. Time of Filing

If an organization wants its tax-exempt status to be retroactive to the date it was incorporated or otherwise organized, it must file IRS Form 1023 within 27 months after the end of the month of incorporation. (Treasury Regulation §1.508-1(a)(2) provides 15 months to file, and Treas Reg §301.9100-2(a)(2)(iv) provides an automatic 12-month extension.) In rare situations, an organization that fails to file within the 27 months will be granted an additional extension if it can show that it acted reasonably and in good faith, and that the extension will not prejudice the government's interests. See Treas Reg §§301.9100-1, 301.9100-3.

An organization that fails to meet the 27-month deadline may still file for exemption. However, the exemption will be effective as of the date of filing, rather than as of the date of incorporation.

PRACTICE TIP: It is always wise to file the exemption application as soon as reasonably possible after incorporation. Donors who are not insiders to an organization will be reluctant to donate until the organization has its IRS letter in hand. Also, it is helpful to have the IRS letter before filing the first tax return for the organization.

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§3.63 4. How and Where to File

The current IRS Form 1023 is available on the IRS website at http://www.irs.gov/formspubs. The form includes clear instructions on where to file and the amount of the filing fee. The address to which it should be sent is specified on the form.

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§3.64 5. Tips on Completing Form and Supporting Documentation

The instructions on IRS Form 1023 provide most of the information the practitioner will need; however, he or she might also consider the following practical tips:

- If the practitioner wants to receive copies of IRS correspondence and be able to speak with IRS agents, he or she must complete and submit the power of attorney form (IRS Form 2848).
- While a conflict of interest policy is not legally required, IRS Form 1023 specifically asks if the organization has adopted one. Having a conflict of interest policy that can be adopted and provided to the IRS is both good corporate policy and will likely diffuse some of the questions that the reviewing agent may have.

NOTE: The newly designed tax return IRS Form 990 also asks a series of questions about the charity's governance structure and about whether the charity has additional policies, such as a document retention policy. In order to fully advise a charity in formation, the practitioner should be familiar with the questions asked on the core portion of IRS Form 990. For additional discussion on completing Form 990, see chap 12.

- The practitioner should include an attachment for each question that requires additional space to answer. The author recommends submitting a single document that contains all attachment information, clearly identifies the question being answered, and includes the organization's name and EIN at the top of each page.
- The practitioner should make sure to complete every schedule that is applicable.
- If a public charity's projected compensation is on the high side, the application should make clear that the organization has been advised on and understands IRC §4958 (see §§3.16-3.27) and has taken, or will take, steps to follow §4958 before approving the compensation.
- It is important that the organization understand whether it is a private foundation and, if it is not, the way in which it will qualify as a nonprivate foundation.

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§3.65 6. The IRS Determination Letter

After the IRS receives and screens an exemption application, it usually sends a Notice of Receipt to the organization's designated representative. If the application is complete and the IRS feels that there are no further issues to address, the organization may receive its IRS determination letter in as few as 4 weeks.

In many situations, however, the IRS will ask for additional information and provide a deadline for responding. The organization will normally be given an automatic 2-week extension to respond, if it requests one. Depending on the complexity of the application and the number of applications under review, the organization can normally expect an IRS determination letter within 6 to 8 months. However, applications involving complex issues or issues that are currently under review by the IRS may take a year or longer to process.

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§3.66 7. Remedies if IRS Denies Exemption

If, after providing the IRS with additional information that it requires, the IRS is inclined to deny the exemption application, the organization still has some recourse. Usually, however, the organization can obtain a determination letter by modifying its activities to satisfy the IRS reviewer. See §§3.67-3.69.

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§3.67 a. Request for Technical Advice

When there is no published precedent and the organization has been notified of a potential adverse determination, the organization or the IRS may request "technical advice" from the IRS national office. "Technical advice" is a request for guidance regarding a procedural or technical issue that the IRS supplies in the form of a memorandum specific to the taxpayer. The IRS encourages requests for technical advice on any technical or procedural question arising with regard to any case in which the issues cannot be resolved on the basis of law, regulations, an applicable revenue ruling, or other published precedent.

Procedural rules pertaining to technical advice are usually updated in the first Internal Revenue Bulletin of each calendar year. If the technical advice comes out in favor of the organization, the IRS will issue the determination letter. If the technical advice is not favorable, the organization will then need to accept the IRS ruling or challenge it in court, as described below.

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§3.68 b. After Denial of Request for Exemption

Protest. If the IRS district office denies an exemption application (without technical advice; see §3.67), it sends the organization a proposed adverse determination. The organization may appeal within 30 days after the mailing date of the adverse determination by filing a protest. Specific instructions are set forth in a letter provided to the organization. The protest should contain a statement of the facts and of the law, and arguments in support of the organization's position. It should also indicate whether an "appeals office conference" is desired.

After considering the organization's protest and any information presented at a conference, the appeals office notifies the organization of its decision and issues an appropriate determination letter. See Rev Proc 90-27, 1990-1 Cum Bull 514.

PRACTICE TIP: It is crucial for the organization to make a complete presentation of all facts, circumstances, and arguments at the initial level of consideration by the appeals office. Doing so will ensure that the organization has exhausted all available administrative remedies, which is a prerequisite for proceeding with a declaratory judgment action.

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§3.69 c. After Exhausting IRS Appeals

Declaratory relief. A special declaratory judgment remedy is provided for obtaining judicial review of an IRS decision on an organization's qualification under IRC §501(c)(3) or its classification as a private foundation or private operating foundation. The applicant may bring suit in the Tax Court, the United States Court of Federal Claims, or the United States District Court for the District of Columbia. IRC §7428(a). (There is no similar provision under California law.)

Exhaustion of remedies. Before bringing a declaratory judgment action, an organization must exhaust all available administrative remedies. Once a "substantially completed" IRS Form 1023 application is filed, the IRS has 270 days in which to make a determination. If the organization cooperates with the IRS in supplying all available information, the organization will be deemed, once 270 days have passed, to have satisfied the exhaustion requirement. IRC §7428(b)(2).

Filing time. The applicant must commence the declaratory judgment action within 90 days after the mailing date of the adverse notice. IRC §7428(b)(3). If the 270-day period has expired, the action may be started within 360 days after the determination request was first mailed. For more information on appeal rights, see IRS Pub 556.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.70 B. Federal Exemption Under Other Provisions of IRC §501(c)--IRS Form 1024

§3.70 B. Federal Exemption Under Other Provisions of IRC §501(c)—IRS Form 1024

Internal Revenue Service Form 1024 is used for exemption applications under most subsections of IRC §501(c) other than §501(c)(3).

The filing requirements for IRS Form 1023, discussed in §§3.62-3.64, generally apply to IRS Form 1024 as well. For specific requirements, see IRS Instructions for Form 1024, available on the IRS website at http://www.irs.gov/pub/irs-pdf/i1024.pdf.

Unlike IRS Form 1023, IRS Form 1024 has no filing deadline. Indeed, there is no actual requirement that organizations, other than those described in IRC §501(c)(3), even apply for exemption, as IRC §508 applies only to IRC §501(c)(3) organizations. Nonetheless, the author recommends that all organizations seeking exemption apply for, and obtain, an IRS determination letter. See §3.65. A determination letter will help the organization avoid confusion about its exempt status, particularly years after the original founders are no longer with the organization.

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Source: Business Law/Advising California Nonprofit Corporations/3 Planning for, Obtaining, and Maintaining Tax-Exempt Status/§3.71 C. Exemption From California Income and Franchise Taxes--FTB Forms 3500 and 3500A

§3.71 C. Exemption From California Income and Franchise Taxes—FTB Forms 3500 and 3500A

Organizations that are exempt under Rev & T C §23701d (IRC §501(c)(3)) must file a short-form application (FTB Form 3500A) with the Franchise Tax Board (FTB), along with a copy of the IRS determination letter. An organization exempt under §501(c)(3) by virtue of being part of a group exemption must submit, with FTB Form 3500A, the group ruling letter issued by the IRS along with evidence that it is included in the group. Rev & T C §23701d(c)(1)(B). Organizations that are exempt under a statute other than Rev & T C §23701d (IRC §501(c)(3)) must instead complete and file the full application for exemption, FTB Form 3500. Both forms are also available on the FTB website at http://www.ftb.ca.gov/forms/index.shtml. The FTB also has an expanded website that answers many questions about tax-exempt organizations and the process of obtaining tax-exempt status. See FTB Public Service Bulletin 09-29, available at http://www.ftb.ca.gov/aboutftb/public_service_bulletins/2009/bulletin_0929.shtml.

The FTB also issues group rulings to parent corporations and their subordinate organizations, whether incorporated or unincorporated. The FTB procedures are set forth in 18 Cal Code Regs §23701(i). An FTB exemption letter is normally retroactive to earlier taxable years during which the organization met the requirements for qualification, but no refund is allowed for any year in which the statute of limitations on the filing of a refund claim has run. 18 Cal Code Regs §23701(b)(4).

NOTE: The period for filing a refund claim is 4 years after the last day prescribed for filing the return to which the claim relates (determined without regard to any extension of time for filing), or 1 year after the date of overpayment, whichever expires later. Rev & T C §19306.

Corporations organized outside of California but doing business in California are also required to file FTB Form 3500 or FTB 3500A after they register to do business in the State of California.

Finally, practitioners should remember that most charitable organizations are also required to register with the California Attorney General's Office. See §5.66.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/Chapter Outline

4

Donor Funds, Private Foundations, and Supporting Organizations

Reynolds T. Cafferata
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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.1 I. SCOPE OF CHAPTER

§4.1 I. SCOPE OF CHAPTER

Many donors who make significant charitable gifts eventually consider the possibility of a private charitable organization. These may include donor funds, private foundations, or supporting organizations. Private charitable organizations offer donors several advantages, including providing donors with the ability to:

- Separate the timing of the tax benefits of a charitable gift from the timing of the decision of which charitable organizations or causes will ultimately benefit from it;
- Participate more directly and to a greater extent in their charitable giving; and
- Create charitable legacies for younger generations.

This chapter surveys the requirements, advantages, and disadvantages of the various alternatives for private charitable organizations. It is intended as a resource for making a choice of entity, rather than a comprehensive guide to the complex operations of each type of organization.

Donor and donor-advised funds are discussed in §§4.3-4.22, private foundations are covered in §§4.23-4.55, and supporting organizations are discussed in §§4.56-4.80. Tax considerations with respect to these entities are discussed in more detail in chap 3. Pledge agreements and self-dealing are touched on in §4.81, and maintaining multiple private charities is addressed in §4.82. A table comparing the different types of private charitable organizations is set forth in §4.83.

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§4.2 II. CHOOSING A PRIVATE CHARITABLE ORGANIZATION

Donors have a number of options for private charitable organizations. Their advisors need to have detailed discussion with donors regarding their plans and objectives. Once the practitioner has a full understanding of the operations that the donor will expect the organization to carry out and how those operations will be funded, the practitioner can match that information against the available alternatives. The practitioner can then recommend the entity that most effectively and efficiently meets the donor's needs.

Practitioners advising donors and private foundations should keep in mind the possibility of forming a new entity to carry out particular operations. There are times when the private foundation limitations create significant barriers to a particular activity that may be eliminated when the same gift or activity is carried out through a donor-advised fund. By thinking outside the box, or at least thinking of all the available boxes, practitioners can help their clients more effectively and more satisfactorily achieve their philanthropic goals.

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§4.3 III. DONOR FUNDS

The first private charitable organization that most donors should consider is a donor fund with a community foundation or other existing public charity. A donor fund is established by an outright gift to the sponsoring charitable organization that has legal control over the fund. Treas Reg §1.170A-9(f)(11)(ii). The charitable organization agrees to separately account for the contribution in the donor fund and to allow the donor to offer advice regarding the fund. See §4.18. The sponsoring organization will usually honor donor recommendations that fall within the sponsoring organization's published guidelines.

Advantages. Donor funds are simple to establish and are usually created by a short agreement with the sponsoring charity. See §4.17. Because donor funds are maintained by public charities, donors receive the most favorable tax treatment for gifts to donor funds. On tax treatment of gifts to public charities, see chap 15. Other than donor-advised funds (as defined in IRC §4966 and discussed in more detail in §§4.9-4.16), donor funds operate under the limitations applicable to public charities, not the more restrictive rules applicable to private foundations. Used creatively, donor funds can be powerful tools for accomplishing philanthropic goals.

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A. Types of Donor Funds

§4.4 1. Donor-Advised Funds

The most common type of donor fund is the donor-advised fund. A donor to a donor-advised fund may advise the sponsoring charity on use of the fund. Alternatively, the donor may name another person or group to advise the charity. The advice, however, is not legally binding on the charitable organization because the organization has ultimate control over the distribution of the funds. See *Lapham Found., Inc. v Commissioner* (6th Cir 2004) 389 F3d 606, discussed in §4.22.

PRACTICE TIP: Although the donor's advice is not legally binding, a charity that maintains a donor-advised fund will almost always follow any advice to make a distribution for a legitimate charitable purpose. Charities that maintain donor-advised funds must have the trust of donors that the charity will follow their advice.

A donor may make grants to any number of charitable organizations over almost any time frame from a donor-advised fund. A more detailed discussion on donor-advised funds is included in §§4.9-4.16.

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§4.5 2. Field-of-Interest Funds

Advantages. The field-of-interest fund is another type of donor fund. A donor establishing a field-of-interest fund designates a charitable area, such as cancer research, after-school programs, or performing arts to be supported by the fund. Periodically, the charity sponsoring the field-of-interest fund selects one or more charities that have programs within the donor's field of interest to receive distributions from the fund. These funds allow a donor to support a particular area of interest with the sponsoring charity selecting and reviewing charities that work in the area. This structure makes the field-of-interest fund flexible, allowing the sponsoring charity to select the best charities each year to meet the donor's objectives, with the option to include new charities formed after the donor's death.

Designation of field of interest generally binding. Unlike the advice for a donor-advised fund, the designation of a field of interest can be legally binding on the charitable organization sponsoring the field-of-interest fund. Treas Reg §1.507-2(a)(8)(v), Example 3. See Bus & P C §17510.8. The charity may not distribute outside the designated field unless it becomes impossible or impractical for the charity to stay within the field of interest. If it becomes necessary for the charity to change the field of interest, the charity must find and select a field as close as possible to the donor's original designation. The extent of a charity's discretion in changing a field of interest and the procedure it must follow depend on the charity's governing instrument, which may expand its variance power.

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§4.6 3. Scholarship Funds

A donor interested in offering scholarships without being tied to a particular educational institution may form a scholarship fund. The donor can create the scholarship criteria applicable to a large enough group of students to constitute a charitable class and formulate objective criteria so that scholarships are awarded in a nondiscriminatory manner. The donor may be part of the selection committee, if desired, as long as the board of the sponsoring charity controls the membership of the selection committee and the donor and related parties do not control the committee.

PRACTICE TIP: Although scholarships should not be awarded to the donor's family members, relatives of employees of the charity sponsoring the fund may be eligible to receive scholarships. See IRS Letter Ruling 7945108.

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§4.7 4. Designated and Restricted Funds

A donor to a donor fund can impose the same legal limits on the donor fund as can be imposed on other gifts: either designating the fund for a particular purpose (a designated fund) or restricting the spending of the fund to its income or annual return (a restricted fund), or both.

A designated fund is one that makes payments to one or more specific charities. When a fund is designated, the donor has specified a particular charitable purpose for which the fund is to be used. The designated fund is useful when a donor wants to provide a long-term funding source to a charity but is concerned about the charity's ability to manage the funds. The sponsoring charity manages the designated fund with its pool of funds, generally distributing the earnings annually to the designated charity.

Designation of charity generally binds sponsoring charity. Similar to a field-of-interest fund, the designation of a specific charity to receive support is legally binding on the sponsoring charitable organization. See Bus & P C §17510.8. The charity may make distributions to other than the designated charity only if it becomes impossible or impractical to follow the donor's designation. The charity must choose a successor charity that is similar or related to the donor's original charity.

A restricted fund (also called an endowment fund) is limited as to the amount that the charity may spend from the fund over time. A donor may restrict the spending of the fund to its income or annual return, or both. If a fund is restricted, the charity may spend only the income earnings of the fund each year. See Prob C §18502(b). See also §§16.21-16.24 regarding spending restrictions on charitable funds. If no other limitations are imposed, the charity is free to spend the income or earnings of the fund on any charitable purpose it chooses.

NOTE: If a donor both restricts and designates the fund, then only the income or earnings of the fund may be spent each year, and that amount must be spent for the designated purpose.

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§4.8 B. Administrative Costs of Donor Funds

Organizations that offer donor funds need to recover the costs of operating the funds. Accordingly, a donor fund may be subject to a fee of 1 percent to 2 percent of the value of the fund each year. The fee may be higher for a fund with a lot of grant-making activity or an administratively burdensome program like scholarships.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.9 C. Definition and Characteristics of Donor-Advised Funds

§4.9 C. Definition and Characteristics of Donor-Advised Funds

Initially, donor funds were governed by the community trust regulations applicable to community foundations. See Treas Reg §1.170A-9(f)(11). These regulations define whether a fund that is separately accounted for by a community trust will be treated as a component part of the community trust or as a separate trust that would be classified as a private foundation. Under these regulations, the sponsoring charity must control the fund's investments. The sponsoring charity also must have discretionary power to change the purpose of the fund if the original purpose becomes impractical or is no longer in accordance with community needs.

Although these regulations for community trusts generally still apply, the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) added a new set of rules that applies to "donor-advised funds." The PPA defines the term "donor-advised fund" in the Internal Revenue Code and subjects these donor-advised funds to certain excise taxes, among other changes, resulting in donor-advised funds that fall within that definition being subject to several limitations. Because of these limits, it is important that the donor and charity determine whether a fund is a donor-advised fund under IRC §4966 or some other donor fund as described in §§4.3-4.7.

"Donor-advised fund" defined. Under IRC §4966(d)(2)(A), a donor-advised fund is defined as a fund or account:

- Owned and controlled by a sponsoring organization;

NOTE: A sponsoring organization is defined as an IRC §170(c) organization that is not a governmental organization or a private foundation. IRC §4966(d)(1). The Bluebook prepared by the Joint Committee on Taxation indicates that an organization's general fund will not be treated as a donor-advised fund if it is not separately identified by a donor. See Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 at 342 (Aug. 3, 2006, JCX-38-06) ("Bluebook").

- That is separately identified by reference to contributions of a donor or donors; and
- With respect to which the donor, or any person appointed or designated by the donor ("donor advisor"), has, or reasonably expects to have, advisory privileges concerning the distribution or investment of the funds.

The term donor-advised fund does not include a fund or account (IRC §4966(d)(2)(B)) in which:

- The fund makes distributions only to a single identified organization or governmental entity; or
- A donor to the fund advises a sponsoring organization regarding grants for travel, study, or similar purposes, if:
- The donor's, or the donor advisor's, advisory privileges are performed in his or her capacity as a member of a committee whose members are appointed by the sponsoring organization;
- No combination of donors or donor advisors (or related persons) directly or indirectly control the committee; and
- All grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's board of directors.

On scholarship funds, see §4.6.

CAUTION: Unlike a private foundation, the sponsoring organization is not required to have every scholarship program approved by the IRS before it can be implemented. Nevertheless, a sponsoring organization may consider seeking IRS approval of its donor-advised funds' scholarship programs to ensure that the programs are consistent with the procedures set forth in IRC §4945(g). See IRC §4966(d)(2)(B).

Exemption from donor-advised fund treatment. The Treasury has authority to exempt certain funds from treatment as donor-advised funds if either (IRC §4966(d)(2)(C)):

- The fund or account is advised by a committee not directly or indirectly controlled by the donor or donor advisor (and any related parties); or

- The fund or account benefits a single identified charitable purpose.

The Treasury has excepted certain employer-sponsored disaster relief assistance programs from the definition of a donor-advised fund. See IRS Notice 2006-109, 2006-51 Int Rev Bull 1121.

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§4.10 1. Taxable Distributions

Excise tax. Internal Revenue Code §4966 imposes an excise tax on a sponsoring organization for each taxable distribution it makes from a donor-advised fund. IRC §4966(a)(1). It also imposes an excise tax on any fund manager of the sponsoring organization who knowingly agrees to make a taxable distribution. IRC §4966(a)(2). The tax on taxable distributions applies to distributions occurring in taxable years beginning after August 17, 2006. Pub L 109-280, §1231(c), 120 Stat 780.

"Taxable distribution" defined. In general, a taxable distribution is any distribution from a donor-advised fund to (IRC §4966(c)(1)):

- An individual; or
- An organization/entity if:
- The distribution is for any purpose other than one specified in IRC §170(c)(2)(B), or
- The sponsoring organization maintaining the donor-advised fund does not exercise expenditure responsibility with respect to such distribution in accordance with expenditure responsibility requirements for private foundations.

NOTE: Although a grant to an individual is a taxable expenditure, certain grants to individuals are excepted from the definition of a donor-advised fund and thus not subject to the taxable distribution rules. Specifically, these include certain scholarship funds (see §4.6) and certain employer-sponsored disaster relief assistance programs.

Donor-advised distribution excluded. A taxable distribution does not include a distribution from a donor-advised fund to (IRC §4966(c)(2)):

- An organization described in IRC §170(b)(1)(A) (other than a disqualified supporting organization);
- The sponsoring organization of that donor-advised fund; or
- Any other donor-advised fund.

Disqualified supporting organizations. Internal Revenue Code §4966(d)(4)) disqualifies the following supporting organizations:

- A Type III supporting organization that is not functionally integrated (*i.e.,* the supporting organization does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the supporting organization is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the supporting organization is *not* the parent of each of the supported organizations) (see Prop Treas Reg 1.509(a)-4(f)); and
- Any Type I, Type II, or functionally integrated Type III supporting organization in which the donor or donor advisor (and any related parties) directly or indirectly controls a supported organization of the supporting organization.

On types of supporting organizations, see §§4.58-4.65.

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§4.11 2. Prohibited Benefits

Excise taxes imposed when more than incidental benefit. Internal Revenue Code §4967 imposes an excise tax of 125 percent if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor-advised fund provides advice as to a distribution from a donor-advised fund that results in any donor, donor advisor, or person related to a donor or donor advisor receiving, directly or indirectly, a more than incidental benefit. IRC §4967(a)(1). The excise tax is imposed on any person who advises as to the distribution and any person who receives the benefit. IRC §4967(a)(1). A separate excise tax may be imposed on a fund manager who agreed to the making of the distribution. IRC §4967(a)(2). The excise tax under IRC §4967 applies to taxable years beginning after August 17, 2006. Pub L 109-280, §1231(c), 120 Stat 780.

Incidental benefit. Based on the Bluebook (see §4.9), generally, a donor receives an incidental benefit if the donor receives any goods or services from the charity that would reduce the donor's income tax deduction for a payment to the charity. For example, if a donor is allowed to attend a charity dinner, the donor will have received an incidental benefit.

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§4.12 3. Excess Benefit Transactions

Automatic excess benefit transactions. Under IRC §4958, certain transactions are automatic excess benefit transactions. These transactions include any grant, loan, compensation, or other similar payment from a donor-advised fund to a person who is a donor, a donor advisor, or a person related to a donor or donor advisor. IRC §4958(c)(1). The *entire* amount paid to any such person is treated as the amount of the excess benefit. IRC §4958(c)(2). The requirement that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rules of IRC §4958, which provide that the excess benefit is the amount by which the value of the economic benefit exceeds the value of the consideration received. The Bluebook indicates that "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement.

CAUTION: Because an expense reimbursement is an automatic excess benefit transaction, a donor cannot be reimbursed from a donor-advised fund for out-of-pocket payments for fundraising event expenses. Donors who put funds for fundraising expenses into a donor-advised fund before the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) was enacted on August 17, 2006, have no way of pulling those funds out of the donor-advised fund. Pub L 109-280, §1232(c), 120 Stat 780. Donors who create a donor-advised fund after the PPA must be aware of this rule and reserve some of the funding to support fundraising events, resulting in a potential trap for the unwary donor.

General excess benefits transactions. Additionally, donor-advised funds are subject to the generally applicable excess benefit transaction rules under IRC §4958 with respect to transactions with its disqualified persons, which include a donor, a donor advisor, an investment advisor, or a person related to such persons. IRC §4958(f)(1)(E)-(F). The term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor-advised funds (including pools of assets all or part of which are attributed to donor-advised funds) owned by the sponsoring organization. IRC §4958(f)(8).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.13 4. Excess Business Holdings

§4.13 4. Excess Business Holdings

Internal Revenue Code §4943 imposes excise taxes on the sponsoring organization for excess business holdings of a donor-advised fund. Generally, such a donor-advised fund's voting or profits interests in a business enterprise, when combined with the interests of related persons, may not exceed 20 percent. IRC §4943(c), (e). The excess business holdings rules apply to donor-advised funds for taxable years beginning after August 17, 2006. Pub L 109-280, §1231(c), 120 Stat 780. A donor-advised fund can follow the transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(c)(3).

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§4.14 5. Grants to Supporting Organizations

Prohibited grants. Grants from donor-advised funds are prohibited to (IRC §4966(c)(2)):

- Type III supporting organizations (SOs) that are not functionally `integrated with the supported organization (*i.e.,* the SO does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the SO is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the SO is *not* the parent of each of the supported organizations (see Prop Treas Reg 1.509(a)-4(f))); and
- Any Type I, Type II, or functionally integrated Type III SO if the donor or donor advisor controls a supported organization, unless the SO exercises expenditure responsibility.

Guidance for donor-advised funds. Rev Proc 2009-32, 2009-28 Int Rev Bull 142, provides criteria for donor-advised funds and private foundations to use in determining whether a potential grantee is an SO. A grantor, acting in good faith, may rely on either the grantee's current IRS letter recognizing the grantee as tax-exempt and indicating the grantee's public charity classification, or information from the IRS Business Master File (BMF). A grantor may download the BMF directly from the BMF website or may obtain the BMF information from a third party, as long as the report includes the following:

- The grantee's name, employer identification number, and public charity classification under §509(a)(1), (2), or (3);
- A statement that the information is from the most-currently available IRS monthly update to the BMF, along with the IRS BMF revision date; and
- The date and time of the grantor's search.

NOTE: Currently the BMF does not indicate whether an SO is a Type I, II, or III, and whether, if it is a Type III, it is or is not functionally integrated. The SO's IRS exempt determination letter may or may not provide this information. The SO's IRS Form 990 or IRS 990-EZ should provide this information. However, the guidance does not state that good faith reliance on information returns is sufficient.

Previously, in Notice 2006-109, 2006-2 Cum Bull 1121, the IRS provided guidance for donor-advised grantors to determine an SO grantee's type, whether the SO is a Type III, whether it is functionally integrated, and, if it is a Type I, Type II, or Type III SO, whether it is controlled. On September 24, 2009, the IRS issued proposed regulations regarding the requirements to qualify as a Type III SO that is operated in connection with one or more supported organizations. See 74 Fed Reg 48672. The Explanation of Provisions in the proposed regulations states that private foundations can continue to rely on the grantor reliance standards of §3.0 of Notice 2006-109, until the proposed regulations are published as final or temporary regulations. 74 Fed Reg 48679 (2009). There is no specific provision for donor-advised funds. However, the Explanation further states that as of September 24, 2009, the IRS will issue functionally integrated Type III SO determinations only to organizations that meet the requirements of Prop Treas Reg §1.509(a)-4(i)(4). See 74 Fed Reg 48675 (2009). An organization that received a determination that it qualified as a functionally integrated Type III SO under the Advanced Notice of Proposed Rulemaking, "Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated" (ANPRM) (see REG-155929-06, 72 Fed Reg 42335 (2007)), may continue to rely on that determination letter until final or temporary regulations are published, as long as the organization continues to meet the requirements of either the ANPRM or Prop Treas Reg §1.509(a)-4(i)(4). See 74 Fed Reg 48679 (2009). An organization that receives a determination that it is a functionally integrated Type III SO under either the ANPRM or the proposed regulations will be required to meet the requirements established in final or temporary regulations as of the first taxable year beginning after final or temporary regulations are published. See 74 Fed Reg 48679 (2009).

On types of supporting organizations, see §§4.58-4.65.

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6. Grants From Donors Seeking Charitable Contribution Deduction

§4.15 a. Income Tax Deductions

No charitable deduction. Contributions to a sponsoring organization for maintenance in a donor-advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is (IRC §170(f)(18)):

- A veterans' organization described in IRC §170(c)(3);
- A fraternal society described in IRC §170(c)(4);
- A cemetery company described in IRC §170(c)(5); or
- A Type III supporting organization (other than a functionally integrated Type III supporting organization).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.16 b. Gift and Estate Tax Deductions

§4.16 b. Gift and Estate Tax Deductions

No charitable deduction. Contributions to a sponsoring organization for maintenance in a donor-advised fund are not eligible for a charitable deduction for gift and estate tax purposes if the sponsoring organization is (IRC §§2522(c)(5), 2055(e)(5)):

- A veterans' organization described in IRC §2522(a)(4) for gift tax purposes and IRC §2055(a)(4) for estate tax purposes;
- A fraternal society described in IRC §2522(a)(3) for gift tax purposes and IRC §2055(a)(3) for estate tax purposes; or
- A Type III supporting organization (other than a functionally integrated Type III supporting organization).

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§4.17 D. Creating a Donor Fund

One of the great attractions of a donor fund is the simplicity of creating it. Generally, donor funds are created with a two- to three-page agreement. The agreement should include the following information:

- The name of the fund;
- The identity of the advisor and successor advisors, if any;
- Procedures to be followed when there are no more advisors;
- An explanation of what fees the sponsoring charity will pass on to the fund;
- The legal status of the funds and whether designated or restricted;
- The means of reporting fund activity to the donor; and
- How the fund will be invested.

PRACTICE TIP: If the donor intends any binding designation or restriction on the fund (see §4.7), it is important to carefully review the fund agreement to ensure that the "boilerplate" provisions do not override the legal limits that the donor intends to impose. To avoid being treated as a donor-advised fund, the donor should meet the scholarship exception to the definition of a donor-advised fund (see §4.9).

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§4.18 E. Pooling Assets of Donor-Advised Funds

Asset allocation. Typically, the assets of donor-advised funds are pooled for investment. The sponsoring charity may give the donor the right to give advice regarding asset allocation. For example, a donor who expects to recommend distribution of the donor-advised fund over 1 or 2 years would recommend the asset allocation for the fund be 10 percent cash and cash equivalents like money markets to avoid the risk of short-term market swings. A donor who wished to advise distribution of a fund over long period of time, however, would recommend an asset allocation with a high percentage of equities for growth over time.

Fund managers. Generally, the sponsoring charity selects the fund managers for all the asset classes available to the donor-advised funds. In limited circumstances, a donor may be allowed to recommend a fund manager for a large donor fund.

PRACTICE TIP: If the charity uses a donor-recommended fund manager, the charity should have the power to remove the manager at will, and the manager's activities must be coordinated with the overall investment strategy of the charity. However, this would also result in the fund being treated as a donor-advised fund and potentially subject to certain excise taxes under the Internal Revenue Code. See §§4.11-4.13.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.19 1. Agency Funds

§4.19 1. Agency Funds

A smaller charitable organization sometimes places funds with a community foundation to take advantage of the community foundation's investment management expertise and ability to pool the funds. A fund held for another charity by a community foundation is often called an agency fund. While this arrangement can be beneficial, the charitable organization considering an agency fund should fully understand the legal implications of the arrangement. In general, the transfer of funds to the community foundation is an outright gift. The charitable organization relinquishes legal control over the funds.

CAUTION: If the charity is using funds that were contributed subject to designations or restrictions imposed by the original donors, the transfer of the funds as an outright gift to another organization may not be permissible.

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§4.20 2. Quasi-Endowment Funds

If an agency fund is restricted as an endowment fund, the board of the charity creating the agency fund has accomplished something that it could not do internally: create an endowment by action of the board. When a board takes unrestricted funds and treats them as endowment, the funds are only a quasi-endowment, and future boards may invade the principal of the fund. Distributions from an endowed agency fund are limited to income, and the endowed agency fund would be restricted in the hands of the community foundation.

NOTE: Theoretically, the community foundation and the original charity creating the restriction could agree to remove the restriction. Accordingly, creating an endowed agency fund is not a guarantee that a future board will not invade the principal of the fund. Regarding releases on restrictions in gift instruments, see §§16.15-16.17.

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§4.21 F. Uses of Donor Funds

Donor funds can be used in many creative ways. For example:

- A donor who needs an income tax deduction in the current year but wants more time to consider which charitable organizations will ultimately benefit from the gift can obtain a current deduction by making a gift to a donor-advised fund. In subsequent years, the donor may advise which charitable organizations should receive gifts from the donor-advised fund.
- A donor fund can be used as a memorial fund to honor a deceased individual. If only family members contribute to the memorial fund, and it is advised by family members, such a fund will be a donor-advised fund. If many non-family members contribute, however, it will not be a donor-advised fund.
- A donor fund could be an alternative wedding gift for a couple that already has a well-established household. If only family members contribute to the wedding fund, it will be a donor-advised fund, but if a large number of non-family members contribute, it will not be a donor-advised fund.
- A newly formed charitable organization awaiting its determination letter can use a donor fund to accept gifts from donors concerned about the certainty of their charitable contribution deduction. After the new organization receives a determination letter, funds can be distributed to the organization from the donor fund.
- A donor who is interested in providing scholarships can operate the program through a donor fund, taking advantage of the sponsoring community foundation's expertise and infrastructure for granting scholarships.

Additionally, the fund agreement should clarify whether the fund will be considered a donor-advised fund under IRC §4966(d)(2). For example, the agreement should indicate whether gifts will be separately tracked in the fund by reference to specific donor and whether the donor will have advisory privileges or merely make nonbinding recommendations with respect to distributions and investments of the fund's assets.

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§4.22 G. Control Over Donor Funds

The lack of a donor's legal control over a donor-advised fund was confirmed in *Lapham Found., Inc. v Commissioner* (6th Cir 2004) 389 F3d 606. That case dealt with the qualification of a supporting organization (see §4.56). The court held that a donor to a donor-advised fund had no legal control over the funds, and, accordingly, a gift to such a fund is an undesignated gift that can be used by the receiving charity for any charitable purpose.

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§4.23 IV. PRIVATE FOUNDATIONS

A private foundation is the form of private charitable organization that offers the founder the greatest degree of legal control over the organization, but it also offers the most limited tax benefits and is subject to the greatest restrictions in its operations.

All charitable organizations that are exempt from tax under IRC §501(c)(3) are private foundations unless the organization meets one of the definitions of a public charity. IRC §509. Public charities include charities that are charities based on their function, such as hospitals, churches, and schools, as well as charities that receive broad public support in the form of contributions. IRC §509(a)(1). In addition, organizations that receive broad public support in the form of contributions and revenue from the exempt activity of the organization are public charities. IRC §509(a)(2). Finally, organizations with a close relationship to one or more public charities called supporting organizations are public charities. IRC §509(a)(3). On supporting organizations, see §§4.56-4.80.

It should be noted that private foundations are not really "private" at all. Private foundations must annually file a IRS Form 990-PF federal tax return. See chap 12. Form 990-PF includes detailed information about the foundation, including the names and addresses of its substantial contributors. The foundation must provide copies of its last three Form 990-PFs to anyone who requests them. They, along with other nonprofit information, are posted on the Internet by GuideStar, at http://www.guidestar.org. For an explanation of the GuideStar database, see §12.84.

Contributions to private foundations are given less favorable tax treatment than contributions to public charities. IRC §170(b)(1)(B). The rules regarding contributions to private foundations are described more fully in §15.40.

NOTE: The IRS has a web-based information tool to assist private foundations in complying with both federal tax rules and requirements that occur through the life cycle of their organizations. It is available online at http://www.irs.gov/charities/foundations/article/0,,id=127912,00.html.

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§4.24 A. Limitations on Private Foundations

Private foundations are subject to a number of limitations and prohibitions that are designed to prevent abuse of the tax advantages they offer. See IRC §§4940-4948. To avoid the administrative difficulty of determining whether transactions between private foundations and their insiders are fair and appropriate, Congress prohibited a number of transactions and relationships between private foundations and their major contributors and managers (*i.e.,* disqualified persons; see §§4.25-4.35). While these prohibitions may simplify the tax administration of private foundations, they significantly limit the flexibility of the private foundation for charitable planning.

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§4.25 1. Self-Dealing Transactions With Disqualified Persons

The limitations and prohibitions on private foundations apply to "disqualified persons." See IRC §4946. Disqualified persons include (IRC §4946(a)(1)):

- Substantial contributors;
- Foundation managers who are the foundation's officers and directors;
- Any owner of more than 20 percent of a business that is a disqualified person;
- Certain family members of disqualified persons, including ancestors, children, grandchildren, and great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren (IRC §4946(d)); and
- A corporation, partnership, or trust that is 35-percent owned by disqualified persons.

CAUTION: If a private foundation has a large board, it can be particularly challenging to determine the identity of all the disqualified persons. In particular, a private foundation board with a number of unrelated directors may not have complete information about each director's family members and business interests.

Self-dealing transactions generally barred. Private foundations are prohibited from entering into self-dealing transactions with disqualified persons unless an exception applies. IRC §4941. Self-dealing transactions include any sale, lease, or use of property for the benefit of the disqualified person. IRC §4941(d)(1)(A). Under the self-dealing prohibitions, it does not matter whether the transaction was beneficial to the private foundation. If, for example, a disqualified person sells publicly traded securities to a private foundation for a price below the current trading price for the stock, the transaction is still a self-dealing transaction that is prohibited.

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§4.26 2. Types of Self-Dealing Transactions

A self-dealing transaction requires two parties: a private foundation and a disqualified person. Any transaction described in IRC §4941(d)(1) is self-dealing, and a private foundation may not engage in it unless one of the exceptions listed in IRC §4941(d)(2) applies. See §§4.27-4.34.

PRACTICE TIP: It is essential to review the self-dealing rules with care before engaging in any transaction involving a disqualified person, so that the transaction may be restructured, or if necessary avoided, so as to comply with IRC §4941. The disclosure and approval provisions of state law should assist private foundations to comply with these federal tax requirements.

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§4.27 a. Sale, Exchange, or Lease of Property

Self-dealing barred. The sale, exchange, or lease of property between a private foundation and a disqualified person is self-dealing. IRC §4941(d)(1)(A). A disqualified person may, of course, permit a private foundation to use the disqualified person's property without charge. IRC §4941(d)(2)(C). For example, it is common for company foundations to operate from the company's office, and for family foundations to operate from the family home or from the business office of a family member. As long as the foundation does not pay rent directly or indirectly to a disqualified person, such use of property is permitted.

Donation of encumbered property. The self-dealing ban does not apply to a disqualified person's donation of property to a private foundation. However, if the disqualified person's property is subject to debt, the private foundation may not assume the debt. IRC §4941(d)(2)(A). Such a transaction would also be barred by IRC §4941(d)(1)(E), which bans the use of a private foundation's assets by or for the benefit of a disqualified person. It is also considered self-dealing if the property is subject to a mortgage or similar lien that a disqualified person placed on the property within the 10-year period ending on the date of the transfer to the private foundation. IRC §4941(d)(2)(A).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.28 b. Extension of Credit

§4.28 b. Extension of Credit

Self-dealing includes lending money, or extending credit, between a private foundation and a disqualified person. IRC §4941(d)(1)(B). There is one exception: a disqualified person may lend money to a private foundation if the loan is without interest or other charge and if the proceeds are used exclusively for IRC §501(c)(3) purposes. IRC §4941(d)(2)(B).

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§4.29 c. Furnishing Goods, Services, or Facilities

Self-dealing includes furnishing goods, services, or facilities between a private foundation and a disqualified person. IRC §4941(d)(1)(C). However, as in §4.28, if the disqualified person provides the goods, services, or facilities without charge and the foundation uses them exclusively for exempt purposes, the rule does not apply. In addition, a private foundation may furnish goods, services, or facilities to a disqualified person if it does so no more favorably than it would to the general public. IRC §4941(d)(2)(D).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.30 d. Payment of Compensation or Expenses

§4.30 d. Payment of Compensation or Expenses

A private foundation may not compensate a disqualified person, or pay or reimburse the expenses of a disqualified person, unless two conditions are met (IRC §4941(d)(2)(E)):

(1) The compensation must be for personal services that are reasonable and necessary to carry out the foundation's exempt purposes; and

(2) The amount of compensation, payment, or reimbursement must be reasonable and not excessive in the circumstances.

CAUTION: Organizations relying on the personal services exception must exercise great care, because the regulations define "personal services" narrowly to include primarily professional services, such as legal counsel, accounting services, and investment advice. Treas Reg §53.4941(d)-3(c). For other types of services, legal counsel should carefully review applicable rulings and cases.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.31 e. Transfer or Use of Foundation Income and Assets

§4.31 e. Transfer or Use of Foundation Income and Assets

Internal Revenue Code §4941(d)(1)(E) is a general provision that traps any self-dealing transactions that might not have been included in the preceding provisions. It bars the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. Unless the transaction falls within one of the exceptions provided by law, this prohibition is absolute.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.32 f. Payments to Government Officials

§4.32 f. Payments to Government Officials

A private foundation may not make, or agree to make, any payment of money or transfer of property to a government official. IRC §4941(d)(1)(F). However, §4941(d)(1)(F) does permit a private foundation to agree to employ a government official after his or her government service is terminated if that service will terminate within 90 days. Further, the ban on payments to government officials does not apply to the types of payments described in IRC §4941(d)(2)(G).

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§4.33 g. Exception for Certain Corporate Transactions

Private foundations are often funded with shares of stock or other investments in enterprises owned or controlled by disqualified persons. Company foundations are often supported by gifts of stock in the company itself. The self-dealing rules, taken literally, appear to bar the redemption by the company of shares held by the foundation, but a specific exception covers this situation. Transactions between a private foundation and a corporate disqualified person under a liquidation, merger, redemption, or similar corporate reorganization are not self-dealing if the following two conditions are met (IRC §4941(d)(2)(F)):

(1) All securities of the same class as that held by the foundation are subject to the same terms; and

(2) Those terms provide that the foundation shall receive no less than fair market value for the securities.

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§4.34 h. Indirect Self-Dealing

Any of the self-dealing acts described in §§4.26-4.33 may also occur indirectly between a disqualified person and an organization controlled by a private foundation. Treas Reg §53.4941(d)-1(b). For the definition of "controlled organization," see Treas Reg §53.4941(d)-1(b)(5).

EXAMPLE: If a private foundation controls ABC Corporation, which makes a loan to XYZ Corporation, which was formed by disqualified persons, the loan is an indirect act of self-dealing between the private foundation and XYZ. Treas Reg §53.4941(d)-1(b)(8), Example 1.

The indirect self-dealing rules apply even if the controlled organization is a public charity. Thus, the payment of a lecture fee to a government official by a private university that is controlled by a private foundation constitutes self-dealing by the foundation. See Treas Reg §53.4941(d)-1(b)(8), Example 3.

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§4.35 3. Penalties for Violating Rules Against Self-Dealing

Annual first-tier excise tax. The IRS automatically imposes an annual first-tier excise tax on the self-dealer of 10 percent of the amount involved. IRC §4941(a)(1). An annual first-tier excise tax of 5 percent of the amount involved (up to a maximum tax of $20,000 for each act of self-dealing) may also be imposed on a foundation manager who knowingly participated in a self-dealing transaction, unless it was not willful and was for reasonable cause. IRC §§4941(a)(2), (c)(2).

NOTE: The manager has a complete defense if he or she acted in reliance on the advice of counsel expressed in a reasoned, written legal opinion. Treas Reg §53.4941(a)-1(b)(6).

Second-tier excise tax. For each act of self-dealing not corrected within a specific period, the self-dealer must pay a second-tier excise tax of 200 percent of the amount involved. IRC §§4941(c)(1), (d)(1), The IRS may impose a second-tier excise tax on the foundation manager of up to 50 percent of the amount involved, but only up to $20,000.

Additional penalties. The IRS can impose an additional penalty equal to the first- and second-tier taxes for willful, flagrant acts by those who have previously been subject to self-dealing excise tax. See IRC §6684. Finally, if a foundation's self-dealing transactions are repeated or willful, the IRS may terminate the foundation's exempt status and impose a substantial termination tax. See IRC §507.

Correcting self-dealing actions. An act of self-dealing is corrected by reversing it, returning any benefit to the charity, and placing the charity in a financial position not worse than that in which it would have been if the disqualified person were dealing under the highest fiduciary standards. Treas Reg §53.4941(e)-1(c)(1).

PRACTICE TIP: The rules regarding correction are complex and often harsh toward the disqualified person. A practitioner should review the correction procedures carefully. See Treas Reg §53.4941(e)-1(c).

CAUTION: Because the facts in a self-dealing situation are often intricate, it is important to ensure that the correction is not itself an act of self-dealing. See Rev Rul 81-40, 1981-1 Cum Bull 508 (when disqualified person attempted to correct indebtedness to private foundation by transferring real property to a private foundation, IRS held that transfer resulted in second act of self-dealing).

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§4.36 4. Minimum Annual Distributions

Private foundations are required to make minimum annual distributions. Generally, the amount that a private foundation is required to distribute is equal to 5 percent of the fair market value of the foundation's noncharitable assets. IRC §4942(e).

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§4.37 a. Computing Minimum Distribution Requirements

To calculate its minimum required distributions for the current year, the foundation must compute the value of its assets for the preceding taxable year. These values are computed differently, according to the nature of each asset. Cash and marketable securities are valued monthly and then averaged to compute the value for the foundation's taxable year. Treas Reg §53.4942(a)-2(c)(4). Other assets, such as real estate or royalty rights, are valued once a year. Treas Reg §53.4942(a)-2(c)(4). The total asset values are then multiplied by 5 percent to reach the amount that the foundation must distribute during the current year. IRC §4942(e)(1). For example, the minimum amount a foundation must distribute in its taxable year ending in 2007 is 5 percent of the fair market value of its assets during the taxable year ending in 2001. Treas Reg §53.4942(a)-2(c)(1).

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§4.38 b. Qualifying Distributions

Qualifying distributions are included in the 5-percent distribution amount. Qualifying distributions include all amounts, including grants or other actual charitable distributions, as well as reasonable and necessary administrative expenses, paid to accomplish one or more exempt purposes. IRC §4942(g)(1)(A). Amounts paid to acquire an asset used directly in carrying out an exempt purpose are also treated as qualifying distributions. IRC §4942(g)(1)(B).

Limitations. Grants to other private foundations that are not private operating foundations, and grants to private operating foundations and public charities that are commonly controlled by the grantor private foundation or its officers, directors, and trustees, will not count as qualifying distributions unless the "out of corpus" rule described in IRC §4942(g)(3)(A) is satisfied. The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) also limits the ability of a private foundation to make qualifying distributions to certain supporting organizations, as discussed more fully in §4.46. IRC §4942(g)(4).

Set-asides for later distribution. From time to time a private foundation may have a philanthropic end in mind that requires more funds than the foundation has on hand in the current year. In this situation, IRC §4942(g)(2) permits the foundation to set aside funds for later distribution and to count the set-aside amount as a qualifying distribution in the year in which the funds are set aside, even though the funds are not actually distributed in that year. Treas Reg §53.4942(a)-3(b)(1).

Carryforward of excess distributions. If a private foundation distributes more than the required 5 percent, the foundation may carry forward, for up to 5 years, any qualifying distributions above the minimum distribution amount. IRC §4942(i)(2). These excess distributions may be applied to reduce the amount that the foundation would otherwise have to distribute in the subsequent year. Treas Reg §53.4942(a)-3(b)(5).

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§4.39 c. Penalties

If a private foundation fails to distribute the required amounts, the IRS imposes an annual tax of 30 percent of the amount that should have been distributed. IRC §4942(a). If the failure is not corrected within a specified period, an additional tax will be imposed equal to 100 percent of the amount remaining undistributed. IRC §4942(b). As with self-dealing, repeated or flagrant violations may lead to the withdrawal of exemption and the imposition of a termination tax. IRC §507.

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§4.40 5. Net Investment Income

Although private foundations are exempt from tax under IRC §501(c)(3), they are required to pay a 2-percent tax on their annual net investment income. IRC §4940. If the private foundation exceeds the required minimum distribution for a year, it can reduce the 2-percent tax down to a 1-percent tax. IRC §4940(e). The increased distribution in 1 year, however, sets the floor for the amount that the private foundation must distribute in the following year in order to take advantage of the 1-percent tax rate. Accordingly, a private foundation will not likely stay in the 1-percent tax rate over several years.

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§4.41 6. Interests in Business Enterprises

Limits on ownership. Private foundations and disqualified persons are prohibited from together owning large interests in business enterprises. IRC §4943. Specifically, a private foundation is prohibited from owning an interest in a corporation or partnership if the ownership interest of the private foundation, when combined with the interests held by disqualified persons, exceeds 20 percent of the business enterprise. IRC §4943(c)(2)(A). If the business is in fact controlled by another person who is not a disqualified person, the percentage that the private foundation and disqualified persons may own increases to 35 percent. IRC §4943(c)(2)(B). There is also a de minimis exception that allows a private foundation to own 2 percent of any business regardless of the holdings of disqualified persons. IRC §4943(c)(2)(C).

Five years to dispose of contributed excess business interest. A private foundation that receives an excess business interest as a contribution has 5 years to dispose of it. IRC §4943(c)(6). This is often done through a redemption at market value, which must be offered to all shareholders. IRC §4941(d)(2)(F). The redemption may not be desirable, as other shareholders also will tender their shares to the company. A private foundation may not dispose of an excess business holding by selling to a shareholder who is a disqualified person, except if the sale is through an administration of an estate. Treas Reg §53.4941(d)-4.

NOTE: The IRS may extend the 5-year period for an additional 5 years for an unusually large gift or bequest in which the foundation establishes that the facts and circumstances warrant an extension. IRC §4943(c)(7). However, if excess business holdings exist because of a purchase, no extensions are available. The matter must be corrected promptly, or the foundation will be subject to a tax equal to 10 percent of the value of the excess holdings, calculated as of the day during the tax year when its holdings were greatest. IRC §4943(a).

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§4.42 7. Jeopardy Investments

Foundation and manager subject to penalties. Internal Revenue Code §4944 provides that, if a private foundation invests in a manner that is likely to jeopardize its ability to carry out its exempt purposes, the foundation is taxed at 10 percent of the amount so invested for each year (or partial year) during which the investment is held. IRC §4944(a)(1). A foundation manager who participated in making that investment, knowing that it could jeopardize the foundation, is also annually taxed at 10 percent of the amount unless the manager's participation was not willful and was due to reasonable cause. IRC §4944(a)(2). If the investment is not "removed from jeopardy," additional taxes are imposed. IRC §4944(b).

Jeopardy investments. Investments that cause the foundation to lose money, thereby jeopardizing its ability to carry out its charitable purpose, are called "jeopardy investments." IRC §4944(a)(1). The regulations state that investments are viewed in the context of the foundation's whole portfolio, and the regulations specifically identify puts, calls, and working oil and gas interests as suspect investments. Treas Reg §53.4944-1(a)(2). However, California nonprofit public benefit corporations are subject to the investment rules imposed by the California Corporations Code, which are similar to the jeopardizing investment rules imposed on private foundations. See Corp C §5240.

CAUTION: Modern hedging strategies often use investments on the suspect list contained in Treas Reg §53.4944-1(a)(2); it is not clear how losses on these investments would be treated.

Exception for program-related investments. Internal Revenue Code §4944(c) specifically excludes program-related investments from the definition of jeopardizing investments. A program-related investment is an investment whose primary purpose is to accomplish one or more charitable purposes, and the production or the appreciation of property is not a significant purpose. Treas Reg §53.4944-3(a)(1).

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§4.43 8. Compensating Family Members

Private foundation governance tends to be dominated by the members of the family that founded the private foundation. It is not unusual for a private foundation board to consist of the initial donor husband and wife and their children with no outsiders. Nor is it uncommon for one or more of the family members to provide services to the private foundation and to be paid for that work.

Public benefit corporations. Compensating a family board member is problematic if the foundation is organized under the Nonprofit Public Benefit Corporation Law (Corp C §§5110-6910), because not more than 49 percent of the directors may be interested directors. Corp C §5227. The attribution rules of financial interest in the Corporations Code are broader than the Internal Revenue Code and include siblings. Accordingly, if the parents and siblings are the directors, and if any one child is receiving compensation, all of the directors are considered to be interested directors.

PRACTICE TIP: This limitation can be avoided by incorporating in Delaware or some other jurisdiction besides California, by forming as a trust, or, if applicable, forming as a California religious corporation.

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§4.44 9. Taxable Expenditures

Foundation and manager subject to penalties. Numerous expenditures that are prohibited to private foundations are called taxable expenditures. See IRC §4945. Taxable expenditures include expenditures for lobbying and for scholarships and grants to individuals for travel or study unless they are part of a program that has been preapproved by the IRS. IRC §§4945(d)(3), (e).

NOTE: These rules require a private foundation to have every scholarship program, as well as any changes in such a program, approved by the IRS before it can be implemented. IRC §4945(g). On scholarship funds, see §4.6.

The IRS imposes penalties on private foundations that make taxable expenditures and on any manager who, knowingly and without reasonable cause, participates in making a taxable expenditure. IRC §4945(a). If the taxable expenditure is not reversed, additional penalties are imposed. IRC §4945(b).

Lobbying. Private foundations may not conduct or pay for any type of lobbying activity at all. IRC §4945(d)(1). Many efforts fall outside the definition of "lobbying" in the regulations, however, and private foundations may conduct such efforts.

Grants to individuals. Private foundations may make grants to individuals only if the selection procedures are objective and nondiscriminatory and if the IRS has formally determined in advance that the foundation's selection procedures meet that standard. IRC §4945(g). The requirements for the selection procedure are in Treas Reg §53.4945-4(b)(3).

PRACTICE TIP: Usually, the most convenient occasion to obtain that determination is as part of the initial exemption application process. Accordingly, practitioners should request the IRS to approve grant selection procedures for individual grantees as part of a new private foundation's tax exemption application if there is any interest on the donor's part in such grants, in order to save the foundation the cost and delay of subsequently obtaining a ruling and the risk of proceeding without one.

Expenditure responsibility. Private foundations may not make a grant to an organization that is not either a public charity or an exempt operating foundation unless the private foundation exercises expenditure responsibility over the grant. IRC §4945(d)(4). "Expenditure responsibility" refers to a process of documented monitoring and oversight, which consists of four elements: a pregrant inquiry, a written grant agreement containing certain specific terms and conditions, a written report from the grantee, and the provision of information to the IRS on Form 990-PF. Treas Reg §53.4945-5(b). Private foundations may also use expenditure responsibility for grants to any supporting organization for which the grant is not considered to be a qualifying distribution under IRC §4942.

Grants to foreign charities. The expenditure responsibility procedures have posed an obstacle to foreign grant-making. If a private foundation makes a good faith determination that a foreign charity would qualify as a public charity if it were a United States organization, or if it obtains and relies on a written legal opinion to that effect, the private foundation may treat a grant to that charity as if it were made to a United States public charity (*i.e.,* the private foundation need not exercise expenditure responsibility). Treas Reg §53.4945-5(a)(5). Few private foundations, however, have taken advantage of this provision. The IRS has sought to ease the burdens on private foundations by issuing Rev Proc 92-94, 1992-2 Cum Bull 507, which provides a simplified affidavit procedure for determining whether a foreign charity is the equivalent of a public charity.

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§4.45 10. Independent Audit Committee Requirement

Audit committee. The Nonprofit Integrity Act (Stats 2004, ch 919) (amending and adding sections to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7)) requires an independent audit committee for corporations holding charitable assets in California with revenues over $2 million. Govt C §12586(e)(2). The composition and permissible members of the audit committee are specified in the statute. The Nonprofit Integrity Act thus poses challenges for families that wish to maintain management of their private foundation within the family. Sometimes, it is possible to name a trusted advisor to the family to serve on the audit committee, but some advisors may be professionals who are also rendering services to the corporation. Professional advisors providing services to the foundation will not be considered independent and able to act as the audit committee. See Govt C §12586(e)(2).

Audit requirement. The Nonprofit Integrity Act also requires that any private foundation holding charitable assets in California, whether a corporation or a trust, must have an audit by a certified public accountant if its revenue exceeds $2 million. Govt C §12586(e)(1). A private foundation with simple operations and modest revenue may be subject to the audit requirement if it receives a contribution of $2 million or more in 1 year.

For a more detailed discussion of these requirements, see §12.53. For a bylaws provision establishing an audit committee, see §7.82.

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§4.46 11. Grants to Supporting Organizations

Grants are not qualifying distributions. Grants by private nonoperating foundations to certain supporting organizations (SOs) do not count as qualifying distributions under IRC §4942. IRC §4942(g)(4). These SOs include (IRC §4942(g)(4)):

- Type III SOs that are not functionally integrated with the supported organization (*i.e.,* the SO does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the SO is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the SO is *not* the parent of each of the supported organizations (see Prop Treas Reg 1.509(a)-4(f))); and
- Any Type I, Type II, or functionally integrated Type III SOs in which a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SOs.

Grants taxable unless expenditure responsibility requirements met. Furthermore, these grants are taxable expenditures for both private nonoperating and private operating foundations under IRC §4945 unless the foundation follows the expenditure responsibility requirements. IRC §4945(d)(4)(A). Regulations may provide other circumstances under which a distribution from a private foundation to a SO is not allowed.

As stated above in §4.14, in connection with donor-advised funds, Rev Proc 2009-32, 2009-28 Int Rev Bull 142, provides criteria for private foundations to use to determine whether a potential grantee is a SO. A grantor, acting in good faith, may rely on either of the following:

- The grantee's current IRS letter recognizing the grantee as tax-exempt and indicating the grantee's public charity classification, or
- Information from the IRS Business Master File (BMF).

A grantor may download the BMF directly from the BMF website. Alternatively, the grantor may obtain the BMF information from a third party, as long as the report includes the following:

- The grantee's name, Employer Identification Number, and public charity classification under §509(a)(1), (2), or (3);
- A statement that the information is from the most-currently available IRS monthly update to the BMF, along with the IRS BMF revision date; and
- The date and time of the grantor's search.

NOTE: Currently the BMF will not tell the grantor whether a SO is a Type I, II, or III SO, and whether, if it is Type III, it is or is not "functionally integrated." The SO's IRS exempt determination letter may or may not provide this information. The SO's Form 990 or 990-EZ should provide this information, but the guidance does not state that good faith reliance on information returns is sufficient.

Previously, in Notice 2006-109, 2006 Cum Bull 1121, the IRS provided guidance for private foundations to determine a SO grantee's type, whether the SO is Type III, whether it is functionally integrated, and, if it is a Type I, Type II, or Type III SO, whether it is controlled.

On September 24, 2009, the IRS issued proposed regulations regarding the requirements to qualify as a Type III SO that is operated in connection with one or more supported organizations. See 74 Fed Reg 48672. The Explanation of Provisions expressly states that private foundations may continue to rely on the grantor reliance standards of §3.0 of Notice 2006-109 until the proposed regulations are published as final or temporary regulations. 74 Fed Reg 48679 (2009). The Explanation further states that as of September 23, 2009, the IRS will issue functionally integrated Type III SO determinations only to organizations that meet the requirements for functionally integrated organizations under Prop Treas Reg §1.509(a)-4(i)(4). 74 Fed Reg 48675 (2009). An organization that received a determination that it qualified as a functionally integrated Type III SO under the Advanced Notice of Proposed Rulemaking, "Payout Requirements for

Type III Supporting Organizations That Are Not Functionally Integrated" (ANPRM) (see REG-155929-06, 72 Fed Reg 42335 (2007)) may continue to rely on that determination letter until final or temporary regulations are published, as long as the organization continues to meet the requirements of either the ANPRM or Prop Treas Reg §1.509(a)-4(i)(4). 74 Fed Reg 48679 (2009). An organization that receives a determination that it is a functionally integrated Type III SO under either the ANPRM or the proposed regulations will be required to meet the requirements established in final or temporary regulations as of the first taxable year beginning after final or temporary regulations are published. 74 Fed Reg 48679 (2009).

On types of supporting organizations, see §§4.58-4.65. On private operating foundations, see §§4.47-4.50.

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§4.47 B. Private Operating Foundations

Donations treated as gifts to public charities. Most private foundations make grants to other charitable organizations. Some private foundations, however, carry out their own charitable activities, such as operating a museum. These private foundations are referred to as private operating foundations. Charitable contributions to private operating foundations are treated as gifts to public charities. IRC §170(b)(1)(A)(vii).

Not subject to 2-percent excise tax. An operating foundation is not subject to the 2-percent excise tax imposed on net investment income that applies to regular private foundations. IRC §4940(d). See §4.40. In addition, other private foundations can make grants to private operating foundations in the same manner as to public charities. IRC §4945(d)(4)(A). No expenditure responsibility is required. See §4.44. In all other respects, a private operating foundation is subject to the same rules as a private foundation relating to reporting, recordkeeping, and restrictions on activities by disqualified persons.

Two tests. To qualify as a private operating foundation, an organization must satisfy two tests: the income test and an alternative test. See §§4.48-4.49.

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§4.48 1. Income Test

All private operating foundations must satisfy the income test. To meet the test, a private foundation must make "qualifying distributions… directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of (i) its adjusted net income… or (ii) its minimum investment return." IRC §4942(j)(3)(A). In general, this means that the private foundation cannot simply make grants and passively support its charitable purposes. Rather, it must use its income to engage in charitable activities directly. If the private foundation makes grants to individuals, the grants can count as direct distributions if the private foundation maintains significant involvement in the programs for which it is making the grant.

Additional direct distributions. In addition to amounts that the private foundation would spend directly on its charitable activities, certain other distributions qualify as direct distributions. The following are considered direct distributions (see IRC §4942(g)):

- Amounts paid to acquire assets held for use by the foundation as operating assets in the exempt function;
- Reasonable administrative expenses necessary to conduct the exempt function are direct even though they are not directly for the active conduct of the exempt function; and
- Amounts properly set aside for the purpose of assets to be held for direct use in the exempt function (*e.g.,* funds accumulated over several years to construct a building to be used in the exempt purposes of the foundation).

"Substantially all" means 85 percent, and as a result, a private operating foundation can only retain (or make nonqualifying grants) of up to 15 percent of the lesser of (1) the private foundation's adjusted net income or (2) its minimum investment return. IRC §4942(j)(3)(A); Treas Reg §53.4942(b)-1(c). Adjusted net income is gross income less deductions allowable to a corporation. IRC §4942(f). Gross income does not include grants received by the private foundation, but would include income from a related business carried on by the private foundation. Minimum investment return equals 5 percent of its assets that are not used directly in carrying out its exempt function, less acquisition indebtedness with respect to those assets.

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§4.49 2. Alternative Test

In addition to the income test, private operating foundations must also satisfy one of the following tests:

- **The asset test** requires that 65 percent of the private foundation's assets must be devoted directly to either (1) the active conduct of activities constituting its exempt purpose, or (2) a functionally related business. IRC §4942(j)(3)(B)(i); Treas Reg §53.4942(b)-2(a). Assets used for an exempt function include real estate, facilities, equipment, and intangible assets. Securities are generally not counted as used for exempt purposes unless the private foundation owns 80 percent of the corporation's stock. There are special rules for valuing nonmarketable assets. This test is usually appropriate if the organization has invested substantial capital in assets, typically art or real estate, which it uses in its exempt activities.
- **The endowment test** requires that a private operating foundation make direct distributions of at least two-thirds of its minimum investment return (*i.e.,* 33⅓ percent of its assets). IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)-2(b). Of the three tests, this is usually the easiest to satisfy.
- **The support test** requires that (1) at least 85 percent of the private operating foundation's support, other than investment income, be from a combination of the general public and five or more exempt organizations; (2) not more than 25 percent of support other than investment income be from any one exempt organization; and (3) not more than 50 percent of its support is received from gross investment income. IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)-2(c). This test rarely applies because organizations that can meet this test usually qualify as public charities.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.50 3. Exempt Operating Foundations

§4.50 3. Exempt Operating Foundations

Some private operating foundations may qualify as "exempt operating foundations" under IRC §4940(d). An exempt operating foundation is not subject to the 2-percent excise tax on its investment income. IRC §4940(d)(1). Moreover, although private foundation grantors must exercise expenditure responsibility over grants to private foundations generally (see §4.44), this requirement does not apply to grants to exempt operating foundations; thus, private foundation grantors may treat grants to private foundations as if the grantee were a public charity. IRC §4945(d)(4).

"Exempt operating foundation" defined. To obtain this privileged status, the foundation must satisfy four criteria (IRC §4940(d)(2)):

- The foundation must either have qualified as a private operating foundation for its last taxable year ending before January 1, 1983, or have qualified as a public charity for at least 10 years;
- At least 75 percent of the governing body must consist of people other than substantial contributors and their relatives;
- The governing body must be broadly representative of the public; and
- No substantial contributor or related person may serve as an officer at any time during the taxable year in question.

As a practical matter, the first of the above criteria makes it unlikely that most operating foundations will ever be able to qualify as exempt operating foundations. Any organization that can demonstrate the necessary degree of public support usually seeks to be classified as a public charity, not a private foundation.

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§4.51 C. Donor-Directed Funds

A donor-directed fund is a private foundation that maintains individual donor accounts similar to donor-advised funds. See IRC §170(b)(1)(F)(iii). However, unlike a donor-advised fund (see §4.4), the donor's directions with respect to a donor-directed fund are legally binding. Donor-directed funds are required to distribute all income annually to public charities. IRC §170(b)(1)(F)(iii). On the death of the donor or the survivor of the donor and the spouse of the donor, the entire principal of the donor-directed fund for that donor must be distributed to a public charity. IRC §170(b)(1)(F)(iii).

NOTE: Donor-directed funds have fallen out of favor because donor-advised funds offer the same practical benefits to donors without the disadvantages of the required annual distribution and all the restrictions of operating as a private foundation.

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D. Private Pass-Through Foundations

§4.52 1. Requirements for Pass-Through Treatment

Another special type of private foundation, known as a private pass-through, conduit, or flow-through foundation, passes through to the ultimate charitable recipients all contributions that it receives, rather than retaining them for use in its own activities. Thus, qualifying distributions include contributions to IRC §501(c)(3) organizations. See IRC §4942(g)(3).

Annual return must show tests satisfied. To qualify for pass-through treatment, a private foundation need not obtain a ruling from the IRS, but it must demonstrate on its annual information return (IRS Form 990-PF) that the manner in which it has operated for that year satisfies the tests in IRC §170(b)(1)(F)(ii) and Treas Reg §1.170A-9(h). Specifically, the private foundation must, within 2½ months after the close of its tax year, make qualifying distributions equal to the value of all contributions received in that year plus all its income from the current year and any undistributed income from its immediately preceding tax year. The donor must attach to his or her tax return (or amended tax return) evidence from the private foundation that it has made such timely qualifying distributions. Treas Reg §1.170A-9(h)(4).

Precise compliance with IRC §170(b)(1)(F)(ii) and the corresponding regulation is required to obtain the advantages of the private pass-through foundation. For example, all distributions must be "qualifying distributions," but that term is applied narrowly to a private pass-through foundation. Distributions must be made within specified time limits, which requires careful recordkeeping. A foundation may make timely qualifying distributions of all its contributions, yet not qualify for pass-through treatment if it has any undistributed income from its current or preceding tax year.

PRACTICE TIP: The precise requirements are not satisfied by distributing the same property received. Rather, the value of the property distributed must equal the value of the property when contributed. See Treas Reg §1.170A-9(h)(2). Thus, any contributed stock or other property that may decrease in value should be sold immediately and converted into cash or cash equivalents.

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§4.53 2. Planning Strategies

Tax strategies. The private pass-through foundation can be a valuable tax-planning vehicle. Like a private operating foundation, an individual donor obtains the same charitable contribution deduction as would be received from contributing to a public charity. IRC §170(b)(1)(A)(vii), (F)(ii). The donor obtains an immediate tax deduction; if he or she controls the foundation, the donor also retains the ability to select the ultimate charitable recipients. The selection and distribution of funds to those recipients by the private pass-through foundation must be made within 2½ months after the close of the foundation's taxable year in which the contribution was received. IRC §170(b)(1)(F)(ii). Thus, selection and distribution may be delayed as long as 14½ months after the foundation receives the contribution. See Treas Reg §1.170A-9(i).

Philanthropic and tax objectives. A donor may also achieve varied philanthropic and tax objectives by switching the foundation from a standard private foundation in one year to a private pass-through foundation in another. Thus, in one year the donor may build an endowment in the foundation through contributions that receive limited deductions and, in a tax year when the donor needs maximum deductions, he or she may use the foundation as a private pass-through foundation. The private pass-through foundation, like any foundation, may also be used by the donor to remain anonymous.

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§4.54 E. Private Common Fund Foundations

A private common fund foundation permits a donor to designate public charity recipients to receive the income and corpus from the donor's portion of a pooled fund of contributions. IRC §170(b)(1)(F)(iii). As with a private pass-through foundation, a donor to a common fund foundation obtains the same charitable contribution deductions that gifts to public charities generate, retains control over the designation of the charitable recipient after his or her contribution to the foundation, and may preserve his or her anonymity. See IRC §170(b)(1)(A)(vii).

"Private common fund foundation" defined. To qualify as a private common fund foundation, the organization must satisfy the tests in IRC §§170(b)(1)(F)(iii) and 509(a)(3)(A)-(B) and Treas Reg §1.170A-9(i), and the organization should obtain a ruling from the IRS. The foundation's governing documents (its articles or bylaws) must require the foundation to distribute all the adjusted net income of the common fund to one or more public charities, classified under IRC §509(a)(1), no later than 2½ months after the close of the tax year in which the income is realized by the fund. Treas Reg §1.170A-9(i)(2)(i). All the corpus of the foundation attributable to any donor's contributions must be distributed to similar recipients within 1 year after the death of the donor or his or her surviving spouse. Treas Reg §1.170A-9(i)(2)(ii).

Distinguished from private pass-through foundations. Important differences exist between private common fund foundations and private pass-through foundations:

- Private common fund donors may designate distributions from the contribution and the net income it generates over their entire lifetime, rather than merely for the taxable year (plus 2½ months) in which the foundation receives that contribution.
- Although the designated time period may be more advantageous to the donor, the range of possible designees is narrower. A private common fund foundation may distribute funds only to public charities classified under IRC §509(a)(1); in contrast, a private pass-through foundation may make grants to all types of public charities and private foundations as long as the transfer satisfies the definition of "qualified distribution" under IRC §170(b)(1)(F)(ii).
- A private common fund foundation may not be used as a standard private foundation in some years, as a pass-through foundation can. This restriction is not significant, however, because the donor will nevertheless be able to obtain maximum tax deductions and build an endowment lasting for the donor's lifetime.

PRACTICE TIP: As with pass-through foundations, private common fund foundations must keep careful records to comply with the precise distribution requirements. Further, private common fund foundations must keep separate records for each donor's contributions and the net income attributable to those contributions; these records must be kept for the life of the donor if the contributions are retained for the maximum period.

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§4.55 F. Termination of Private Foundation Status

A charity may terminate its private foundation status by distributing all its net assets to a qualified public charity, or by transforming itself into a public charity. IRC §§507(a)-(b). See chap 3. When distributing all net assets, the public charity distributee must that have been in existence for a continuous period of 60 months or more. IRC §507(b)(1)(A). If terminating private foundation status by transforming into a public charity, the private foundation must operate in a manner to qualify as a public charity for 60 months; notify the IRS before that 60-month period begins; and establish, immediately after that period ends, that it has met the applicable public charity test. IRC §507(b)(1)(B).

Termination tax. Any other termination of private foundation status may result in a termination tax. The tax imposed will be the lesser of the aggregate tax benefits obtained by the private foundation during its existence or the value of the net assets of the foundation. IRC §507(c). The termination tax will apply if the IRS terminates the organization's private foundation status for repeated or flagrant willful violations that resulted in liability for excise taxes under IRC §§4942-4945. See IRC §507(a)(2). The tax will also apply if the private foundation voluntarily terminates itself other than by transforming itself into a public charity or distributing all its assets to a public charity. See IRC §507(a)(1).

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V. SUPPORTING ORGANIZATIONS

§4.56 A. Definition

A supporting organization (SO) is a charitable organization operated exclusively for the benefit of one or more public charities described in IRC §509(a)(1)-(2). IRC §509(a)(3)(A). Because of its close relationship with one or more public charities, an SO is treated as a public charity. Thus, donations to SOs receive the most favorable tax treatment. SOs are not subject to as many prohibitions as private foundations. On SO limitations, see §§4.66-4.79.

Close relationship with supported charity. All SOs must satisfy certain basic requirements with respect to support of the public charities and the composition of their board. Each SO must also establish a close relationship with the supported public charities in one of three different ways. IRC §509(a)(3)(C). This relationship requirement distinguishes a Type I SO from a Type II SO or a Type III SO. See §§4.58-4.65.

Operated exclusively for benefit of public charity. Supporting organizations must be operated exclusively for the benefit of the supported public charities. IRC §509(a)(3)(A). These charities can be identified by name or, in some instances, as a class. All of the SO's distributions must be to or for the benefit of the supported public charities.

EXAMPLE: An organization formed to support a university could either make grants directly to the university or distribute scholarships to the students at the university.

Community foundations play an important role in an SO's obligation to make distributions to or for the benefit of its supported charities. Because community foundations support a wide variety of causes, a community foundation SO has tremendous grant-making flexibility. If an SO supports only a specific-purpose charity, such as a hospital or a university, it will be able to make only distributions related to those charities and purposes.

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§4.57 B. Directors

Supporting organizations must satisfy certain basic requirements with respect to the composition of their board. More than 50 percent of the directors of a supporting organization must be persons who are not disqualified persons. IRC §509(a)(3)(C). For a definition of disqualified persons, see §4.25.

EXAMPLE: A board that had two disqualified persons and two persons who were not disqualified persons would not be a legal board, but a board with three nondisqualified persons and two disqualified persons would be a legal board.

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§4.58 C. Types of Supporting Organizations

The relationship between a supporting organization (SO) and its supported public charities, as defined in IRC §509(a)(3)(B), may be structured in one of three ways (Treas Reg §1.509(a)-4(f)(2)):

- The SO is *operated, supervised, or controlled by* the supported public charities (Treas Reg §1.509(a)-4(g));
- The SO is *supervised or controlled in connection with* the supported public charities (Treas Reg §1.509(a)-4(h)); or
- The SO is *operated in connection with* the supported public charities (Treas Reg §1.509(a)-4(i)).

These three types of SOs are discussed in §§4.59-4.68.

NOTE: Notice 2006-109, 2006-2 Cum Bull 1121, alerted taxpayers to the new SO rules enacted by the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), and provided interim guidance to SOs. In August 2007, the Treasury Department and the IRS issued an Advanced Notice of Proposed Rulemaking, "Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated" (ANPRM) (see REG-155929-06, 72 Fed Reg 42335 (2007)) that described proposed rules to implement the PPA changes to the Type III SO requirements. Proposed regulations issued in September 2009 with respect to Type III SOs have superseded the ANPRM. IRS guide sheets and other materials on SOs can be found on the IRS website at http://www.irs.gov/charities/article/0,, id=174956,00.html. However, the guide sheets on Type III SOs, dated March 13, 2008, do not reflect the recently issued proposed regulations. See §§4.14, 4.46.

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§4.59 1. Type I Supporting Organizations

Operated, supervised, or controlled by supported charity. A supporting organization (SO) that is operated, supervised, or controlled by the supported public charities is a Type I SO. A public charity is considered controlling if it appoints a majority of the voting members of the SO's board, *e.g.,* four members of a seven-member board.

Designation of directors. In a Type I SO, not every supported public charity is required to have the right to designate a director. One organization could designate all of the directors for the public charities, or several public charities could each designate one director. As long as the charities that are designating the directors can be reasonably expected to represent the interests of all the public charities supported by the SO, the board will meet the requirements for a Type I SO.

Relationship. A Type I SO is sometimes viewed as having a parent-child relationship with the supported public charities. Certainly in circumstances when one public charity appoints the majority of the directors of the SO, the SO functions very much like a subsidiary of the public charity.

PRACTICE TIP: A public charity that appoints the majority of the board of directors of the SO will be required to consolidate its accounting with that of the SO under rules promulgated by the Financial Accounting Standards Board (FASB), available on the Internet at http://www.fasb.org. For further discussion of accounting principles, see chap 21.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.60 2. Type II Supporting Organizations

§4.60 2. Type II Supporting Organizations

A supporting organization (SO) supervised or controlled in connection with its public charities is a Type II SO. A Type II SO may have the same directors as the directors of its supported public charity, or a third entity may appoint the directors of both the SO and the supported public charity. Type II SOs are referred to as brother-sister organizations. They are typically found in healthcare systems and are not generally used by donors.

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§4.61 3. Type III Supporting Organizations

Connected with one or more public charities. A supporting organization (SO) operated in connection with one or more public charities is a Type III SO. Generally, the public charities will appoint only a minority, if any, of the board members of a Type III SO.

Close relationship with supported public charities. Unlike Type I or Type II SOs, a Type III SO is not controlled by public charities or the same persons that control the public charities. Instead, the Type III SO must demonstrate a close relationship with the supported public charities. To show this relationship, a Type III SO must satisfy two tests: a responsiveness test and an integral part test. Treas Reg §1.509(a)-4(i)(1). See §§4.62-4.68. Prop Treas Reg §1.409(a)-4(i)(1)-(2) also add a notification requirement.

NOTE: Proposed regulations issued pursuant to the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), have made significant changes to the rules relating to Type III SOs. See Prop Treas Reg §1.509(a)-4; 74 Fed Reg 48672. See §§4.14, 4.46. The Explanation of Provisions issued with the revisions expressly states that a Type III SO that fails to meet the requirements of the proposed regulations, once they are published as final or temporary regulations, will be classified as a private foundation. See 74 Fed Reg 48678 (2009).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.62 a. Responsiveness Test

§4.62 a. Responsiveness Test

An SO is responsive to the needs or demands of a supported organization if (Prop Treas Reg §1.509(a)-4(i)(3)):

- One or more officers, directors, or trustees of the SO are elected or appointed by the officers, directors, trustees, or membership of the supported organization; or
- One or more members of the governing bodies of the supported organization are also officers, directors, or trustees of, or hold other important offices in the SO; or
- The officers, directors, or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization; and
- By reason of one of the relationships above, the officers, directors, or trustees of the supported organization have a significant voice in (1) the investment policies of the SO; (2) the timing of grants; (3) the manner of making grants; (4) the selection of recipients by such SO; and (5) in otherwise directing the use of the income or assets of the SO.

These requirements are consistent with the responsiveness test set forth in current regulations. See Treas Reg §1.509(a)-4(i)(2)(ii).

The IRS has argued that one director named by the public charities may not be sufficient for a SO to meet the responsiveness test. *Roe Found. Charitable Trust*, TC Memo 1989-566. In contrast, the tax court has held that, generally, one director named by the public charities will satisfy this test. *Lapham Found., Inc.* TC Memo 2002-293, aff'd *Lapham Found, Inc. v Commissioner* (6th Cir 2004) 389 F3d 606.

NOTE: Before the Pension Protection Act of 2006 (PPA) (Pub L 109-280, §1231(c), 120 Stat 780), the responsiveness test required that the SO be a trust under state law, that the supported public charities be identified by name, and that the public charities have the right to enforce the trust and compel an accounting. Treas Reg §1.509(a)-4(i)(2)(iii). The PPA eliminated the ability to set up such a trust as a Type III SO, effective August 17, 2007. Pub L 109-280, §1241(c) (26 USC §509 nt).

The proposed regulations provide that all Type III SOs, including those organized as charitable trusts, must demonstrate a relationship between its officers, directors or trustees, and those of the supported organization that results in the officers, directors, or trustees of the supported organization having a "significant voice" in the operations of the SO. Prop Treas Reg 1.509-4(i)(3)(iii). The Explanation of Provisions of the proposed regulations expressly rejects a special rule for trusts, stating that requiring charitable trusts to meet the responsiveness test in the proposed regulations is consistent with Congress's intent in the PPA. 74 Fed Reg 48675 (2009).

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§4.63 b. Integral Part Test

The PPA distinguishes between "functionally integrated" and "non-functionally integrated" Type III SOs. Pub L 109-280, §1241, 120 Stat 780. The proposed regulations require that a Type III SO demonstrate that it is an integral part of a supported organization by satisfying the requirements for either a functionally integrated or a non-functionally integrated Type III SO.

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§4.63A (1) Functionally Integrated Type III Supporting Organizations

The proposed regulations provide that a supporting organization (SO) meets the integral part test as a "functionally integrated" Type III SO if it meets either of following tests (Prop Treas Reg §1.409(a)-4(i)(4)(i)):

- The SO engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which the SO is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s), and that but for the involvement of the SO, would normally be engaged in by the supported organization; or
- The SO is the parent of each of its supported organizations.

A SO is the parent of a supported organization if the SO exercises a substantial degree of direction over the policies, programs, and activities of the supported organization, and a majority of the officers, directors, or trustees of the supported organization is appointed or elected by the governing body, members, or officers of the SO. Prop Treas Reg §1.509(a)-4(i)(4)(i)(B).

The Advanced Notice of Proposed Rulemaking, "Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated" (ANPRM) (see REG-155929-06, 72 Fed Reg 42335 (2007)) had proposed requiring an organization to meet a "but for" test under existing Treas Reg §1.509(a)-4(i)(3)(ii), as well as an expenditure test and an assets test, in order to qualify as a functionally integrated Type III SO. The proposed regulations retain the modified "but for" test, but do not adopt the expenditure test and the assets test that had been proposed in the ANPRM.

The proposed regulations provide that a SO directly furthers the exempt purposes of its supported organization by holding or managing exempt-use assets but does not directly further such exempt purposes by fundraising, grant making, or investing and managing non-exempt-use assets. Prop Treas Reg §1.509(a)-4(i)(4)(ii). The Explanation of Provisions of the proposed regulations states that the latter activities do not alone establish a sufficient nexus between a SO and its supported organization. 74 Fed Reg 48676 (2009). The Explanation states that if a SO does not engage in activities that directly further an exempt purpose, then it will achieve a sufficient nexus with its supported organization only if it distributes a significant amount to its supported organizations. 74 Fed Reg 48676 (2009).

An exception is provided for a SO of a governmental entity (as defined in the Proposed Regulations) if the SO supports only one supported organization and a substantial part of the SO's total activities directly furthers the exempt purposes of its supported organization and are activities other than fundraising, grant making, and investing and managing non-exempt use assets. Prop Treas Reg §1.509(a)-4(i)(4)(iii).

The proposed regulations provide the following example of a functionally integrated Type III SO (Prop Treas Reg §1.509(a)-4(i)(4)(iv), Example 3):

> O is a nonprofit publishing organization under section 501(c)(3). It does all of the publishing and printing for the eight churches of a particular denomination in a particular geographic region, each of which is a 509(a)(1) organization. Control of O is vested in a five-man Board of Directors, which includes an official from one of the churches and four lay members of the congregations of that denomination. The officers of O maintain a close and continuing working relationship with each of the eight churches for whom it publishes and prints materials, and as a result, each of the churches has a significant voice in the operations of O. O does no other printing or publishing. All of O's activities directly further the exempt purposes of supported organizations to which it is responsive. But for the activities of O, the churches would normally publish these materials themselves. Based on these facts, O qualifies as a functionally integrated Type III supporting organization under Prop. Reg. §1.509(a)-4(i)(A).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.63B (2) Non-Functionally Integrated Type III Supporting Organizations

§4.63B (2) Non-Functionally Integrated Type III Supporting Organizations

A supporting organization (SO) meets the integral part test as a "non-functionally integrated" Type III SO if it satisfies a distribution requirement and an attentiveness requirement. Prop Treas Reg §1.509(a)-4(i)(9).

NOTE: An exception to the attentiveness requirement is provided for a trust that was in existence on November 20, 1970, and continues to meet the pre-1970 "attentiveness" rules restated in Prop Treas Reg §1.509(a)-4(i)(9).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.63C (i) Distribution Requirement

§4.63C (i) Distribution Requirement

The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) required the Secretary of the Treasury to set payout distribution requirements for organizations that are not functionally integrated to ensure that such organizations pay a "significant amount" to their supported organization(s). To satisfy the distribution requirement of Prop Treas Reg §1.509(a)-4(i)(5)(ii), a Type III non-functionally integrated supporting organization (SO) must annually distribute to or distribute for the use of its supported organizations amounts equaling or exceeding the SO's "annual distributable amount" for such year.

The "annual distributable amount" for a taxable year is (Prop Treas Reg §1.509(a)-4(i)(5)(ii)(B)):

- Five percent of the aggregate fair market value of its non-exempt-use assets; *plus*
- Amounts received or accrued as repayments of amounts which were taken into account by the organization to meet the distribution requirement for any taxable year; plus
- Amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the distribution requirement imposed by this section for any taxable year; less
- The amount of taxes imposed on the SO for the taxable year.

The annual distributable amount for the first taxable year an organization is treated as a non-functionally integrated Type III SO is zero. Prop Treas Reg §1.5090(a)-4(i)(5)(ii)(C).

The proposed regulations provide a reasonable cause exception for failure to meet the distribution requirement. Under the exception, an organization that fails to meet the distribution requirement will not be classified as a private foundation in the taxable year for which it fails to meet such distribution requirement, if the organization establishes to the satisfaction of the Secretary that (Prop Treas Reg §1.5090(a)-4(i)(5)(ii)(E)):

- The failure was due to the valuation of assets, a ministerial error, or unforeseen events or circumstances that are beyond the organization's control;
- The failure was due to reasonable cause and not to willful neglect; and
- The distribution requirement is met within 180 days after the date the incorrect valuation or ministerial error was or should have been discovered, or 180 days after the organization is first able to make its required payout, notwithstanding the unforeseen event or circumstances.

The proposed regulations also provide for a temporary reduction in the annual distributable amount in the event of a disaster or emergency. Prop Treas Reg §1.509(a)-4(i)(5)(ii)(D).

NOTE: An SO that is formed to hold assets for the supported public charity may find meeting the definition of a functionally integrated Type III SO difficult and the payout requirements onerous, especially if it does not hold liquid or income-producing assets. The Treasury Department and the IRS are seeking comments regarding the need for a transition rule for non-functionally integrated Type III SOs whose assets, as of the effective date of these regulations, consist predominantly of assets that are not readily marketable, and who therefore may have difficulty with the distribution requirement of the proposed regulations. 74 Fed Reg 48678 (2009).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.63D (ii) Fair Market Value

§4.63D (ii) Fair Market Value

The proposed regulations specifically provide the methodology for valuation of assets in determining the "annual distributable amount." Prop Treas Reg §1.509(a)-4(i)(8). The fair market value of the SO's assets is made in the year preceding the year of the required distribution and is the sum of the following (Prop Treas Reg §1.509(a)-4(i)(8)(i)(A)):

- The average of the fair market value on a monthly basis of its readily marketable securities;
- The average of the SO's cash balances on a monthly basis; and
- The fair market value of all other assets for the period of time during the taxable year for which such assets are held by the SO.

The calculation of the annual distributable amount does not include the following assets ((Prop Treas Reg §1.509(a)-4(i)(8)(i)(B)):

- Any future interest, until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or until such future interest has been constructively received by the SO;
- The assets of an estate until such time as assets are distributed to the SO, or due to a prolonged period of administration, such estate is considered terminated;
- Any present interest of a SO in any trust created and funded by another person;
- Any pledge to the SO of money or property (whether or not the pledge may be legally enforced; and
- Any assets used (or held for use) to carry out the exempt purposes of the SO(s).

An asset is "used (or held for use) to carry out the exempt purposes of the supported organization(s)" (Prop Treas Reg §1.409(a)-4(i)(8)(i)(C)):

> only if the asset is actually used by the supporting organization in activities that carry out the exempt purposes of its supported organization(s), or if the supporting organization owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use on behalf of its supported organization(s) within a reasonable period of time.

The amount of a distribution made to a supported organization is the fair market value of such property as of the date the distribution is made, determined solely on the cash receipts and disbursements method of accounting. Distributions that count toward the distribution requirements include (Prop Treas Reg §1.409(a)-4(i)(5)(iv), Example 4):

- Any amount paid to a supported organization to accomplish its exempt purposes;
- Any amount paid to acquire an asset used (or held for use) to carry out the exempt purposes of the supported organization(s); and
- Any amount expended by the SO for reasonable and necessary administrative expenses.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.63E (iii) Attentiveness Requirement

§4.63E (iii) Attentiveness Requirement

To meet the "attentiveness requirement," a non-functionally integrated Type III supporting organization (SO) must distribute one-third or more of its annual distributable amount to one or more supported organizations that are attentive to the operations of the SO *and* to which the SO is "responsive" under the responsiveness test. Prop Treas Reg §1.509(a)-4(i)(5)(iii)(A). A supported organization is "attentive" to the operations of the supported organization if the SO distributes annually to such supported organization an amount of support that represents a sufficient part of the supported organization's total support. Prop Treas Reg §1.509(a)-4(i)(5)(iii)(B). Specifically, the SO must meet one of the three following requirements:

- Distribute annually to the supported organization an amount that is 10 percent or more of the supported organization's total support;
- Provide an amount of support to the supported organization that is "necessary to avoid the interruption of the carrying on of a particular function or activity." The support is necessary if the SO or the supported organization earmarks the support for a particular program or activity, even if such program or activity is not the supported organization's primary program or activity, so long as such program or activity is a substantial one; or
- Provide an amount of support that constitutes a "sufficient part of a supported organization's total support," based on a consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and SO, and the purpose to which the funds are put.

The proposed regulations note that normally the attentiveness of a supported organization is motivated by reason of the amounts received from the SO; thus, the more substantial the amount involved, in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. Prop Treas Reg §1.509(a)-4(i)(5)(iii)(B)(3). However, the proposed regulations further state that in determining whether the amount received from the SO is sufficient to ensure the attentiveness of the supported organization to the operations of the SO (including attentiveness to the nature and yield of such SO's investments), evidence of actual attentiveness is of almost equal importance.

A supported organization will not be considered attentive to the operations of a SO with respect to any amount received from the SO that is held by the supported organization in a donor-advised fund. Prop Treas Reg. §1.409(a)-4(i)((5)(iii)(C).

Examples provided in the proposed regulations help to illustrate the distribution and attentiveness requirements of the integral part test. First, with respect to providing support for a particular activity, the Proposed Regulations describe the following example (Prop Reg §1.509(a)-(4)(i)(5)(iv), Example 1):

> K, an organization described in section 5019(c)(3), annually pays over an amount equal to five percent of its assets to L, a museum described in section 509(a)(2). K meets the responsiveness test with respect to L. In recent years, L has earmarked the income received from K to underwrite the cost of carrying on a chamber music series performed for the public free of charge at its premises. The chamber music series is not L's primary activity. L could not continue the performances without K's support. Based on these facts, K meets the attentiveness requirement set out in Prop Reg §1.509(a)-(4)(i)(5)(iii)(B)(2).

Another example illustrates distribution requirements for an SO that supports multiple organizations (Prop Reg §1.509(a)-(4)(i)(5)(iv), Example 3):

> O is an organization described in section 501(c)(3) that is organized to support five private universities, V, W, X, Y and Z, each of which is described in section 501(c)(9). O meets the responsiveness test only as to V. Each year, O distributes five percent of the fair market value of its non-exempt-use assets in equal amounts to the five universities. O distributes annually more than 10 percent of the total annual support of V and W. Based on these facts, O does not meet the integral part requirements set out in Prop. Reg. §1.509(a)-(4)(i)(5)(iii)(B). Although both V and W are attentive to the operations of O, O is only responsive to V. Accordingly, O distributes only one-fifth (i.e., less than the required one-third) of its annual distributable

income to supported organization(s) that are both attentive to O and to which O is also responsive under Prop. Reg. §1.509(a)-4(i)(3).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.64 c. Advantages of Type III Supporting Organizations

§4.64 c. Advantages of Type III Supporting Organizations

Donors are attracted to Type III supporting organizations, because they appear to afford the donor the greatest degree of control. The donor will be able to select a majority, if not all, of the members of the board of directors. Although a majority of the directors will need to be individuals who are not family members or employees, close advisors and trusted friends may comprise the majority of the directors of a Type III SO.

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§4.65 d. Disadvantages of Type III Supporting Organizations

The main drawback of a Type III supporting organization (SO) is that the IRS subjects exemption applications for Type III SOs to a great deal of scrutiny. For an SO that is satisfying the integral part test based on its financial support of the supported public charity, the IRS will require extensive documentation of the SO's finances and the supported public charity's finances to confirm the significance of the SO's payments to the supported public charity. The IRS does not have the same concerns with respect to Type I SOs and a determination letter for a Type I SO is obtained relatively easily.

NOTE: Type III SOs are complicated to operate because of the tests that they must continue to satisfy. These rules have been further complicated since the enactment of the Pension Protection Act of 2006 (PPA) (Pub L 109-280, §1231(c), 120 Stat 780). See §§4.66-4.73.

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§4.66 D. Limitations on Supporting Organizations

Over the past several years, the IRS has expressed concerns that supporting organizations (SOs) in general, and Type III SOs in particular, have been abused by taxpayers. In response, when it enacted the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), Congress applied a number of the rules applicable to private foundations to SOs. See §§4.72-4.84.

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1. Rules Applicable to Type III Supporting Organizations

§4.67 a. Responsiveness Information

A Type III supporting organization (SO) must provide to each of its supported organizations information that the IRS requires to ensure that the organization is responsive to the needs or demands of the supported organizations. IRC §509(f)(1)(A). Prop Treas Reg §1.509(a)-4(i)(2) requires that each taxable year, a Type III SO provide the following to each of its supported organizations:

- A written notice describing the amount and type of support it provided to the supported organization in the past year;
- A copy of the SO's most recently filed Form 990; and
- A copy of the SO's governing documents, including any amendments.

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§4.68 b. Foreign Supported Organizations

A Type III supporting organization (SO) cannot have a foreign supported organization. IRC §509(f)(1)(B)(i). Transition rules apply for existing SOs that support foreign organizations. See IRC §509(f)(1)(B)(ii). See also Prop Treas Reg §1.509(a)-4(i)(10), which states that a Type III SO may not support a supported organization that is organized outside of the United States.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.68A c. No Control by Donor

§4.68A c. No Control by Donor

The proposed regulations provide that an organization may not qualify as a supporting organization of any kind if the organization accepts any gift or contribution from any person (other than a publicly supported organization or a public safety organization) who directly or indirectly controls one or more of the supported organizations, either alone or together with (Prop Treas Reg §1.409(a)-4(f)(5))

- Members of an individual's family (as determined under the "intermediate sanctions" definition of IRC §4958(f)(4), or
- A 35-percent controlled entity (as defined under the "intermediate sanctions" definition of IRC §4958(f)(3).

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§4.69 d. Charitable Trusts

After the enactment of the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), a charitable trust that is a Type III supporting organization (SO) no longer qualifies as a Type III SO solely because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting. Pub L 109-280, §1241(c), 120 Stat 780. As stated previously, charitable trusts must meet the responsiveness requirements applicable to other Type III SOs. The Explanation of Provisions of the proposed regulations expressly rejects a special rule for trusts. 74 Fed Reg 48674 (2009). Therefore, as of August 17, 2007, trusts previously classified as Type III SOs may be classified as private foundations as a result of the PPA. For transitional relief and filing procedures for such charitable trusts, see Notice 2008-6, 2008-1 Cum Bull 275.

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§4.70 e. Payout Requirements

Pursuant to the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), the Department of the Treasury has issued regulations to ensure that a "significant amount" of a supporting organization's (SO's) income or assets is paid to its supported organization(s). Bluebook at 360. As recognized in the Explanation of Provisions to the proposed regulations, the payout provisions of the proposed regulations generally draw from the regulations under IRC §4942 for principles on valuation, timing, and carryovers, with a few distinctions. 74 Fed Reg 48677 (2009).

The proposed regulations do not permit set-asides, which count towards a private foundation's distribution requirement under IRC §4942(g)(2). The proposed regulations also provide a slightly different rule regarding the carryover of excess distributions than is applicable to private foundations. Under IRC§4942(i), a private foundation that distributes more than its distributable amount may carry forward that excess amount for 5 years; when calculating qualifying distributions in a future year under IRC §4942, amounts paid out in the future year count first towards the required distributable amount, and any amount carried forward is not "used" in the future year to the extent that the organization made qualifying distributions in that future year. Prop Treas Reg §1.409(a)-4(i)(7). The proposed regulations reverse the ordering rule and first count any excess amount carried forward toward the non-functionally integrated Type III SO's annual distributable amount, followed by amounts paid out in the later year. See the Explanation of Provisions to the proposed regulations (74 Fed Reg 48677 (2009)).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.71 (1) 'Functionally Integrated' Requirements [Deleted]

§4.71 (1) "Functionally Integrated" Requirements [Deleted]

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.72 (2) Proposed Payout Requirements [Deleted]

§4.72 (2) Proposed Payout Requirements [Deleted]

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§4.73 f. Limitation on Number of Supported Organizations

In the Advanced Notice of Proposed Rulemaking, Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated (ANPRM) (see REG-155929-06, 72 Fed Reg 42335 (2007)) the IRS proposed limiting the number of supported organizations that a non-functionally integrated Type III supporting organization can support to five organizations. The regulations proposed in 2009 do not adopt the five-organization limitation. See 74 Fed Reg 48672 (2009).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.74 2. Contributions to Type I and III Supporting Organizations

§4.74 2. Contributions to Type I and III Supporting Organizations

Type I and III supporting organizations (SOs) may not accept any gifts or contributions from any person who directly or indirectly controls the governing body of a supported organization. IRC §509(f)(2). Additionally, no charitable contribution deduction is allowed for gifts to donor-advised funds operated by a Type III SO that is not functionally integrated. IRC §170(f)(18).

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§4.75 3. Excess Business Holdings of Type II and III Supporting Organizations

Existing private foundation excess business holdings rules apply to Type III supporting organization (SOs) that are not functionally integrated with the supported organization, and to Type II SOs if the supported organization is controlled by the SO's donors. IRC §4943(f). Generally, these SOs' voting or profits interests in a business enterprise, when combined with the interests of disqualified persons, may not exceed 20 percent. IRC §4943(c). The excess business holdings rules apply to taxable years beginning after August 17, 2006. Pub L 109-280, §1243(b), 120 Stat 780. An SO can follow the same transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(f)(7).

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4. Rules Applicable to All Supporting Organizations

§4.76 a. Excess Benefit Transactions

Automatic excess benefit transactions. Any grant, loan, compensation, or other similar payment provided by a supporting organization (SO) to a substantial contributor, a family member of the substantial contributor, or a business they control is treated as an automatic excess benefit transaction. IRC §4958(c)(3)(A)(i)(I). Furthermore, any loan to a disqualified person is an automatic excess benefit transaction. IRC §4958(c)(3)(A)(i)(II).

Entire amount treated as excess benefit. The *entire* amount paid to any such person is treated as the amount of the excess benefit. See IRC §4958(c)(3)(A)(ii). The requirement that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rules of IRC §4958, which provide that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received. The Bluebook indicates that "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Exceptions apply for substantial contributors or other disqualified persons who are public charities. IRC §4958(c)(3)(C)(ii). See Bluebook at 342. (On the Bluebook, see §4.9.) The automatic excess benefit transactions rules are effective for transactions occurring after July 25, 2006 (with certain transition rules that are set forth in IRS Notice 2006-109, 2006-51 Int Rev Bull 1121). Pub L 109-280, §1242(c)(2), 120 Stat 780.

NOTE: Persons who are disqualified persons with respect to an SO are also disqualified persons with respect to the supported organizations under the general excess benefit rules. IRC §4958(f)(1)(D). Organization managers who knowingly participate in the transaction are subject to excise tax as well. IRC §4958(a)(2).

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b. Distributions to Supporting Organizations

§4.77 (1) From Private Foundations

If distributions are made by a private nonoperating foundation to (a) Type III supporting organizations (SOs) that are not functionally integrated with the supported organization, or (b) any Type I, Type II, or functionally integrated Type III SO when a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SO, then the foundation must exercise expenditure responsibility. IRC §4945(d)(4). Additionally, for all private foundations, distributions to such SOs will not count as a qualifying distribution under IRC §4942. IRC §4942(g)(4). Regulations may provide other circumstances under which a distribution from a private foundation to an SO is not allowed.

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§4.78 (2) From Donor-Advised Funds

Grants from donor-advised funds are prohibited to (a) Type III supporting organizations (SOs) that are not functionally integrated with the supported organization, and (b) any Type I, Type II, or functionally integrated Type III SO if the donor or donor advisor controls a supported organization or the Treasury Department determines by a rule that a distribution is inappropriate. IRC §4966(c)(2).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.79 (3) From a Retirement Plan

§4.79 (3) From a Retirement Plan

Persons who have reached 70½ years of age may exclude from income up to $100,000 per year in retirement plan assets if contributed to a qualifying charity. A supporting organization is not a qualifying charity for this purpose. IRC §408(d)(8).

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.80 E. Reclassification as Public Charity

§4.80 E. Reclassification as Public Charity

A supporting organization can seek to change its public charity classification from an IRC §509(a)(3) organization to an IRC §509(a)(1) or §509(a)(2) organization for reasons related to changes made by the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) by submitting a written request for reclassification to the IRS pursuant to Rev Proc 2009-4, 2009-1 Int Rev Bull 118.

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VI. ESTABLISHING AND MAINTAINING PRIVATE CHARITABLE ORGANIZATIONS

§4.81 A. Pledge Agreements and Self-Dealing

Problems with satisfying pledges. Donors who enter into pledge agreements with charitable organizations must draft the agreements carefully if they wish to have the flexibility to satisfy the pledge with payments from a private charitable organization. If a private foundation satisfies a legally binding obligation to an individual donor who is a disqualified person under a pledge agreement, that will be an act of self-dealing by using the foundation's assets for the benefit of the disqualified person. IRC §4941(d)(1)(E). It is likely a prohibited benefit for a donor-advised fund to satisfy the pledge, because the individual donor would receive a more than incidental benefit. See IRC §4967. Alternatively, it could be considered an automatic excess benefit transaction, because the donor is indirectly receiving a grant from the donor-advised fund. IRC §4958. It may be prohibited private inurement for a supporting organization to satisfy the enforceable pledge of an individual donor. IRC §501(c)(3).

Planning strategies. One option to consider is to have the private foundation, rather than the donor, make the pledge. In the situation of a donor-advised fund, a community foundation may be willing to make a pledge agreement if the donor has sufficient funds to satisfy the pledge in the donor-advised fund at the time the pledge is entered into. A donor can maintain maximum flexibility by drafting such an agreement as a statement of an intent to make a gift, not to pay as a legally binding pledge. Then, there is no economic benefit to the donor by having the donor-advised fund or the private foundation make a payment under that intent to make a gift.

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§4.82 B. Maintaining Multiple Private Charities

Some philanthropists find that their needs cannot be satisfied by any one of the private charitable organizations available to them. It is not uncommon for an active philanthropist to have more than one private charitable organization. The donor may form a donor-advised fund and a private foundation. In some cases, the donor may even form a donor-advised fund, a private foundation, and a support organization.

Sharing overhead expenses. Generally, overhead administration expenses of these multiple identities can be shared so that the cost of maintaining the structures remains reasonable. A donor might give the private foundation unrestricted publicly traded stock while contributing appreciated real estate to the donor-advised fund. The donor might make grants to established public charities from the private foundation while running a scholarship program in the donor-advised fund.

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Source: Business Law/Advising California Nonprofit Corporations/4 Donor Funds, Private Foundations, and Supporting Organizations/§4.83 VII. TABLE: COMPARISON OF PRIVATE CHARITABLE ORGANIZATIONS

§4.83 VII. TABLE: COMPARISON OF PRIVATE CHARITABLE ORGANIZATIONS

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COMPARISON OF PRIVATE CHARITABLE ORGANIZATIONS			
	Donor-Advised Fund	Private Foundation	Supporting Organization
Public Charity or Private Foundation?	Public Charity	Private Foundation	Public Charity
Adjusted Gross Income (AGI) Limit on Cash Gifts	50%	30% (if not an operating foundation)	50%
AGI Limit on Appreciated Property	30%	20% (if not an operating foundation)	30%
FMV Deduction for Gifts Other Than Public Stock?	Yes	No (limited to basis)	Yes
Form of Tax Return	None (Form 990 filed by supporting organization)	Form 990-PF	Form 990
Are Donors Private or Public on Tax Return?	Donors are private	Donors are public	Donors are private
Subject to Self-Dealing Limits?	No	Yes	No
Required Minimum Distribution	None	5%	None for Type I, II and functionally integrated Type III SOs; 5% if non-functionally integrated Type III.
Limits on Business Holdings?	Yes	Yes	Yes
Subject to Prohibited Benefits Limits?	Yes	No	No
Subject to Automatic Excess Benefits	Yes	No	Yes

Limits?			
Distribution Requirements?	No	Yes	Yes–Type III
Subject to Jeopardizing Investment Rules?	No	Yes (if not an operating foundation)	No
Funding Limitations Due to Charitable Contribution Deduction Exclusions?	Yes	No	Yes

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5

Forming the Corporation and Beginning Operations

Cynthia R. Rowland

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§5.1 I. SCOPE OF CHAPTER

This chapter discusses the types of nonprofit corporations (see §5.2); certain preliminary considerations necessary in forming such a corporation (see §§5.3-5.9); and the steps to take to complete the corporate organization (see §5.10). It includes forms for the appointment of the initial directors and adoption of bylaws (see §5.11); as well as a complete set of forms for the minutes of the first meeting of the board of directors (see §§5.12-5.38) and for actions by consent of the board (see §§5.39-5.62). The chapter also includes a form of whistleblower policy or consent to use electronic transmissions, for inclusion in the minutes of the first meeting of the board or actions by unanimous written consent of the board. See §§5.63-5.64. In addition, the chapter covers filing an initial statement by domestic nonprofit corporation with the Secretary of State, registration with the Attorney General and the Secretary of State, and compliance with California and federal security laws. See §§5.65-5.69.

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§5.2 II. TYPES OF NONPROFIT CORPORATIONS

California's Corporations Code provides for three categories of nonprofit corporations: "nonprofit public benefit," "nonprofit mutual benefit," and "religious." They are covered, respectively, in Parts 2, 3, and 4 of Division 2 of the Nonprofit Corporation Law (Corp C §§5000-10841) and have many similarities.

The statutes applicable to public benefit corporations are Corp C §§5110-6910; those for mutual benefit corporations are Corp C §§7110-8910; and those for religious corporations are Corp C §§9110-9690. General provisions and definitions that apply to all nonprofit corporations are in Corp C §§5000-5080. On factors that influence the choice of form of a nonprofit entity, see chaps 1-2.

The assets of a corporation formed for charitable or public purposes are irrevocably dedicated to charitable or public purposes. The corporation must use the assets for the stated purpose and, on dissolution, may distribute the assets only to an organization having similar purposes.

Nonprofit public benefit corporation. A corporation formed for charitable or public purposes may be incorporated as a nonprofit "public benefit" corporation under California law. Corp C §5111. Typically, public benefit corporations seek exemption from California franchise tax under Rev & T C §§23701d-23701f, and seek exemption from federal income tax under IRC §501(c)(3)-(4). However, exempt status for state and federal income tax purposes is neither a prerequisite for nor a consequence of incorporation as a public benefit corporation. The requirements for tax exemption of public benefit corporations are discussed in chap 3.

Nonprofit religious corporation. A corporation organized primarily or exclusively for religious purposes is ordinarily incorporated as a nonprofit "religious" corporation. Of the three forms of nonprofit corporations, religious corporations have the least government oversight. They are usually exempt under IRC §501(c)(3) and Rev & T C §23701d, and the procedures and requirements for religious corporations and churches are somewhat different than for public benefit corporations. See chap 3.

Nonprofit mutual benefit corporation. A nonprofit corporation organized for the benefit of its members may be incorporated as a "mutual benefit" corporation. Generally, a mutual benefit corporation permits distribution of its assets to its members on dissolution or is operated for the specific benefit of its members. The requirements for tax exemption of mutual benefit corporations differ from the requirements for a public benefit corporation, and are discussed in chap 3.

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III. PRELIMINARY CONSIDERATIONS

§5.3 A. Checklist: Formation of Nonprofit Corporation

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Many of the steps involved in incorporating a California nonprofit corporation are the same as incorporating a for-profit entity. At a minimum, the following steps should be taken, or at least considered, in forming a nonprofit corporation:

- (1) Clear and reserve, if desired, the name of the corporation with the California Secretary of State (see §§5.4-5.7).
- (2) Draft the articles of incorporation and file them with the Secretary of State (see chap 6).
- (3) Order minute book, seal (if desired), and membership certificates (if necessary) (see §5.10).
- (4) Draft corporate bylaws (see chap 7).
- (5) Draft the following:
- (a) Appointment of initial directors, if directors are not named in the articles of incorporation (see §5.11);
- (b) Directors' waiver of notice and consent to hold organizational meetings of the board of directors (see §5.12) or, if desired, documentation permitting directors' action without a meeting (see §§5.39-5.62);
- (c) Minutes of organizational meetings of the board of directors (see §§5.13-5.38); or
- (d) Action by unanimous written consent of the directors in lieu of first meeting (see §§5.39-5.62).
- (6) Apply for federal Employer Identification Number (EIN) (see §13.2).
- (7) Apply for federal tax exemption (see §§3.60-3.69).
- (8) To obtain California franchise tax exemption, notify California Franchise Tax Board of IRS determination of tax exemption (see §3.71).
- (9) File a Statement by Domestic Nonprofit Corporation with the Secretary of State (see §5.65).
- (10) Register the corporation with the Attorney General's Registry of Charitable Trusts (see §5.66).
- (11) Register the corporation with the Secretary of State's Political Reform Division, if lobbying or employing a lobbyist is intended or if the corporation meets the definition of "Recipient Committee" in Govt C §82013 (see §5.67).
- (12) Ascertain whether issuance of memberships is exempt under state and federal securities laws and, if not, apply for state qualification with the Commissioner of Corporations and federal registration with the Securities and Exchange Commission (see §§5.68-5.69).
- (13) Register as a charity in any jurisdiction other than California where the nonprofit will solicit charitable contributions either by mail, electronic mail, on a website, or by telephone, as required by the jurisdiction.
- (14) Obtain other licenses and permits as necessary from state and local authorities to perform specific acts of businesses or professions or solicitation of funds (see chaps 12-13).
- (15) Obtain nonprofit mailing permit, if desired (see §13.52).

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B. Choosing and Reserving Name

§5.4 1. Restrictions and Procedures

Words not permitted in name. Sometimes the most difficult aspect of incorporating a new entity is choosing a name that is not already taken and that meets the statutory requirements. California law does not require the name to include a corporate designation (that is, "Corporation" or "Inc."). However, the name of a nonprofit corporation may *not* contain the words "bank," "trust," "trustee," or related words without the approval of the Commissioner of Financial Institutions. Corp C §§5122(a), 7122(a), 9122(a). Nor may the name contain the word "cooperative" or any abbreviation of it unless a statutory exception applies. Corp C §12311(b). Restrictions are also imposed on the words "Olympic" and "Olympiad" (36 USC §220506), and on certain terms associated with the federal government and its activities (18 USC §§709, 711-712).

Names Secretary of State will not accept. The Secretary of State will not accept a name that "is likely to mislead the public or that is the same as, or resembles so closely as to tend to deceive" the following (Corp C §§5122(b), 7122(c), 9122(b)):

- A name already reserved, or
- The name of a domestic corporation or a foreign corporation qualified or registered in California, unless the corporation consents (see §5.8).

The name of a nonprofit mutual benefit corporation may not create the impression that the corporation's purpose is public, charitable, or religious, or that it is a charitable foundation. Corp C §7122(b).

List up to three names. Choosing a name for the corporation can be difficult because many desirable names are already taken. The client should list up to three names, which may be checked for availability by calling or writing the Secretary of State. For detailed information on checking name availability, including a form for a name availability inquiry letter that may be completed online and printed, see http://www.sos.ca.gov/business/be/name-availability.htm. If a desired name is available, the articles may be filed immediately.

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2. Reserving a Name

§5.5 a. Reserving by Mail

A name may be reserved for 60 days, for a fee, on written request. Corp C §§5122(c), 7122(d), 9122(c); Govt C §12186(a). For a name reservation request form, see http://www.sos.ca.gov/business/corp/pdf/naavreservform.pdf. The form may be completed online and printed for mailing with the fee.

PRACTICE TIP: Although the name may not be reserved for successive 60-day periods by the same applicant (Corp C §§5122(c), 7122(d), 9122(c)), as a practical matter, if one business day elapses after the end of the 60-day period and no one else reserves the name, the applicant may reserve it for an additional 60 days.

Before submitting proposed names, counsel should check the Secretary of State's website because the procedures, forms, and fees are revised frequently.

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§5.6 b. Prepaid Accounts

Attorneys who often incorporate entities may establish prepaid priority accounts by calling the Secretary of State's Name Availability Unit at (916) 653-1233. Prepaid accounts are available for name availability or name reservation and status information via priority telephone lines. Clients establish an account and maintain a specified balance. Once the account is established, the client is given a private priority telephone number for the Name Availability Unit and a private priority telephone number for the Status Unit. Name availability and status searches can then be made via telephone, with the client account debited when each name is searched. Approved proposed corporate names may be reserved, via telephone, for an additional payment.

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§5.7 c. Intellectual Property Issues

Even if the desired name for the corporation is available, the name may contain a word or phrase to which another person has acquired rights under other laws, such as the federal Trademark Act of 1946 (the Lanham Act) (15 USC §§1051-1141n), the Model State Trademark Law (Bus & P C §§14200-14272), or the Fictitious Business Name Act (Bus & P C §§17900-17930), or under common law. The Secretary of State's records provide no assurance that the name chosen does not infringe another's rights. Accordingly, unless the name is highly unlikely to be a trademark or service mark, or otherwise subject to federal and state copyright protections, the client should authorize a search of the federal registrations before naming the corporation or committing substantial resources to developing public recognition of the name.

If the new entity will have a website, the availability of the desired domain name also should be checked at any domain registrar, *e.g.,* http://www.networksolutions.com. See Internet Law and Practice in California, chap 3 (Cal CEB 2004).

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§5.8 3. Form: Consent to Use of Name

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CONSENT TO USE OF NAME

Under Corporations Code §_ _[*5122(b)/7122(b)-(c)/9122(b)*]_ _, the undersigned, on behalf of _ _[*full name of entity*]_ _**, a** _ _[*describe entity, e.g., California corporation*]_ _**, hereby consents to the use of the name "**_ _[*specify*]_ _**" by** _ _[*name(s) and title(s) of incorporator(s)*]_ _ **for the purpose of incorporating a California** _ _[*public benefit/mutual benefit/religious*]_ _ **nonprofit corporation with that name.**

IN WITNESS WHEREOF, the undersigned has caused the execution of this Consent to Use of Name.

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a California corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form is provided for consent to use a similar name to one that is already qualified or registered. This form must be filed with the Secretary of State when the articles are filed. See Corp C §§201(b), 5122(b), 9122(b).

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§5.9 C. Selecting Initial Agent for Service of Process

The articles of incorporation must state the name of the corporation's agent for service of process. The agent may be either a natural person (*e.g.,* director, officer, or employee of the corporation) residing in California or a qualified corporate agent with an office in California. Corp C §§5130(c), 7130(c), 9130(c). If the agent is a natural person, the articles must include his or her complete California business or residence street address. See §§6.12, 6.19, 6.26.

NOTE: For a small annual fee, a corporate agent will contract to accept service of process on behalf of the corporation, thus ensuring continuity over the years.

If the designated agent resigns, dies, or no longer resides in the state, the corporation must promptly file with the Secretary of State a new designation of agent that conforms to Corp C §6210(b) or §8210(b). Corp C §§6212, 8212, 9660(a). If the agent is a corporation, a new designation must be promptly filed if the corporation resigns, dissolves, withdraws from the state, forfeits the right to transact intrastate business, is suspended, or ceases to exist. Corp C §§6212, 8212, 9660(a).

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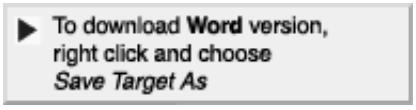
IV. COMPLETING CORPORATE ORGANIZATION

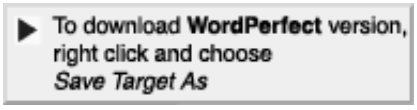
§5.10 A. Necessary Steps

In addition to filing the articles of incorporation, the corporation must choose directors, adopt bylaws, and elect officers. It must also choose an accounting year, choose a seal (if desired), decide on the form of membership certificate (if necessary), authorize the issuance of memberships, and open bank accounts. If the initial directors are not named in the articles, the incorporators, until directors are elected, "may do whatever is necessary and proper to perfect the organization of the corporation, including the adoption and amendment of bylaws of the corporation and the election of directors and officers." Corp C §§5134, 7134, 9134. Incorporators who know who the directors will be usually appoint the initial directors (see §5.11), who complete the organization process at their first meeting. See §§5.12 (waiver of notice and consent), 5.13-5.38 (minutes of first meeting), 5.39-5.62 (action by unanimous written consent).

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§5.11 B. Form: Appointment of Initial Directors and Adoption of Bylaws





APPOINTMENT OF THE INITIAL DIRECTORS AND ADOPTION OF BYLAWS OF _ _[*NAME OF CORPORATION*]_ _

The undersigned, as Sole Incorporator of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation (the Corporation), adopts the following resolutions on behalf of the Corporation:

WHEREAS, no bylaws have been adopted for the regulation of the affairs of the Corporation;

WHEREAS, it is deemed to be in the best interests of the Corporation and its prospective shareholders that the bylaws be adopted as the bylaws of the Corporation; and

WHEREAS, under Corporations Code §_ _[*5134/7134/9134*]_ _, the Sole Incorporator is authorized to adopt the bylaws:

RESOLVED, that the bylaws attached to these resolutions are adopted as the Corporation's bylaws; and

RESOLVED, FURTHER, that the secretary of the Corporation is authorized and directed to execute a certificate of the adoption of these bylaws, to insert the bylaws as so certified in the minute book of the Corporation, and to see that a copy of the bylaws, similarly certified, is kept at the principal office to transact the business of the Corporation.

WHEREAS, the bylaws of the Corporation provide that the initial authorized number of directors of the Corporation shall be _ _[*number*]_ _; and

WHEREAS, under Corporations Code §_ _[*5134/7134/9134*]_ _, the Sole Incorporator is authorized to elect the initial directors of the Corporation:

RESOLVED, that the persons listed below are hereby elected as the initial directors of the Corporation, to serve until they resign or are removed or until their successors are duly elected and qualified.

_ _[*Name*]_ _
_ _[*Address*]_ _

_ _[*Name*]_ _
_ _[*Address*]_ _

_ _[*Name*]_ _
_ _[*Address*]_ _

_ _[*Name*]_ _
_ _[*Address*]_ _

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Sole Incorporator

Comment: This form should be used when the sole incorporator is appointing the initial board of directors and also adopting the bylaws of the corporation. This form may be modified for use by more than one incorporator or to appoint only one director.

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§5.12 C. Form: Waiver of Notice and Consent to Holding First Meeting of Board of Directors

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WAIVER OF NOTICE AND CONSENT TO HOLDING THE FIRST MEETING OF THE BOARD OF DIRECTORS OF _ _[*NAME OF CORPORATION*]_ _ A California Nonprofit_ _[*Public Benefit/Mutual Benefit/Religious*]_ _ Corporation

The following directors of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation, waive notice of and consent to the holding of the first meeting of the board of directors of the Corporation on _ _[*date*]_ _, at _ _[*place*]_ _, California, and consent to the transaction of any and all business that may be properly brought before that meeting.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Director

Date: _ _ _ _ _ _ __[*Signature*]__

_ _[*Typed name*]_ _
Director

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Director

Comment: A waiver of notice of the first meeting is customarily used instead of going to the trouble of giving notice. The waiver may be signed either before or after the meeting; it must be filed with the minutes. Corp C §§5211(a)(3), 7511(e), 9411(d). The directors may all sign the same copy, or each director may sign a separate copy.

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D. Minutes of First Meeting of Board of Directors

§5.13 1. Form: Heading and Participants

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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MINUTES OF THE FIRST MEETING OF THE BOARD OF DIRECTORS OF _ _[*NAME OF CORPORATION*]_ _ **A California Nonprofit** _ _[*Public Benefit/Mutual Benefit/Religious*]_ _ **Corporation**

The directors named _ _[*by the incorporator/in the articles of incorporation*]_ _ **of the Corporation, constituting the board of directors of the Corporation, held their first meeting at the time, on the day, and at the place set forth as follows:**

Time: _____

Date: _____

Place: _____

The following directors, constituting _ _[*the full/a quorum of the*]_ _ **board, were present at the meeting:**

_ _[*List names*]_ _

The following directors were absent:

_ _[*List names*]_ _

On motion duly made, seconded, and _ _[*unanimously*]_ _ **carried, the following were elected temporary chair and temporary secretary of the first meeting:**

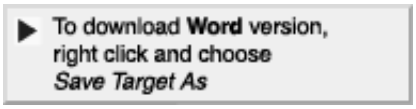
Temporary Chair: _____

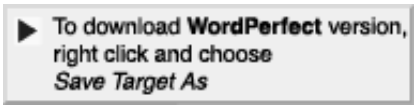
Temporary Secretary: _____

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§5.14 2. Form: Adoption of Waiver of Notice and Consent to Meeting

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Adoption of Waiver of Notice and Consent to Meeting. **The temporary chair announced that the meeting of the board of directors was held pursuant to a written waiver of notice and consent to the holding of the meeting, signed by all directors of the Corporation who were named as directors _ _**[*by the incorporator/in the articles of incorporation*]**_ _. The waiver and consent was presented and, on motion duly made, seconded, and _ _**[*unanimously*]**_ _ carried, was made a part of the minutes of the meeting.**

Comment: For a form of waiver of notice and consent to the holding of the first meeting, see §5.12.

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§5.15 3. Form: Articles Filed

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Articles Filed. **The temporary chair informed the board of directors that the Corporation's original articles of incorporation were filed with the California Secretary of State on _ _[*date*]_ _, and that they designated _ _[*name*]_ _ as initial agent for service of process.**

The temporary chair presented to the meeting a certified copy of the articles of incorporation, showing filing as stated. The temporary secretary was directed to insert the copy in the minute book of the Corporation and to keep a copy at the principal office for the transaction of the Corporation's business. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, it was resolved that _ _[*name*]_ _ be confirmed as the Corporation's agent for service of process.

Comment: For the procedure for filing the articles, see §§6.31-6.33.

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§5.16 4. Form: Ratification of Actions by Incorporator

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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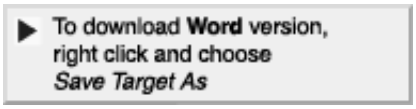
Ratification of Actions By **_ _[*Name*]_ _. The temporary secretary reported that _ _[*name*]_ _ has taken certain actions as incorporator of the Corporation to perfect the organization of the Corporation. On motion duly made, seconded and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

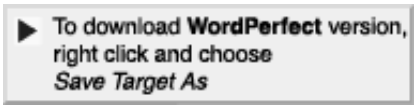
RESOLVED, that the actions taken by _ _[*name*]_ _ as incorporator of the Corporation to perfect the organization of the Corporation, including the filing of the Corporation's Certificate of Incorporation and the election of _ _[*names*]_ _ as the initial directors of the Corporation, be, and they hereby are, ratified, approved, and confirmed.

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§5.17 5. Form: Adoption of Bylaws

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.





Adoption of Bylaws. **The temporary secretary presented to the meeting a form of bylaws that was considered and discussed. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the resolutions below were adopted:**

WHEREAS, the directors of the Corporation have not yet adopted bylaws for the Corporation; and

WHEREAS, the best interests of the Corporation will be served by the adoption of bylaws:

RESOLVED, that the bylaws presented and discussed at this meeting are adopted as the bylaws of the Corporation; and

RESOLVED, FURTHER, that the secretary of the Corporation is authorized and directed to execute a certificate of the adoption of those bylaws, to insert them as so certified in the minute book of the Corporation, and to ensure that a copy of the bylaws, similarly certified, is kept at the principal office for the transaction of business of the Corporation.

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§5.18 6. Form: Number of Directors

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Number of Directors. **The temporary chair announced that the number of directors would be established under Section _ _**[*number; see §7.53*]**_ _ of the bylaws. On motion duly made, seconded, and _ _**[*unanimously*]**_ _ carried, the following resolution was adopted:**

RESOLVED, that the authorized number of directors of the Corporation shall be _ _[*number*]**_ _.**

Comment: This resolution is needed only if the bylaws require the board to set the number of directors. See the form in §7.53.

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§5.19 7. Form: Election of Officers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Election of Officers. **At the meeting, the board of directors elected a president, a vice president, a chief financial officer, and a secretary. The following persons were duly nominated and elected to the offices indicated before their names to serve for 1 year or until their respective successors are duly elected and qualified, whichever occurs later:**

President: _ _[*name*]_ _

Vice President: _ _[*name*]_ _

Chief Financial Officer: _ _[*name*]_ _

Secretary: _ _[*name*]_ _

The officers so elected accepted their respective offices; thereafter the president presided at the meeting as chair, and the secretary acted as secretary of the meeting.

Comment: A vice president is not required by statute. In general, a person may hold two or more offices; however, neither the secretary nor the chief financial officer may serve concurrently as president or chair of the board in a nonprofit public benefit or religious corporation. Corp C §§5213(a), 9213(a). See §9.11.

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§5.20 8. Form: Corporate Seal

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Corporate Seal. **The secretary presented for approval a proposed seal of the Corporation, consisting of a circle having on its circumference the name of the Corporation, the word "INCORPORATED," the date of incorporation, and "CALIFORNIA" in the form and figures as follows:**

_ _[*Copy of seal*]_ _

On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:

RESOLVED, that the corporate seal in the form, words, and figures presented to this meeting is adopted as the seal of the Corporation.

Comment: A corporate seal is not required under California law. Failure to affix a seal does not affect the validity of any corporate instrument. See Corp C §§5140(a), 7140(a), 9140(a). For this reason, few California nonprofit corporations adopt a seal.

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§5.21 9. Form: Accounting Year

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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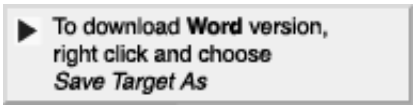
Accounting Year. **The board next considered adoption of an accounting year. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

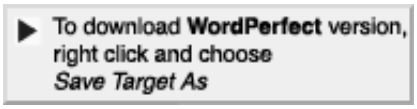
RESOLVED, that the Corporation adopt an accounting year ending on the last day of _ _[*specify month*]_ _ of each year.

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§5.22 10. Form: Principal Office Location

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Principal Office. **After discussion and on motion duly made and seconded, the following resolution was _ _[*unanimously*]_ _ adopted:**

RESOLVED, that the County of _ _[*name of county*]_ _, California, is designated and fixed as the county in which the principal office for the transaction of the business of the Corporation shall be located, unless changed by resolution of the board of directors.

Comment: For a bylaw provision, see §7.5.

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§5.23 11. Form: Bank Account

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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[*Add one of the following alternatives*]

[*Alternative 1: Bank account—short form*]

Bank Account. **The directors next considered providing for the deposit and disbursement of corporate funds and authorizing certain officers to be responsible for deposits and disbursements. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolutions were adopted:**

RESOLVED, that the president and secretary of the Corporation, acting jointly on the Corporation's behalf, are authorized to open such bank accounts as may be necessary or appropriate to conduct the Corporation's business; that such bank accounts shall require the signature of at least two officers of the Corporation on all checks drawn on such accounts; that all resolutions required by the depository banks with respect to such accounts are hereby adopted; and that the secretary of the Corporation is authorized to certify to any bank the adoption of the resolution in the form used by that bank.

[*Alternative 2: Bank account—long form*]

Bank Account. **The chair suggested that the directors consider providing for the deposit and disbursement of corporate funds and authorizing certain officers to be responsible for deposits and disbursements. After discussion and on motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolutions were adopted:**

RESOLVED, that the president and secretary of the Corporation, acting jointly on the Corporation's behalf, are authorized:

(a) To designate one or more banks, trust companies, or similar institutions as depositories of the funds of the Corporation;

(b) To establish, maintain, and close general and special bank accounts _ _[*,including general deposit accounts, payroll accounts, and working fund accounts,*]_ _ with any such depository;

(c) To cause to be deposited in those accounts with any such depository, from time to time, such funds, including without limitation cash and cash equivalents, of the Corporation as those officers consider necessary or advisable _ _[*, and to designate or change the designation of the officer or officers and the agent or agents of the Corporation who will be authorized to make such deposits,*]_ _ and to endorse checks, drafts, and other instruments of deposit;

(d) To sign and countersign, or to use facsimile signatures for signing and countersigning, checks, drafts, or other orders for the payment of money and to enter into such agreements as banks and trust companies customarily require as a condition for using facsimile signatures;

(e) From time to time, to designate or to change the designation of the officer or officers and agent or agents of the Corporation who will be authorized to sign or countersign checks, drafts, or other orders for the payment of money issued in the name of the Corporation against funds deposited in those accounts, and to revoke any such designation;

(f) To make such general and special rules and regulations for such accounts as they may consider necessary or advisable; and

(g) To complete or execute, or both, any customary blank signature card forms in order to conveniently

exercise the authority granted by this resolution; any resolutions printed on those forms shall be deemed adopted as a part of this resolution.

RESOLVED, FURTHER, that all specific forms of resolutions required by such depository as presented at this meeting _ _[*not inconsistent with these resolutions*]_ _ are adopted in the form provided by the depository, and the secretary of the Corporation is authorized to certify the resolutions as having been adopted at this meeting and is directed to insert the form of the resolutions in the minute book immediately following the minutes of this meeting.

RESOLVED, FURTHER, that any depository to which a copy of such resolutions, certified by the secretary (or an assistant secretary) of the Corporation, is delivered shall be entitled to rely on those resolutions for all purposes unless it has received written notice of the revocation or amendment of these resolutions by the board of directors of the Corporation.

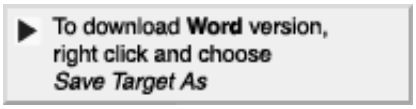
Comment: Alternative 1 is the broadest type of authorization. Some attorneys prefer to restrict the authorization to specific banks, specific accounts, or limited sums of money. Although two signatures for withdrawals are not required legally, it is a good practice for withdrawals of a size that is unusual for the organization. For forms of more limited authorizations, see Organizing Corporations in California §2.198 (3d ed Cal CEB 2001).

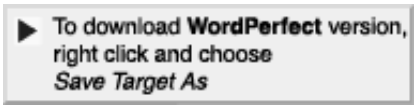
On establishing a bank account, see §§13.72-13.75

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§5.24 12. Form: Membership Certificate

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.





Membership Certificate. **The secretary presented a proposed form of membership certificate for use by the Corporation. After discussion and on motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the form of membership certificate presented to this board is approved and adopted as the membership certificate of the Corporation. The secretary was instructed to insert a copy of the certificate in the book of minutes immediately following the minutes of this meeting.

Comment: This resolution is used only if the corporation has voting members under California law and wishes to issue certificates. A membership certificate in a mutual benefit corporation evidences a transferable property interest in the corporation. See §10.33.

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§5.25 13. Form: Incorporation Expenses

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Incorporation Expenses. **To pay the expenses of incorporation and organization, on motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that each officer of the Corporation is authorized and directed to pay, on the Corporation's behalf, the expenses of incorporation and organization of the Corporation.

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§5.26 14. Form: Exemptions From Federal and State Taxes

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Exemptions From Taxes. **The chair noted that federal and state tax exemptions are available to certain nonprofit corporations. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the president consult with legal counsel to ascertain the availability of exemptions from taxation under state and federal tax laws and, if such exemptions are available, the president is authorized and directed to execute and file all necessary applications for such exemption with the appropriate federal and state tax authorities and to pay filing fees.

Comment: For filing requirements and procedures, see §§3.60-3.69.

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§5.27 15. Form: Statement by Domestic Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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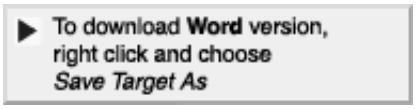
Statement by Domestic Corporation. **On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

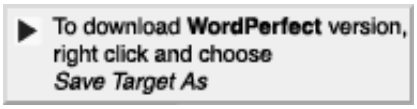
RESOLVED, that the president is authorized and directed to execute and file with the office of the California Secretary of State, at the times required by law, the annual statement required by the Corporations Code to be filed by domestic nonprofit corporations.

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§5.28 16. Form: Compliance With Local Solicitation Ordinances

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.





Local Ordinances. **On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the president is directed to ascertain the legal requirements imposed on organizations soliciting funds for charitable purposes in the _ _[*City/cities*]_ _ of _ _[*name(s)*]_ _ and the _ _[*County/counties*]_ _ of _ _[*name(s)*]_ _; and

RESOLVED, FURTHER, that the president is authorized and directed to make all necessary filings and obtain all necessary permits authorizing and allowing the Corporation to make public solicitations for contributions for charitable purposes in the jurisdictions named above.

Comment: This resolution is necessary only if the corporation will make public solicitations. See chap 14.

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§5.29 17. Form: Compliance With Political Reform Act

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Compliance with Political Reform Act. **On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the president is authorized and directed to file the necessary forms registering the Corporation as a _ _[*lobbyist employer/Recipient Committee*]_ _ with the California Secretary of State and identifying any and all lobbyists engaged or to be engaged on behalf of or by the Corporation; and

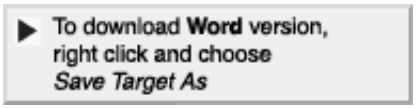
RESOLVED, FURTHER, that the president shall make all necessary periodic filings required by the Political Reform Act of 1974, describing all lobbying and campaign activities and other information required by that Act to be disclosed and reported.

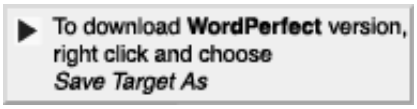
Comment: This resolution should be adopted if the corporation will engage a lobbyist or will qualify as a "Recipient Committee" under the Political Reform Act of 1974 (Govt C §§81000-91014). See §§19.41-19.46.

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§5.30 18. Form: Issuance of Memberships and Establishment of Dues

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.





Memberships and Dues. **The chair stated that legal counsel had advised that the issuance and sale of memberships in the Corporation would be exempt from qualification and registration under state and federal securities laws; the chair reviewed for the board the nature and limitations of those exemptions. The following resolutions were then adopted on motions duly made, seconded, and _ _[*unanimously*]_ _ carried:**

RESOLVED, that the consideration for which memberships in the Corporation will be issued is the sum of _ _[*dollar amount*]_ _ payable on initiation or acceptance as a member of the Corporation;

RESOLVED, FURTHER, that the _ _[*annual/monthly*]_ _ dues to the Corporation shall be _ _[*dollar amount*]_ _ until changed by action of the board of directors; and

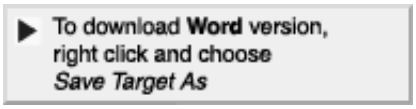
RESOLVED, FURTHER, that the president and secretary are authorized to issue membership certificates to persons who apply for membership, who are found to be qualified by the _ _[*membership committee/board of directors*]_ _, and who have tendered payment of the _ _[*membership/initiation*]_ _ fee and the first _ _[*year's/month's*]_ _ dues.

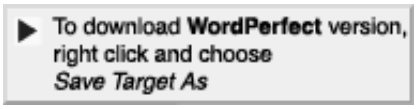
Comment: This resolution is recommended if the corporation has memberships that are exempt from registration or qualification under state and federal securities laws. For an overview of securities law exemptions for nonprofit corporations, see §§5.68-5.69, 10.12-10.24.

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§5.31 19. Form: Application for Qualification or Registration of Offer and Sale of Membership Securities

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.





Qualification or Registration of Offer and Sale of Membership Securities. **The chair reported that the offer and sale of the memberships of the Corporation were subject to the state and federal securities laws and would have to be qualified, registered, or both with the appropriate regulatory authorities unless an exemption is available. On motions duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolutions were adopted:**

RESOLVED, that the president direct the Corporation's attorney to ascertain whether an exemption from qualification or registration of the offer and sale of the Corporation's memberships is available under California's Corporate Securities Law of 1968 or the federal Securities Act of 1933; and

RESOLVED, FURTHER, that if exemptions are not available, the president is authorized and directed to file an application for permit or registration to offer and sell memberships to the public within _ _[*or outside*]_ _ California with the California Commissioner of Corporations, the federal Securities and Exchange Commission, or both, for the public offer and sale of _ _[*number*]_ _ memberships at _ _[*dollar amount*]_ _ per membership.

Comment: This resolution is appropriate if the corporation has memberships that must be registered or qualified under state or federal securities laws. See §§5.68-5.69.

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§5.32 20. Form: Employer Identification Number

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Employer Identification Number. **The chair stated that a federal employer identification number was needed for use on certain tax returns and statements. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the officers of the Corporation and each of them are authorized and directed to make such filings and applications as are necessary to secure for the Corporation a federal employer identification number.

Comment: Use IRS Form SS-4, available on the IRS website at http://www.irs.gov/formspubs/index.html. See §13.2.

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§5.33 21. Form: Nonprofit Mailing Permit

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Nonprofit Mailing Permit. **The chair stated that it would be to the Corporation's benefit to obtain a nonprofit mailing permit. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

RESOLVED, that the officers of the Corporation and each of them are authorized and directed to make such filings and applications as are necessary to secure for the Corporation a nonprofit mailing permit.

Comment: See §13.52.

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§5.34 22. Form: Adoption of Conflict of Interest Policy

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Conflict of Interest Policy. **The Board of Directors discussed the desire that the Corporation conduct its business affairs so as to avoid any possible conflict of interest between the duties and responsibilities that the Corporation's directors and officers owe to the Corporation and other duties and responsibilities those individuals may have, and reviewed the Conflict of Interest Policy attached as Exhibit _ _[*number or letter*]_ _ and determined that it is appropriate for this Corporation. On motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted:**

NOW, THEREFORE, RESOLVED, that the Conflict of Interest Policy attached as Exhibit _ _[*number or letter*]_ _ be, and it hereby is, the Policy of this Corporation; and

RESOLVED, FURTHER, that each director and officer of this Corporation shall be provided a copy of the Conflict of Interest Policy and shall be directed to provide the completed Questionnaire to _ _[*name*]_ _; and

RESOLVED, FURTHER, that _ _[*name*]_ _ shall report any conflict of interest reported to _ _[*him/her*]_ _, or of which _ _[*he/she*]_ _ becomes aware, at the next meeting of the Board of Directors.

Comment: On conflicts of interest of the directors and officers, see chap 9.

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§5.35 23. Form: Adoption of Policy for the Detection and Reporting of Fraudulent Activity (Whistleblower Policy)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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Adoption of Policy on Fraudulent Activity. **The Board of Directors discussed the policy of the Corporation to be committed to integrity and ethical behavior, and to encourage employees who reasonably believe that they are aware of any violations of federal or state law such as fraud, questionable accounting practices, or the reporting of fraudulent financial information, to disclose any such violations without fear of retaliation, discrimination, or harassment with respect to their employment. The Board of Directors reviewed the Policy for the Detection and Reporting of Fraudulent Activity attached hereto as Exhibit _ _[*number or letter*]_ _ and determined that it is appropriate for this Corporation. On motion duly made, seconded, and _ _[*unanimously*]__ carried, the following resolution was adopted:**

RESOLVED, that the Policy for the Detection and Reporting of Fraudulent Activity attached hereto as Exhibit _ _[*number or letter*]_ _, be, and it hereby is, the policy of this Corporation; and

RESOLVED, FURTHER, that the officers of the Corporation shall distribute the Policy to all staff of the Corporation; and

RESOLVED, FURTHER, that, as a standing resolution of this Board, the officers of this Corporation, in consultation with legal counsel, be, and they hereby are, directed and authorized to investigate any report of wrongful behavior made by an employee or volunteer, and to report to the Board the findings of any such investigation.

Comment: This provision adopts a whistleblower policy, which is intended to help the corporation avoid violation of the Sarbanes-Oxley Act of 2002 (SOX) (Pub L 107-204, 116 Stat 745) (15 USC §§7201-7266) prohibition on retaliating against employees who report violations of law. For a form of whistleblower policy, see §5.63. The current IRS Form 990 requires a tax-exempt organization to state whether it has adopted such a policy. On whistleblower policies generally, see Advising California Employers and Employees §9.16 (Cal CEB 2005).

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§5.36 24. Form: Approval of Consent to Use of Electronic Transmissions by Director or Officer

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Approval of Consent to Electronic Transmissions. **The Board determined that it will be to the benefit of the Corporation to allow approval of corporate actions to be evidenced by electronic communications, as permitted by Corporations Code §§20 and 5079, and accordingly on motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the following resolution was adopted.**

RESOLVED, that the Corporation may send meeting notices, annual reports, and all other materials by electronic transmission at the e-mail address or facsimile number designated on the form of Consent attached as Exhibit _ _[*number or letter*]_ _; and

RESOLVED, FURTHER, that the Corporation may rely on communications sent to the corporation by electronic transmission from the e-mail address or facsimile number listed on the form of Consent attached as Exhibit _ _[*number or letter*]_ _.

Comment: Modern corporate law allows approval of actions by e-mail if a consent is filed with the corporation by each director and officer. See Corp C §20. Note that to be effective, the consent must be preceded by or include a clear written statement as to (Corp C §20):

> (a) any right of the recipient to have the record provided or made available on paper or in nonelectronic form, (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the recipient must use to withdraw consent.

For a form of consent, see §5.64.

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§5.37 25. Other Resolutions

Other resolutions may be included as needed, such as establishing regular meetings of the board of directors, appointing accountants, executing deeds or leases of property, executing notes or loan agreements, establishing health, accident, or life insurance for employees, or authorizing the purchase or lease of automobiles for corporate personnel.

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§5.38 26. Form: Adjournment

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.13-5.38.

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There being no further business, on motion duly made, seconded, and _ _[*unanimously*]_ _ carried, the meeting was adjourned.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Secretary

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E. Action by Unanimous Written Consent of Board

§5.39 1. Form: Heading; Participants

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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ACTION BY UNANIMOUS WRITTEN CONSENT OF THE BOARD OF DIRECTORS OF _ _[*NAME OF CORPORATION*]**_ _ A California Nonprofit _ _**[*Public Benefit/Mutual Benefit/Religious*]**_ _ Corporation**

The undersigned, constituting all the directors of _ _[*name of corporation*]**_ _, a California nonprofit _ _**[*public benefit/mutual benefit/religious*]**_ _ corporation (the Corporation), do hereby adopt the following resolutions by unanimous written consent under Corporations Code section _ _**[*5211(b)/7211(b)/9211(b)*]**_ _:**

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§5.40 2. Form: Articles of Incorporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned have reviewed the Articles of Incorporation attached as Exhibit _ _[*number or letter*]**_ _ and approve of the same without modification:**

RESOLVED, that the Articles of Incorporation attached as Exhibit _ _[*number or letter*]**_ _ are hereby approved.**

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§5.41 3. Form: Ratification of Actions by Incorporator

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, _ _[*name*]_ _ has taken certain actions as incorporator of the Corporation to perfect the organization of the Corporation.

RESOLVED, that the actions taken by _ _[*name*]_ _ as incorporator of the Corporation to perfect the organization of the Corporation, including the filing of the Corporation's Certificate of Incorporation and the election of _ _[*name*]_ _ and _ _[*name*]_ _ as the initial directors of the Corporation, be, and they hereby are, ratified, approved, and confirmed.

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§5.42 4. Form: Bylaws

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned have reviewed the bylaws attached as Exhibit _ _[*number or letter*]**_ _ and approve of the same without modification:**

RESOLVED, that the bylaws attached as Exhibit _ _[*number or letter*]**_ _ are hereby approved.**

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§5.43 5. Form: Number of Directors

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned desire to establish the authorized number of directors, under Article _ _[*specify article; see §7.53*]**_ _ of the bylaws:**

RESOLVED, that the authorized number of directors of the Corporation shall be _ _[*number*]**_ _.**

Comment: This resolution is needed only if the bylaws require the board to set the number of directors. See §7.53.

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§5.44 6. Form: Election of Officers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the following individuals have been proposed as the initial officers of the Corporation, and the undersigned approve of their appointment to the office designated next to the name of each:

RESOLVED, that the following officers are elected to the office specified before their respective names:

President: _____

Secretary: _____

Chief Financial Officer: _____

Comment: In general, a person may hold two or more offices; however, neither the secretary nor the chief financial officer may serve concurrently as president or chair of the board in a nonprofit public benefit or religious corporation. Corp C §§5213(a), 9213(a). See §9.11.

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§5.45 7. Form: Principal Office Location

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned approve of _ _[*specify location*]**_ _ as the Corporation's principal place of business:**

RESOLVED, that _ _[*supply corporate address*]**_ _ is hereby located and fixed as the principal office of the Corporation in the State of California.**

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§5.46 8. Form: Incorporation Expenses

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS the undersigned determine it to be in the best interests of the corporation to provide for the payment of the expenses of incorporation and organization of the corporation:

RESOLVED, that the President of the Corporation is hereby authorized and directed to pay the expenses of the incorporation and organization of the Corporation.

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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.47 9. Form: Authorization to File Applications for Tax Exemptions

§5.47 9. Form: Authorization to File Applications for Tax Exemptions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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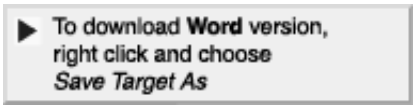
WHEREAS, the undersigned desire to authorize the filing of applications for tax exemptions:

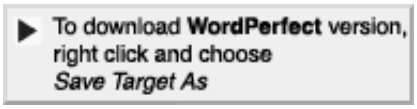
RESOLVED, that the President is hereby authorized to take all necessary steps to execute all necessary instruments to apply for federal and California tax exemptions as a charitable nonprofit organization.

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§5.48 10. Form: Authorization to Enter Into Contracts

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





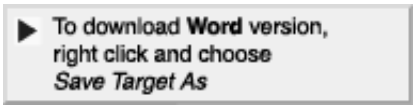
WHEREAS, the undersigned desire to enable the President to enter into contracts related to the Corporation's business:

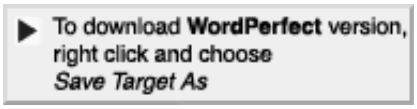
RESOLVED, that the President is hereby authorized to enter into agreements for the benefit of the Corporation in amounts not to exceed _ _[*dollar amount*]_ _ in the aggregate for any single transaction or series of related transactions.

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§5.49 11. Form: Authorization to Retain Counsel and Waive Conflicts

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





WHEREAS, the undersigned desire that the Corporation retain _ _[*name of attorney or law firm*]_ _ to advise it on incorporation and adoption of Bylaws:

RESOLVED, that the President is hereby authorized and directed to execute an Agreement retaining attorneys with _ _[*name of law firm*]_ _, and a Waiver Agreement, both agreements in the form attached to this document as Exhibit _ _[*number or letter*]_ _.

Comment: If the same law firm represents the entity and a member, substantial contributor, or related organization, consider whether there are conflicts of interest and whether a waiver of those conflicts is required under the ethics rules. See §§1.25-1.38.

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§5.50 12. Form: Accounting Method

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the Directors wish to adopt the cash method of accounting:

RESOLVED, that the Corporation shall use the cash method of accounting for all tax reporting requirements unless required otherwise by law.

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§5.51 13. Form: Bank Account

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned desire that the President establish such bank accounts as he or she deems appropriate:

RESOLVED, that the President is hereby authorized to open bank accounts as necessary for the Corporation, requiring one signature for withdrawals, with such signatories as he or she deems appropriate, and that any required resolution establishing the selected bank as the depository is hereby adopted.

Comment: On establishing a bank account, see §§13.72-13.74. For additional forms for authorization of bank accounts, see §5.23.

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§5.52 14. Form: Admission of Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the undersigned wish to be admitted to the Corporation as initial members of this Corporation, having all rights and duties set forth in the Bylaws, the persons listed on Exhibit _ _[*number or letter*]**_ _:**

RESOLVED, that the persons listed on Exhibit _ _[*number or letter*]**_ _ shall be admitted as members, each having such rights and obligations as set forth in the Bylaws.**

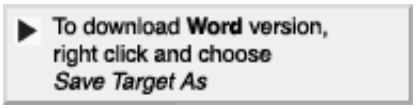
Comment: This resolution is necessary only if the corporation will have members. For a form of resolution for the adoption of membership certificates if the corporation has voting members and wishes to issue membership certificates, see §5.24.

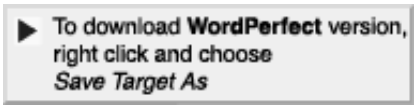
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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.53 15. Form: Compliance With Local Solicitation Ordinances

§5.53 15. Form: Compliance With Local Solicitation Ordinances

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





WHEREAS, the undersigned wish to comply with all applicable local solicitation ordinances:

RESOLVED. that the President is directed to ascertain the legal requirements imposed on organizations soliciting funds for charitable purposes in the _ _[*City/cities*]_ _ of _ _[*name(s)*]_ _ and the _ _[*County/counties*]_ _ of _ _[*name(s)*]_ _; and

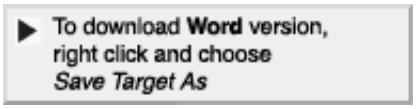
RESOLVED, FURTHER, that the President is authorized and directed to make all necessary filings and obtain all necessary permits authorizing and allowing the Corporation to make public solicitations for contributions for charitable purposes in the jurisdictions named above.

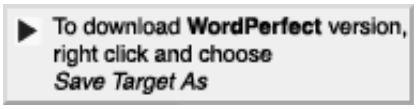
Comment: This resolution is necessary only if the corporation will make public solicitations. See chap 14.

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§5.54 16. Form: Compliance With Political Reform Act

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





WHEREAS, the undersigned wish to comply with the requirements of the Political Reform Act of 1974 (the Act):

RESOLVED, that the President is authorized and directed to file the necessary forms registering the Corporation as a _ _[*lobbyist employer/Recipient Committee*]_ _ with the California Secretary of State and identifying any and all lobbyists engaged or to be engaged on behalf of or by the Corporation; and

RESOLVED, FURTHER, that the President shall make all necessary periodic filings required by the Act, describing all lobbying and campaign activities and other information required by that Act to be disclosed and reported.

Comment: These resolutions should be adopted if the corporation will engage a lobbyist or will qualify as a "Recipient Committee" under the Political Reform Act of 1974. See §§5.67, 19.41-19.46.

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§5.55 17. Form: Issuance of Memberships and Establishment of Dues

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, legal counsel has advised that the issuance and sale of memberships in the Corporation would be exempt from qualification and registration under state and federal securities laws:

RESOLVED, that the consideration for which memberships in the Corporation will be issued is the sum of _ _[*dollar amount*]**_ _, payable on initiation or acceptance as a member of the Corporation; and**

RESOLVED, FURTHER, that the _ _[*annual/monthly*]**_ _ dues to the Corporation shall be _ _**[*dollar amount*]**_ _ unless changed by action of the board of directors; and**

RESOLVED, FURTHER, that the president and secretary are authorized to issue membership certificates to persons who apply for membership, who are found to be qualified by the _ _[*membership committee/board of directors*]**_ _, and who have tendered payment of the _ _**[*membership/initiation*]**_ _ fee and the first _ _**[*year's/month's*]**_ _ dues.**

Comment: This resolution is recommended if the corporation has memberships that are exempt from registration or qualification under state and federal securities laws. For an overview of securities law exemptions for nonprofit corporations, see §§5.68-5.69.

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§5.56 18. Form: Application for Qualification or Registration of Offer and Sale of Membership Securities

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the offer and sale of the memberships of the Corporation are subject to the state and federal securities laws and must be qualified or registered, or both, with the appropriate regulatory authorities unless an exemption is available:

RESOLVED, that the President direct the Corporation's attorney to ascertain whether an exemption from qualification or registration of the offer and sale of the Corporation's memberships is available under California's Corporate Securities Law of 1968 or the federal Securities Act of 1933; and

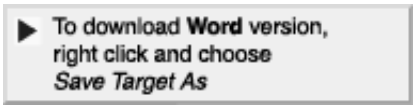
RESOLVED, FURTHER, that if exemptions are not available, the President is authorized and directed to file an application for permit or registration to offer and sell memberships to the public within _ _[*or outside*]_ _ California with the California Commissioner of Corporations, the federal Securities and Exchange Commission, or both, for the public offer and sale of _ _[*number*]_ _ memberships at _ _[*dollar amount*]_ _ per membership.

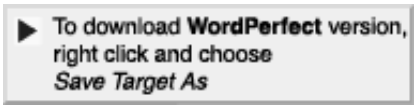
Comment: This resolution is appropriate only if the corporation has memberships that must be registered or qualified under state or federal securities laws. See §§5.68-5.69, 10.12-10.24.

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§5.57 19. Form: Employer Identification Number

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





WHEREAS, the Corporation must secure a federal employer identification number for use on certain tax returns and statements:

RESOLVED, that the Officers of the Corporation and each of them are authorized and directed to make such filings and applications as necessary to secure for the Corporation a federal employer identification number.

Comment: Use IRS Form SS-4, available on the IRS website at http://www.irs.gov/formspubs/index.html. See §§5.65, 13.2.

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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.58 20. Form: Nonprofit Mailing Permit

§5.58 20. Form: Nonprofit Mailing Permit

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the Corporation should obtain a nonprofit mailing permit:

RESOLVED, that the Officers of the Corporation and each of them are authorized and directed to make such filings and applications as necessary to secure a nonprofit mailing permit for the Corporation.

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§5.59 21. Form: Adoption of Conflict of Interest Policy

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the Board of Directors of this Corporation desires that the Corporation conduct its business affairs so as to avoid any possible conflict of interest between the duties and responsibilities that the Corporation's directors and officers owe to the Corporation, and other duties and responsibilities those individuals may have; and

WHEREAS, the Board of Directors has reviewed the Conflict of Interest Policy attached hereto as Exhibit _ _[*number or letter*]_ _ and determined that it is appropriate for the Corporation;

RESOLVED, that the Conflict of Interest Policy attached hereto as Exhibit _ _[*number or letter*]_ _ be, and it hereby is, the Policy of the Corporation; and

RESOLVED, FURTHER, that each director and officer of the Corporation shall be provided a copy of the Conflict of Interest Policy and shall be directed to provide the completed Questionnaire to _ _[*name*]_ _; and

RESOLVED, FURTHER, that _ _[*name*]_ _ shall report any conflict of interest reported to _ _[*him/her*]_ _, or of which _ _[*he/she*]_ _ becomes aware, at the next meeting of the Board of Directors.

Comment: On conflicts of interest of the directors and officers, see chap 9.

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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.60 22. Form: Approval of Policy for the Detection and Reporting of Fraudulent Activity (Whistleblower Policy)

§5.60 22. Form: Approval of Policy for the Detection and Reporting of Fraudulent Activity (Whistleblower Policy)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, the Corporation is committed to integrity and ethical behavior, and encourages employees who reasonably believe that they are aware of any violations of federal or state law such as fraud, questionable accounting practices, or the reporting of fraudulent financial information, to disclose any such violations, without any fear of retaliation, discrimination, or harassment with respect to their employment; and

WHEREAS, the Board of Directors has reviewed the Policy for the Detection and Reporting of Fraudulent Activity attached hereto as Exhibit _ _[*number or letter*]_ _ and determined that it is appropriate for this Corporation.

RESOLVED, that the Policy for the Detection and Reporting of Fraudulent Activity attached hereto as Exhibit _ _[*number or letter*]_ _, be, and it hereby is, the policy of this Corporation; and

RESOLVED, FURTHER, that the officers of the Corporation shall distribute the Policy to all staff of the Corporation; and

RESOLVED, FURTHER, that, as a standing resolution of this Board, the officers of this Corporation, in consultation with legal counsel, be, and they hereby are, directed and authorized to investigate any report of wrongful behavior made by an employee or volunteer, and to report to the Board the findings of any such investigation.

Comment: This provision adopts a whistleblower policy to help the corporation avoid violating the Sarbanes-Oxley Act of 2002 (SOX) (Pub L 107-204, 116 Stat 745) (15 USC §§7201-7266) prohibition on retaliating against employees who report violations of law. For the form of whistleblower policy itself, see §5.63. Internal Revenue Service Form 990 requires a tax-exempt organization to state whether it has adopted such a policy.

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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.61 23. Form: Approval of Consent to Use of Electronic Transmissions by Director or Officer

§5.61 23. Form: Approval of Consent to Use of Electronic Transmissions by Director or Officer

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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WHEREAS, in accordance with Corporations Code §§20 and 5079, this Corporation desires to authorize electronic transmission of corporate notices and approvals.

RESOLVED, that the Corporation may send meeting notices, annual reports, and all other materials by electronic transmission at the e-mail address or facsimile number designated on the form of Consent attached as Exhibit _ _[*number or letter*]_ _; and

RESOLVED, FURTHER, that the corporation may rely on communications sent to the corporation by electronic transmission from the e-mail address or facsimile number listed on the form of Consent attached as Exhibit _ _[*number or letter*]_ _.

Comment: Corporation law allows approval of actions by e-mail if a consent is filed with the corporation by each director and officer. Note that to be effective, the consent must be preceded by or include a clear written statement as to (Corp C §20):

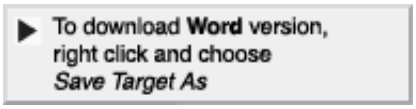
> (a) any right of the recipient to have the record provided or made available on paper or in nonelectronic form, (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the recipient must use to withdraw consent.

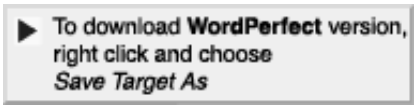
For the form of consent, see §5.63.

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§5.62 24. Form: Execution of Consent

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.





This consent may be executed in one or more counterparts, each of which shall be deemed an original and all of which shall constitute a single instrument.

Date: _ _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_
Its: _ _[*Title*]_ _

Comment: On obtaining a nonprofit mailing permit, see §13.52. Board actions by written consent require the approval of all board members. If unanimous approval is not possible, these actions can be taken by approval of a majority of a quorum of directors present in person, by telephone, or by electronic media, at a properly noticed meeting. On the manner of attending meetings, see §9.78.

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F. Exhibits for Attachment to Minutes of First Meeting or Action by Unanimous Consent of Board

§5.63 1. Form: Corporation's Policy on the Detection and Reporting of Fraudulent Activity (Whistleblower Policy)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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POLICY FOR THE DETECTION AND REPORTING OF FRAUDULENT ACTIVITY

_ _[*Name of corporation*]_ _ is committed to integrity and ethical behavior. _ _[*Name of corporation*]_ _ thus encourages employees who reasonably believe that they are aware of any violations of federal or state law such as fraud, questionable accounting practices, or the reporting of fraudulent financial information, to disclose any such violations, without any fear of retaliation, discrimination, or harassment with respect to their employment. This policy does not replace or supersede _ _[*name of corporation*]_ _ s unlawful harassment and discrimination policy; to the contrary, both policies are important components of _ _[*name of corporation*]_ _'s commitment to providing a professional work environment.

***Reports of Wrongdoing.* The following are examples of actions or behavior that should be reported:**

Fraud or deliberate error in the preparation, evaluation, review, or audit of any financial statement or accounting records of _ _[*name of corporation*]_ _.

Deviation from full and fair reporting of _ _[*name of corporation*]_ _ 's financial condition.

Stealing or misappropriation of _ _[*name of corporation*]_ _'s or its donors' funds or assets.

Deficiencies in or non-compliance with _ _[*name of corporation*]_ _'s internal accounting controls.

Misrepresentations or false statements that constitute a violation of federal law (*e.g.,* mail, wire, bank, or securities fraud).

Violation of other federal or state laws by _ _[*name of corporation*]_ _.

_ _[*Name of corporation*]_ _ strictly prohibits any retaliation, discrimination, or harassment against any employee (or non-employee, such as a board member or donor) who reports what he or she reasonably believes to be violations of federal or state law, such as incident(s) of mail, wire, or securities fraud, questionable accounting practices, or the reporting of fraudulent financial information. _ _[*Name of corporation*]_ _ also will not retaliate against any person who participates in an investigation of such complaints. Conduct that is protected from retaliation includes, but is not limited to:

Providing information or otherwise assisting in an investigation regarding any conduct that the employee reasonably believes constitutes a violation of federal law, such as (but not limited to) tax, mail, wire, or securities fraud laws, or any rule or regulation of the Securities and Exchange Commission (SEC), when the information is provided to or the investigation is conducted by any federal regulatory or law enforcement agency, a member of the United States Congress or any committee of Congress, or any institution supervisor or person with similar authority over the employee, *or*

Filing, testifying, participating in, or otherwise assisting in an investigation, hearing, court proceeding, or other administrative inquiry in relation to an alleged violation of federal law, such as tax, mail, wire or securities fraud laws, or any SEC rule or regulation.

_ _[*Name of corporation*]_ _ also strictly prohibits any retaliation or harmful action against any person (*e.g.,* an employee, donor, or board member) on the basis that the person provided truthful information to law enforcement authorities relating to the violation (or possible violation) of any federal law.

This policy presumes that employees will act in good faith and will not make false accusations. Employees are encouraged to err on the side of caution by reporting any apparent act of wrongdoing, so long as the report is made in good faith. Employees who report acts of wrongdoing or suspected wrongdoing pursuant to this policy will continue to be held to general job performance standards and adherence to _ _[*name of corporation*]_ _'s other applicable policies and procedures.

***Report Procedure.* A person who becomes aware of any act or behavior described above is encouraged to report such incidents as soon as possible to the Chair of the Audit Committee of _ _[*name of corporation*]_ _'s Board of Directors. Reports may be provided in writing, telephonically, or in person. Reports should be as complete as possible, including the details of the incident(s), names of the individual(s) allegedly involved, date(s), and the name(s) of any witness(es). You may send the report or complaint by e-mail or by letter (which may be anonymous, at your discretion) to the Chair of the Audit Committee of _ _[*name of corporation*]_ _ at the following address: _ _[*mailing address, e-mail address, and telephone number*]_ _.**

If the subject of the report involves the Chair of the Audit Committee, you may report your concern to your immediate supervisor and/or the Human Resources Manager.

_ _[*Name of corporation*]_ _ will investigate the complaint and will endeavor to protect the privacy and confidentiality of all parties involved, to the maximum extent possible, consistent with _ _[*name of corporation*]_ _'s obligations to conduct a thorough investigation, to comply with all applicable laws, and/or to cooperate with law enforcement authorities. If necessary, legal counsel and/or _ _[*name of corporation*]_ _'s independent auditing firm will be involved in any investigation.

***Non-retaliation.* Employees and non-employees *(e.g.,* board members, donors) making reports or complaints under this policy will not be subject to any retaliation, discrimination, or harassment. Prohibited retaliation includes firing, demotion, suspension, harassment, failure to consider the employee for promotion, or any other kind of discrimination against the employee in the terms and conditions of employment because of the employee's involvement in protected activity.**

Any employee who discourages or prevents other employees or persons from making reports under this policy or participating in any investigation of such a report will be subject to disciplinary action, up to and including termination.

Any complaint of acts of retaliation in relation to any reports made under this policy should be submitted to the Human Resources Manager. The complaint will be promptly investigated in accordance with the investigation procedures set forth under _ _[*name of corporation*]_ _'s policy prohibiting unlawful harassment and discrimination. If a complaint of retaliation, discrimination, or harassment is substantiated, appropriate disciplinary action, up to and including termination, will be taken. Appropriate legal action may also be taken.

***Receipt of Complaints*. On receipt of any complaint made under this policy, the Chair of the Audit Committee will report to the Audit Committee of _ _[*name of corporation*]_ _ Board of Directors the receipt of any such complaints. On at least a quarterly basis, the Chair of the Audit Committee will also report to _ _[*name of corporation*]_ _ Board of Directors and the Audit Committee the receipt of any complaints made under this policy, the current status of the investigation of any such complaint, and the disposition of any reports of suspected wrongdoing at the conclusion of the investigation.**

***Additional Enforcement Information.* _ _[*Name of corporation*]_ _'s employees and constituents should be aware that certain violations of _ _[*name of corporation*]_ _'s policies and practices could subject _ _[*name of corporation*]_ _ and/or the individual(s) involved to civil and/or criminal penalties. Before issues or behavior rise to that level, employees are encouraged to report to the Audit Committee any violation of federal or state law, any questionable accounting or auditing matters, any reporting of fraudulent financial information, or retaliation related to such reports. Nothing in this policy is intended to prevent an individual from reporting information to a government or law enforcement agency, when the person reasonably believes that _ _[*name of corporation*]_ _ has violated a federal or state statute, rule, or regulation.**

_ _[*Name of corporation*]_ _ **may modify this policy unilaterally at any time without notice. Modification may be necessary, among other reasons, to maintain compliance with state and federal laws or regulations.**

ACKNOWLEDGMENT

I acknowledge that I have received, read, and understand the Policy for the Detection and Reporting of Fraudulent Activity of _ _[*name of corporation*]_ _ and agree to comply with it at all times.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: This whistleblower policy may be adopted by the corporation. For a provision for the minutes of the first meeting of the board of directors resolving to adopt the policy, see §5.35. For a provision adopting the policy by unanimous consent of the board, see §5.60.

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§5.64 2. Form: Consent to Use of Electronic Transmissions by Director or Officer

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.39-5.64.

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CONSENT TO USE OF ELECTRONIC TRANSMISSIONS

In accordance with Corporations Code §§20 and 5079 and Article _ _[*number*]_ _, Section _ _[*number*]_ _ of the Bylaws of this corporation, the undersigned hereby agrees to the following:

1. The Corporation may send meeting notices, annual reports, and all other materials ("Records") to me by electronic transmission at the e-mail address or facsimile number listed below.

2. The Corporation may rely on communications sent by me to the corporation by electronic transmission from the e-mail address or facsimile number listed below for any purposes, including action by written consent. I hereby certify that the corporation may reasonably conclude that I am the author of communications so sent.

3. I understand that I have the right to have all Records provided or made available on paper or in nonelectronic form, but only if requested by me in writing. Requested Records shall be provided within a reasonable period of time.

Electronic transmissions may be sent and received as follows:

By e-mail: _ _[*e-mail address*]_ _.

By facsimile: _ _[*fax number*]_ _.

This consent shall remain in full force and effect until I revoke it in writing and so notify the corporation.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: For a provision for the minutes of the first meeting of the board of directors approving a consent to use electronic transmission, see §5.36. For a provision adopting the use of the consent by the board, see §5.61. Note that to be effective, the consent must be preceded by or include a clear written statement as to (Corp C §20):

> (a) any right of the recipient to have the record provided or made available on paper or in nonelectronic form, (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the recipient must use to withdraw the consent.

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Source: Business Law/Advising California Nonprofit Corporations/5 Forming the Corporation and Beginning Operations/ §5.65 G. Filing Statement by Domestic Nonprofit Corporation

§5.65 G. Filing Statement by Domestic Nonprofit Corporation

Within 90 days after filing the original articles of incorporation, the corporation must file an initial Statement by Domestic Nonprofit Corporation (Secretary of State Form SI-100) with the California Secretary of State. Corp C §§6210(a), 8210(a), 9660(a). This is the same form that nonprofit corporations must also file biennially. Corp C §§6210(a), 8210(a), 9660(a). The form is available and may be completed online at the Secretary of State's website at http://www.sos.ca.gov/business/corp/pdf/so/corp_so100.pdf.

NOTE: The Secretary of State's office ordinarily mails a statement form to the corporation when the articles of incorporation are filed. However, the office's failure to mail the form does not relieve the corporation of responsibility for timely filing the statement.

PRACTICE TIP: An incorporating attorney may find it convenient to keep a supply of blank forms so that this statement may be signed by an officer at the same time that other documents are being signed. Blank forms are available at no charge from the Secretary of State's office, and fill-in forms are available on its website.

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§5.66 H. Registration With Attorney General's Registrar of Charitable Trusts

Newly formed California public benefit corporations and other charitable organizations and trustees holding property for charitable purposes are required to register with the Attorney General. Govt C §12585(a). The organization must submit articles of incorporation and bylaws and pay an initial registration fee within 30 days after its receipt of assets for the charitable purpose for which it was organized. Govt C §12585. Organizations should use the Attorney General's Form CT-1, available on the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/ct1-form.pdf. Every charitable nonprofit corporation, association, or trustee holding assets for charitable purposes is also required to file the Attorney General's Form RRF-1 annually. For discussion of Form RRF-1, see §§12.58-12.59; the form is available on the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/rrf1_form.pdf.

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§5.67 I. Registration With Secretary of State (Political Reform Division)

Many nonprofit and mutual benefit corporations are formed as trade associations, chambers of commerce, or other special interest groups, with a view to influencing public policy through lobbying, campaign contributions, and related political activities. Corporations engaging in these activities may be subject to registration and reporting requirements. Govt C §§81000-91014. For requirements and discussion, see chap 19.

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J. Compliance With Securities Laws

§5.68 1. California Requirements

A membership in an incorporated or unincorporated association is a security for purposes of California securities regulations (Corp C §25019), and the offer or sale of such membership must be qualified with the Commissioner of Corporations unless exempted from this requirement (Corp C §§25110, 25120, 25130). However, not every interest called a "membership" is a membership within the meaning of the statute. For discussion of the distinction between proprietary and nonproprietary memberships, see Cal Comm'r Corps Release No. 15-C (rev Oct. 7, 1970). See §10.16.

Securities (other than debt securities) of corporations organized for religious, charitable, social, or public purposes and not for pecuniary profit are exempt if none of the issuer's net earnings inure to the benefit of any person. Securities issued by a chamber of commerce or trade or professional organization are also exempt. Corp C §25100(j). Even though the statute exempts "trade organizations," the Commissioner of Corporations takes the position that the exemption is not available for trade associations that are formed in order to enhance the economic gain or position of their members. See Cal Comm'r Corps Policy Letter No. 10 (July 10, 1969); Ops Cal Comm'r Corps 75/8C (1975) 1975 Cal Sec Lexis 35; Ops Cal Comm'r Corps 75/3C (1975) 1975 Cal Sec Lexis 43.

A corporation is not disqualified from using this exemption merely because it receives from its members dues or fees that are to be used to build or acquire facilities for the members' use. The exemption does not apply to a promoter of the corporation who intends to profit, directly or indirectly, from a business or an activity associated with the corporation or its operation, or from remuneration by the corporation. Corp C §25100(j). For example, if a promoter of a nonprofit country club retains the right to operate a bar or a golf shop for personal profit, the exemption is not available. In very limited circumstances, however, the Commissioner of Corporations does allow the exemption even if promoters intend to make a profit. See 10 Cal Code Regs §260.105.20.

The fact that debt securities (interest-bearing or non-interest-bearing) are issued by a nonprofit corporation does not exempt this type of security from qualification requirements. Corp C §25100(j). See Ops Cal Comm'r Corps 79/14C (1979) 1979 Cal Sec Lexis 5; Ops Cal Comm'r Corps 75/29C (1975) 1975 Cal Sec Lexis 10; Ops Cal Comm'r Corps 74/80C (1974) 1974 Cal Sec Lexis 30; Ops Cal Comm'r Corps 73/11C (1973) 1973 Cal Sec Lexis 201; Ops Cal Comm'r Corps 72/31C (1972) 1972 Cal Sec Lexis 188.

Exemptions that are available to corporations are generally available to nonprofit corporations. For discussion of the exemptions and the qualification procedure, see Organizing Corporations in California, chap 4 (3d ed Cal CEB 2001). Exemptions from the qualification requirements do not include exemption from antifraud requirements. Corp C §§25400-25404. For further discussion, see §§10.12-10.20.

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§5.69 2. Federal Requirements

Membership in a nonprofit organization is not a security for purposes of the Securities Act of 1933 (15 USC §§77a-77aa). 15 USC §77b(a)(1). If a nonprofit corporation and its members expect no profit or pecuniary return and the corporation does not issue stock or other instruments considered to be a security (*e.g.,* a bond), issuance of memberships is probably not a security, and federal securities law will not apply. However, if the corporation issues stock or finances its activities by selling notes or bonds, or sells memberships from which the members expect to derive a pecuniary return, the stock, notes, bonds, or memberships are considered to be securities. The issuance of such securities must be registered with the Securities and Exchange Commission unless an exemption from registration is available.

For additional discussion, see §§10.21-10.24.

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6

Articles of Incorporation

Cynthia R. Rowland

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§6.1 I. SCOPE

This chapter covers articles of incorporation for public benefit, mutual benefit, and religious corporations. The chapter discusses mandatory and optional provisions, provisions that are only effective when included in the articles, and execution requirements. See §§6.2-6.7. For a list of Corporations Code provisions that may be altered by the articles of incorporation, see §7.2A.

The chapter then provides articles for each type of nonprofit corporation. See §§6.8-6.15 (public benefit corporation), §§6.16-6.22 (mutual benefit corporation), §§6.23-6.30 (religious corporation). The chapter also discusses filing requirements (see §§6.31-6.33) and the procedures for amending the articles (see §§6.34-6.46).

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II. GENERAL REQUIREMENTS

§6.2 A. Mandatory Provisions

The articles of incorporation must include (Corp C §§5130, 6210(b), 7130, 8210(b), 9130, 9660):

- The name of the corporation;
- A statement, in exact statutory language, that it is a specific type of nonprofit corporation; and
- The name of the corporation's initial agent for service of process, and the complete California business or residence street address if the agent is a natural person.

A nonprofit public benefit corporation formed for a "public" purpose must describe the purposes of the corporation in the articles. All other nonprofit corporations may, at their option, describe in more detail the purposes of the corporation. Corp C §§5130(b), 7130(b), 9130(b).

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§6.3 B. Checklist: Articles of Incorporation

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Initial considerations:

- What will be the corporation's name (see §§5.4-5.8)?
- Where will the principal office for the corporation be located?
- What will be the name and California business or residence street address (if an individual) or name and state of incorporation (if a corporation) of the corporation's agent for service of process in California (see §5.9)?
- What is the specific type of nonprofit corporation (see §2.29)?

Other issues:

- Who will be the person for the attorney to contact?
- What public purposes, if any, will the entity serve?
- What will be the corporation's fiscal year?
- Does this corporation have a parent corporation? If so, what is the parent corporation's name, and what is the reason for, or nature of, the relationship?
- Is it anticipated that the corporation will be a public charity or a private foundation (see chaps 3, 4)?
- Will the corporation seek tax-exempt status as a public charity or a private foundation (see chaps 3, 4)?
- What provisions will be made for distribution of assets on dissolution (see §20.83)?

Comment: When the corporate form of organization has been selected, this checklist can be useful to the attorney preparing the articles of incorporation. The questions are intended to provide basic information required in the articles of incorporation. The availability of one or more acceptable names should be checked promptly with the Secretary of State (see §§6.3-6.5).

Private foundations often include provisions in their articles of incorporation covering the special restrictions that the Internal Revenue Code imposes on private foundations. On private foundations, see chap 4.

The requirements for distribution of assets on dissolution of public benefit, mutual benefit, and religious corporations are different. See chap 20.

If the corporation's purposes include any public purposes, briefly describe each public purpose. If the corporation's purposes include any religious purposes, briefly describe each religious purpose, including a statement about the religious faith. See §6.5.

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§6.4 C. Provisions That Are Effective Only When Included in Articles

All nonprofit corporations. The articles of incorporation may include certain additional provisions that are effective only if expressly stated in the articles. If a limited term is desired, the articles must include a provision limiting the duration of the corporation's existence to a specified date in order to be effective. Similarly, if the corporation is a subordinate corporation, the articles must include a provision setting forth either or both of the following requirements (Corp C §§5132(a), 7132(a), 9132(a)):

- A requirement that the subordinate corporation will dissolve whenever its charter is surrendered to, taken away by, or revoked by the head organization; and/or
- A requirement that the subordinate corporation will convey its assets to the head organization on dissolution.

For a list of provisions that may be altered by the bylaws or articles of incorporation, see §7.2A.

Mutual benefit corporations. To be effective for a mutual benefit corporation, provisions giving voting rights to holders of evidences of indebtedness or giving members the right to set the consideration for which memberships are issued must appear in the articles. Corp C §7132(a)(2)-(3).

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§6.5 D. Provisions Required to Secure Tax-Exempt Status

To be exempt from taxation as a corporation formed for charitable purposes, the corporation must have appropriate public or charitable purposes, must dedicate its assets on dissolution to a similarly exempt organization, and must be restricted from engaging in political campaigning or excessive lobbying. Rev & T C §§214, 23701d; IRC §501(c)(3). Certain nonprofit mutual benefit corporations also must include specified provisions in the articles to secure tax-exempt status. For example, a social and recreational club must provide that no part of the net earnings of the corporation may inure to the benefit of any member or private shareholder. For discussion of these requirements, see §§3.15-3.28; see also the form in §6.13. In addition, IRS Publication 557, Tax-Exempt Status for Your Organization, is helpful when drafting provisions to secure tax-exempt status. This publication is available online at the IRS website: http://www.irs.gov/formspubs/index.html?portlet=3

Broad statement of purpose. When stating the corporation's purposes, corporate counsel should consider using a clause that defines purposes broadly. If charitable purposes are limited to a narrow range of activities (for example, finding a cure for a specified disease), use of charitable funds will also be forever limited, even if circumstances change (for example, if the cure is found) or the corporation's focus changes. In addition, the purpose clause may affect the possible application of income tax on unrelated business income. See chap 17. This tax applies only to income from certain activities that are not substantially related to the corporation's exempt purpose. By stating the purposes broadly enough to include activities that might otherwise be subject to this tax while staying within the statutory requirements for obtaining and retaining tax-exempt status, the risk of imposition of the unrelated business income tax may be reduced.

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§6.6 E. Optional Provisions

For all three types of nonprofit corporations, the following provisions may be added to the articles of incorporation (Corp C §§5132(c), 7132(c), 9132(c)):

- Names and addresses of initial directors;
- Classes of members, if any, and their rights, preferences, privileges, and restrictions;
- Terms or conditions under which any member may have more or less than one vote;
- A provision that requires an amendment to the articles (as set forth in Corp C §5812(a) for public benefit corporations or Corp C §7812(a) for mutual benefit corporations) or to the bylaws, and any amendment or repeal of that amendment, to be approved in writing by a specified person or persons other than the board or the members; and
- Any other provision for the management of the corporation, including provisions required or permitted to be included in the bylaws. For example, the articles may set forth the staggering of the directors' terms by dividing the number of directors into two or more classes (see Corp C §§5220, 7220, 9220), or prescribe the qualifications of directors (see Corp C §§5221(b), 7221(b), 9221(b)).

Nonprofit mutual benefit corporations may add provisions on membership transfers under Corp C §7320. Corp C §7132(c)(2).

PRACTICE TIP: These optional provisions may be set forth in the bylaws. Corp C §§5151(c)(1), 7151(c)(1), 9151(c)(1). It is usually to the corporation's advantage not to include them in the articles, because it is more cumbersome and expensive to amend articles than to amend bylaws. See §§6.2, 6.4. On amending bylaws, see 7.111-7.122.

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§6.7 F. Execution of Articles of Incorporation

A corporation may be formed by one or more natural persons, partnerships, associations, or corporations. Corp C §§5065, 5120(a), 7120(a), 9120(a). If a nonprofit corporation is created by an elected legislative body, special rules apply. See Corp C §5120(e) and provisions of the Government Code that apply to joint powers authorities (*e.g.,* Govt C §§6500-6599.3).

Single incorporator. The use of a single incorporator expedites formation of the corporation. The incorporator need not be one of the initial directors. For convenience, the incorporator is often the attorney forming the corporation or a person in the attorney's office. After the articles are filed, if directors are not named in the articles, the incorporator may do whatever is necessary and proper to perfect the organization of the corporation. For example, the incorporator may adopt and amend bylaws, amend the articles, and elect directors and officers of the corporation. Corp C §§5134, 7134, 9134. Usually, the incorporator simply elects directors who then complete the organization. See §5.10.

Initial directors. The names of the initial directors need not be included in the articles of incorporation. If the initial directors are named, each named director must sign and acknowledge the articles and no other "incorporator" need execute them. If no directors are named, the articles need only be signed by the incorporator or incorporators. Corp C §§5120(b), 7120(b), 9120(b). The procedure for acknowledging the articles by named directors is specified in Corp C §5030. Either an acknowledgment by a notary or a declaration is allowed.

PRACTICE TIP: A declaration is widely used as the acknowledgment because of its convenience: a declaration need not be notarized, state the date and place of its execution, or be made under penalty of perjury. It must state that the signer is the person executing the articles and that the articles are his or her act and deed.

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III. ARTICLES OF INCORPORATION

A. Public Benefit Corporation

§6.8 1. Form: Heading

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ARTICLES OF INCORPORATION OF _ _[*NAME OF CORPORATION*]_ _, A California Nonprofit Public Benefit Corporation

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§6.9 2. Form: Name

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ARTICLE I: NAME OF CORPORATION

[*Add one of the following alternatives*]

[*Alternative 1: Corporation is new entity*]

1. The name of the corporation is _ _[*name*]_ _.

[*Alternative 2: Existing unincorporated association is being incorporated*]

1. The name of the corporation is _ _[*name*]_ _. The name of the existing unincorporated association now being incorporated by the filing of these articles is _ _[*name*]_ _.

Comment: The articles of incorporation must state the name of the corporation. Corp C §5130(a). For allowable names and reservation procedure, see §§5.4-5.8.

When an unincorporated association is being incorporated, the articles must also state that an existing unincorporated association is being incorporated and identify that association by name. Corp C §5121(b). A verified statement by any two officers or governing board members of the association, stating that the incorporation of the association has been approved by the association in accordance with its rules and procedures, must accompany the articles when they are filed. Corp C §5121(c). See §6.15.

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§6.10 3. Form: Purpose

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ARTICLE II: PURPOSE OF CORPORATION

2. This corporation is a nonprofit public benefit corporation and is not organized for the private gain of any person. It is organized under the Nonprofit Public Benefit Corporation Law for _ _[*public/charitable/public and charitable*]**_ _ purposes.**

3. The specific purpose of this corporation shall be to _ _[*describe activities*]**_ _ and to carry on other _ _**[*charitable/educational/charitable and educational*]**_ _ activities associated with this goal as allowed by law.**

[If applicable, add the following option]

[Option: Corporation will be exempt under IRC §501(c)(3)]

4. This corporation is organized exclusively for _ _[*insert one or more of the following purposes: charitable, religious, scientific, testing for public safety, literary, or educational purposes, fostering national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals*]**_ _ within the meaning of Internal Revenue Code §501(c)(3) or the corresponding provision of any future United States internal revenue law. Despite any other provision in these articles, the corporation shall not, except to an insubstantial degree, engage in any activities or exercise any powers that do not further the purposes of this corporation, and the corporation shall not carry on any other activities not permitted to be carried on by (a) a corporation exempt from federal income tax under Internal Revenue Code §501(c)(3) or the corresponding provision of any future United States internal revenue law, or (b) a corporation, contributions to which are deductible under Internal Revenue Code §170(c)(2) or the corresponding provision of any future United States internal revenue law.**

Comment: The first clause is required by Corp C §5130(b). If the organization's purposes include "public" purposes, those purposes must be further described; otherwise, further description of purposes is optional.

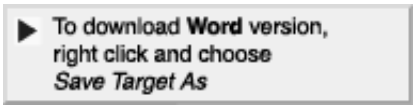
The purposes and limitations in the optional clause are necessary to qualify for tax-exempt status under IRC §501(c)(3) and are permitted by Corp C §§5130(b) and 5131. If the corporation will attempt to secure tax-exempt status other than under IRC §501(c)(3) and Rev & T C §23701d, counsel should consult applicable federal and state tax statutes to ascertain what other provisions, if any, the articles must contain.

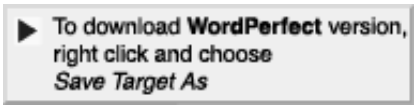
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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/§6.11 4. Form: Optional Supporting Organization Provision

§6.11 4. Form: Optional Supporting Organization Provision

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[5.] This corporation is formed, and shall be operated, exclusively to support _ _[*name of supported public charity*]**_ _.**

Comment: This optional provision and Alternative 2 in §6.13 are required if the organization intends to qualify as a public charity described in IRC §509(a)(3). See §3.44.

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§6.12 5. Form: Agent for Service of Process

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ARTICLE III: AGENT FOR SERVICE OF PROCESS

[Add one of the following alternatives]

[Alternative 1: Agent is corporation]

[6.] The name of the corporation's initial agent for service of process is _ _[*name*]_ _**.**

[Alternative 2: Agent is natural person]

[6.] The name and address in the State of California of the corporation's initial agent for service of process are _ _[*name and complete California business or residence street address*]_ _**.**

Comment: The selection of an initial agent for service of process is discussed in §5.9. For provisions that are required in the articles of incorporation, see §6.2. See Corp C §§5130, 6210(b).

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§6.13 6. Form: Tax-Exempt Status

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ARTICLE IV: TAX-EXEMPT STATUS OF CORPORATION

[7.] Tax-exempt status

(a) No substantial part of the activities of this corporation shall consist of carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise permitted by Internal Revenue Code §501(h)(9)), and this corporation shall not participate or intervene in (including publishing or distributing statements) any political campaign on behalf of any candidate for public office.

(b) All corporate property is irrevocably dedicated to the purposes set forth in Article 2. No part of the net earnings of this corporation shall inure to the benefit of any of its directors, trustees, officers, private shareholders or members, or to individuals.

[*Add one of the following alternatives*]

[*Alternative 1: Distribution of assets on dissolution of corporation*]

(c) On the winding up and dissolution of this corporation, after paying or adequately providing for the debts, obligations, and liabilities of the corporation, the remaining assets of this corporation shall be distributed to an organization (or organizations) organized and operated exclusively for _ _[*insert one or more of the following purposes: charitable, religious, scientific, testing for public safety, literary, or educational purposes, fostering national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals*]**_ _, if the organization has established its tax-exempt status under Internal Revenue Code §501(c)(3) (or corresponding provisions of any future federal Internal Revenue Code law) _ _**[*./;/, and*]**_ _**

[*If appropriate, add*]

has established its tax-exempt status under Revenue and Taxation Code §23701d (or the corresponding section of any future California revenue and tax law) _ _[*./;/, and*]**_ _**

[*If appropriate, add*]

satisfies the requirements of Revenue and Taxation Code §214.

[*If applicable, add the following option to Alternative 1*]

[Option: Distributee is named]

The distributee will be _ _[*name of specific organization*]**_ _ if it qualifies as a distributee under this Article 6.**

[*Alternative 2: Distribution to supported organization on dissolution of corporation]*

(c) On the winding up and dissolution of this corporation, and after paying or adequately providing for its debts and obligations, the remaining assets shall be distributed to _ _[*name of supported public charity*]**_ _, as long as it is then described in Internal Revenue Code §§170(b)(1)(A), 501(c)(3), and 509(a)(1), and as long as it then meets the requirements of California Revenue and Taxation Code §214. If _ _**[*name of supported public charity*]**_ _ is not then so described, distribution of the remaining assets shall be to such corporation, described in such Code provisions, as shall have been substituted for _ _**[*name of supported public charity*]**_ _, as the organization this corporation is operated exclusively to support.**

[Continue]

[*If applicable, add the following option to either Alternative 1 or Alternative 2*]

[Option: Tax-exempt provisions for private foundation]

(d) The corporation will distribute its income for each tax year at such time and in such manner as not to become subject to the tax on undistributed income imposed by Internal Revenue Code §4942 or by corresponding provisions of any later federal tax laws.

(e) The corporation will not engage in any act of self-dealing as defined in Internal Revenue Code §4941(d) or in corresponding provisions of any later federal tax laws.

(f) The corporation will not retain any excess business holdings as defined in Internal Revenue Code §4943(c) or in corresponding provisions of any later federal tax laws.

(g) The corporation will not make investments in a manner that would subject it to tax under Internal Revenue Code §4944 or under corresponding provisions of any later federal tax laws.

(h) The corporation will not make any taxable expenditures as defined in Internal Revenue Code §4945(d) or in corresponding provisions of any later federal tax laws.

Comment: If the corporation will attempt to secure tax-exempt status other than under IRC §501(c)(3) and Rev & T C §23701d, the appropriate federal and state tax statutes must be consulted to ascertain what provisions, if any, the articles must contain. If the corporation is a private foundation (see §§4.23-4.55) its articles of incorporation may contain special provisions for it to be tax exempt and for contributions to it to be deductible as charitable contributions. Every §501(c)(3) corporation is a private foundation under IRC §509(a) unless it falls into a category specifically excluded from that definition.

The property tax exemption clause is necessary if the corporation anticipates applying for an exemption from property tax for real or personal property located in California. See chap 11.

The provisions for private foundation clauses in subparagraphs (d) through (h) are suggested in IRS Publication 557, Tax-Exempt Status for Your Organization. These requirements are also made applicable to the corporation by Corp C §§5260, 9260. Any inconsistent or contrary provision in the articles is void. These provisions may be included in the articles, the bylaws, or both.

Optional provisions that are effective only if they appear in the articles are listed in Corp C §5132(a). Other optional provisions that may be included are listed in Corp C §5132(c).

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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/§6.14 7. Form: Signature Block

§6.14 7. Form: Signature Block

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Date: _ _ _ _ _ _ __[*Signature(s)*]__

Name: _ _[*Typed name(s) of incorporator(s)*]_ _

Comment: For discussion of execution of articles, see §6.7. If the articles name the initial directors, each director must sign and acknowledge the articles. Corp C §5120(b).

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§6.15 8. Form: Declaration; Incorporation of Existing Unincorporated Association

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DECLARATION

_ _[*Names of two officers or governing board members*]_ _ **declare under penalty of perjury under the laws of the State of California that they are the** _ _[*e.g., president and secretary, respectively,*]_ _ **of** _ _[*name of unincorporated association*]_ _ **referred to in the Articles of Incorporation to which this declaration is attached, and that that association has duly authorized and approved in accordance with its rules and procedures its incorporation by means of those articles.**

Executed at _ _[*city and state*]_ _**, on** _ _[*date*]_ _**.**

__[*Signature*]__
Name: _ _[*Typed name*]_ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Comment: This declaration is required when an existing unincorporated association is being incorporated. Corp C §§5076, 5121(c).

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B. Mutual Benefit Corporation

§6.16 1. Form: Heading

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ARTICLES OF INCORPORATION OF
_ _[*NAME OF CORPORATION*]_ _,
A California Nonprofit Mutual Benefit Corporation

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§6.17 2. Form: Name

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ARTICLE I: NAME OF CORPORATION

[Add one of the following alternatives]

[*Alternative 1: Corporation is new entity*]

1. The name of the corporation is _ _[*name*]_ _.

[*Alternative 2: Existing unincorporated association is being incorporated*]

1. The name of the corporation is _ _[*name*]_ _. The name of the existing unincorporated association now being incorporated by the filing of these articles is _ _[*name*]_ _.

Comment: The articles of incorporation must state the name of the corporation. Corp C §7130(a). For allowable names and reservation procedure, see §§5.4-5.8.

When an unincorporated association is being incorporated, the articles must also state that an existing unincorporated association is being incorporated and identify that association by name. Corp C §7121(b). A verified statement by any two officers or governing board members of the association, stating that the incorporation of the association has been approved by the association in accordance with its rules and procedures, must accompany the articles when they are filed. Corp C §7121(c). See §6.22.

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§6.18 3. Form: Purpose

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ARTICLE II: PURPOSE OF CORPORATION

2. This corporation is a nonprofit mutual benefit corporation organized under the Nonprofit Mutual Benefit Corporation Law. The purpose of this corporation is to engage in any lawful act or activity other than credit union business for which a corporation may be organized under such law.

[If applicable, add the following option]

[Option: Corporation will be exempt under IRC §501(c)(3)]

The purposes for which this corporation is formed are pleasure, recreation, and other nonprofit purposes and are _ _[*specific description of purposes*]_ _. Despite any other provision of these articles, this corporation shall not, except to an insubstantial degree, engage in any activities or exercise any powers that do not further the purposes of this corporation.

Comment: The specific wording of the first two sentences is mandated by Corp C §7130(b)(1). Specific wording for credit unions is mandated by the California Credit Union Law (Fin C §§14000-16906). Corp C §7130(b)(2).

The purposes and limitations in the optional clause are necessary to qualify for tax-exempt status under IRC §501(c)(7) and are permitted by Corp C §§7130(b) and 7131. If the corporation will attempt to secure tax-exempt status other than under IRC §501(c)(7) and Rev & T C §23701g, counsel should consult applicable federal and state tax statutes to ascertain how to structure the purposes provisions.

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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/§6.19 4. Form: Agent for Service of Process

§6.19 4. Form: Agent for Service of Process

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ARTICLE III: AGENT FOR SERVICE OF PROCESS

[Add one of the following alternatives]

[Alternative 1: Agent is corporation]

3. The name of the corporation's initial agent for service of process is _ _[*name*]_ _**.**

[Alternative 2: Agent is natural person]

3. The name and California address of the corporation's initial agent for service of process are _ _[*name and complete California business or residence address*]_ _**.**

Comment: The selection of an initial agent for service of process is discussed in §5.9. For provisions that are required in the articles of incorporation, see §6.2. See Corp C §§7130(c), 8210(b).

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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/§6.20 5. Form: Tax-Exempt Status

§6.20 5. Form: Tax-Exempt Status

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ARTICLE IV: TAX-EXEMPT STATUS OF CORPORATION

4. No part of the net earnings of the corporation shall inure to the benefit of any member or private shareholder, as defined in Internal Revenue Code §501(c)(7).

Comment: If the corporation will attempt to secure a tax-exempt status other than under IRC §501(c)(7) and Rev & T C §23701g, counsel should consult the applicable federal and state tax statutes to learn what other provisions, if any, the articles must contain. Optional provisions that are effective only if they appear in the articles are listed in Corp C §7132(a) and may be inserted here. Other optional provisions are listed in Corp C §7132(c). For discussion of provisions required to secure tax-exempt status, see §6.5.

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Date: _ _ _ _ _ _ __[*Signature(s)*]__

Name: _ _[*Typed name(s) of incorporator(s)*]_ _

Comment: For discussion of execution of articles, see §6.7. If the articles name the initial directors, each director must sign and acknowledge the articles. Corp C §7120(b).

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§6.22 7. Form: Declaration; Incorporation of Existing Unincorporated Association

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DECLARATION

_ _[*Names of two officers or governing board members*]_ _ **declare under penalty of perjury under the laws of the State of California that they are the** _ _[*e.g., president and secretary, respectively,*]_ _ **of** _ _[*name of unincorporated association*]_ _ **referred to in the Articles of Incorporation to which this declaration is attached and that that association has duly authorized and approved in accordance with its rules and procedures its incorporation by means of those articles.**

Executed at _ _[*city and state*]_ _**, on** _ _[*date*]_ _**.**

__[*Signature*]__
Name: _ _[*Typed name*]_ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Comment: This declaration is required when an existing unincorporated association is being incorporated. Corp C §§5076, 7121(c).

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C. Religious Corporation

§6.23 1. Form: Heading

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§6.23-6.28.

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ARTICLES OF INCORPORATION OF _ _[*NAME OF CORPORATION*]_ _, A California Nonprofit Religious Corporation

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§6.24 2. Form: Name

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§6.23-6.28.

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ARTICLE I: NAME OF CORPORATION

[Add one of the following alternatives]

[*Alternative 1: Corporation is new entity*]

1. The name of the corporation is _ _[*name*]_ _.

[*Alternative 2: Existing unincorporated association is being incorporated*]

1. The name of the corporation is _ _[*name*]_ _. The name of the existing unincorporated association now being incorporated by the filing of these articles is _ _[*name*]_ _.

Comment: The articles must state the name of the corporation. Corp C §9130(a). For allowable names and reservation procedure, see §§5.4-5.8.

When an unincorporated association is being incorporated, the articles must also state that an existing unincorporated association is being incorporated and identify that association by name. Corp C §9121(b). A verified statement by any two officers or governing board members of the association, stating that the incorporation of the association has been approved by the association in accordance with its rules and procedures, must accompany the articles when they are filed. Corp C §9121(c). See §6.29.

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§6.25 3. Form: Purpose

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ARTICLE II: PURPOSE OF CORPORATION

2. This corporation is a religious corporation and is not organized for the private gain of any person. It is organized under the Nonprofit Religious Corporation Law _ _[*primarily/exclusively*]_ _ for religious purposes.

[If applicable, add the following option]

[Option: Corporation will be exempt under IRC §501(c)(3)]

[3.] This corporation is organized exclusively for religious purposes within the meaning of Internal Revenue Code §501(c)(3) (or the corresponding section of any future federal internal revenue law). Notwithstanding any other provision of these articles, the corporation shall not, except to an insubstantial degree, engage in any activities or exercise any powers that are not in furtherance of the purposes of this corporation, and the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under Internal Revenue Code §501(c)(3) (or the corresponding provision of any future federal internal revenue law), or (b) by a corporation, contributions to which are deductible under Internal Revenue Code §170(c)(2) (or the corresponding provision of any future federal internal revenue law).

Comment: The specific wording of the first two sentences is mandated by Corp C §9130(b). A corporation that is to be tax exempt under IRC §501(c)(3) and Rev & T C §23701d should be organized "exclusively" for religious purposes.

The purposes and limitations in the optional clause are necessary to qualify for tax-exempt status under IRC §501(c)(3) and are permitted by Corp C §§9130(b) and 9131. If the corporation will attempt to secure tax-exempt status other than under IRC §501(c)(3) and Rev & T C §23701d, counsel should consult applicable federal and state tax statutes to ascertain what other provisions, if any, the articles must contain.

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§6.26 4. Form: Agent for Service of Process

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ARTICLE III: AGENT FOR SERVICE OF PROCESS

[Add one of the following alternatives]

[Alternative 1: Agent is corporation]

[4.] The name of the corporation's initial agent for service of process is _ _[*name*]_ _.

[Alternative 2: Agent is natural person]

[4.] The name and California address of the corporation's initial agent for service of process are _ _[*name and complete California business or residence address*]_ _.

Comment: The selection of an initial agent for service of process is discussed in §5.9. See Corp C §9130(c); see also Corp C §§6210(b), 9660.

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§6.27 5. Form: Tax-Exempt Status

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ARTICLE IV: TAX-EXEMPT STATUS OF CORPORATION

[5.] Tax-exempt status

(a) No substantial part of the activities of this corporation shall consist of carrying on propaganda or otherwise attempting to influence legislation (except as otherwise permitted by Internal Revenue Code §501(h)), and this corporation shall not participate or intervene in (including publishing or distributing statements) any political campaign on behalf of any candidate for public office.

(b) The property of this corporation is irrevocably dedicated to religious purposes, as set forth in Article 2. No part of the net earnings of this corporation shall inure to the benefit of its directors, trustees, officers, private shareholders or members, or to any individual.

(c) On the winding up and dissolution of this corporation, after paying or adequately providing for the debts and obligations of the corporation, the remaining corporate assets shall be distributed to an organization (or organizations) that is organized and operated exclusively for religious purposes and that is tax exempt under Internal Revenue Code §501(c)(3) or corresponding provisions of any future federal Internal Revenue Code law)_ _[*./;/, and*]_ _

[*If appropriate, add*]

that has established its tax-exempt status under Revenue and Taxation Code §23701d_ _[*./;/, and*]_ _

[*If appropriate, add*]

satisfies the requirements of California Revenue and Taxation Code §214.

[*If appropriate, add*]

That organization shall be _ _[*name of specific organization*]_ _ if it qualifies as a distributee under this Article 5.

Comment: Optional provisions that are effective only if they appear in the articles are listed in Corp C §9132(a) and may be inserted here. Other optional provisions are listed in Corp C §9132(c).

The second option is necessary if the corporation anticipates applying for an exemption from property tax for real or personal property located in California. See chap 11.

For discussion of the lobbying limitations and the election under IRC §501(h), see §§19.5-19.32.

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§6.28 6. Form: Signature Block

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Date: _ _ _ _ _ _ __[*Signature(s)*]__

Name: _ _[*Typed name(s) of incorporator(s)*]_ _

Comment: For discussion of execution of articles, see §6.7. If the articles name the initial directors, each director must sign and acknowledge the articles. Corp C §9120(b).

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§6.29 7. Form: Declaration; Incorporation of Existing Unincorporated Association

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DECLARATION

_ _[*Names of two officers or governing board members*]_ _ **declare under penalty of perjury under the laws of the State of California that they are the** _ _[*e.g., president and secretary, respectively,*]_ _ **of** _ _[*name of unincorporated association*]_ _ **referred to in the Articles of Incorporation to which this declaration is attached, and that that association has duly authorized and approved in accordance with its rules and procedures its incorporation by means of those articles.**

Executed at _ _[*city and state*]_ _**, on** _ _[*date*]_ _**.**

__[*Signature*]__
Name: _ _[*Typed name*]_ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Comment: This declaration is required when an existing unincorporated association is being incorporated. Corp C §§5076, 9121(c).

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§6.30 D. Other Forms

The Franchise Tax Board (FTB) has published form Articles of Incorporation for various types of nonprofit corporations, including charities and religious corporations (see IRC §501(c)(3)), social welfare corporations (see IRC §501(c)(4)), and mutual benefit corporations. These forms can be found in the FTB Form 3500 Booklet, which is available on the FTB website at http://www.ftb.ca.gov/forms.

The Secretary of State has also published form Articles of Incorporation, which are available on the California Secretary of State's website at http://www.sos.ca.gov/business/corp/pdf/articles/corp_artsnp.pdf.

For special provisions required in the articles of a community association (*i.e.,* an association organized to manage a common interest development), see CC §1363.5 and Advising California Common Interest Communities, chap 2 (Cal CEB 2003).

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IV. FILING ARTICLES OF INCORPORATION

§6.31 A. Timing Considerations

The corporation's existence begins when the Secretary of State files the articles of incorporation. The incorporator must submit the articles to the Secretary of State, accompanied by a check for the filing fee. The Secretary of State will file the articles. When the endorsed copy of the articles is returned, the incorporator must file the application for federal tax exemption with the IRS and, on receipt of the IRS determination letter, submit the IRS letter to the Franchise Tax Board to obtain franchise tax exemption. When the exemption is granted, it is ordinarily retroactive to the incorporation date. Under current law, prepayment of the minimum franchise tax is not necessary. Rev & T C §§23153, 23221.

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§6.32 B. Filing Procedure

Articles may be filed by mail or in person at the Secretary of State's Sacramento office. Articles may also be filed in person at the Los Angeles office of the Secretary of State. An extra copy of the articles must be submitted if they are filed in person. For current addresses and fee schedules, see the California Secretary of State's website at http://www.sos.ca.gov. See also Govt C §12186(d).

If copies of the articles are supplied to the Secretary of State, two certified copies will be returned at no extra charge. Additional copies will be certified and returned for a fee.

Every nonprofit public benefit corporation must provide the Secretary of State with an additional copy of its articles for forwarding to the Attorney General. Corp C §5120(d). A corporation created by an elected legislative body to exercise authority that may lawfully be delegated to a private corporation or other entity must furnish an additional copy of its articles to the Secretary of State, who will forward the additional copy to the controller. Corp C §5120(e); see, *e.g.,* Govt C §§6500-6599.3.

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§6.33 C. Form: Transmittal Letter

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Secretary of State
Corporate Filing Division
1500 11th St., 3rd Floor
Sacramento, CA 95814-5701
Re: _ _[*Name of corporation*]_ _, a proposed nonprofit corporation

Dear Sirs or Mesdames:

Enclosed are the original and _ _[*number*]_ _ copies of the articles of incorporation of the above-named proposed nonprofit corporation; our check for _ _[*dollar amount*]_ _, payable to you, as prepayment of the minimum franchise tax; and our check for _ _[*dollar amount*]_ _ in payment of your fees. Please file the articles and compare, certify, and return the enclosed copies to us.

Very truly yours,

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Comment: On procedures for obtaining the franchise tax exemption, see §3.71. If a name has been reserved (see §§5.4-5.8), it is helpful to mention this fact in the letter or attach a copy of the reservation certificate.

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V. AMENDMENTS TO ARTICLES

§6.34 A. Limitations on Amendments

The Nonprofit Corporation Law provides corporations with great flexibility in amending their articles of incorporation. See Corp C §§5810(a), 7810(a), 9620(a).

NOTE: The Secretary of State will notify the Franchise Tax Board of any amendments to the articles of a public benefit corporation. Corp C §5813.5(a).

A nonprofit corporation may ordinarily amend its articles in any manner desired, subject to the following limitations:

- **Quorum of board.** Unless there is only one director, the articles or bylaws may not provide for a quorum of a board of directors that is less than one fifth of the authorized number directors or fewer than two directors, whichever is larger. See Corp C §§5211(a)(7), 7211(a)(7). There are no similar provisions for religious corporations.
- **Majority vote.** The articles or bylaws may not provide that a vote of less than a majority of the directors present is an act of the board. Corp C §§5211(a)(8), 7211(a)(8), 9211(a)(8).
- **Extending director's term.** The articles or bylaws may not be amended to extend the term of a director beyond the period for which the director was elected. Corp C §§5220(a), 7220(a). There is no similar provision for religious corporations.
- **Lawfulness requirement.** The articles as amended may contain only provisions that could lawfully be included in original articles filed at the time amendment is filed. Corp C §§5810(a), 7810(a), 9620(a).
- **Change in members' rights.** If an amendment changes the rights of members or if it exchanges, reclassifies, or cancels memberships, the amended articles must include the provisions necessary to make the change, exchange, reclassification, or cancellation. Corp C §§5810(a), 7810(a), 9620(a). For mutual benefit corporations, equitable principles prohibit changes by the majority that would have an unduly harsh or oppressive effect on a minority of members. See 3 Ballantine & Sterling, California Corporation Laws §412.02[4] (4th ed 1962).
- **Charitable trusts.** Amendments purporting to change limitations imposed on the corporation or any of its property in a charitable trust may require approval by the Attorney General; see §§6.40-6.41.
- **Terminating all memberships (public benefit corporations).** An amendment of a public benefit corporation's articles or bylaws that would terminate all memberships or any class of memberships must be approved by the members, after written notice describing the amendment's effect on the corporation and on the members. Other procedural requirements are specified in the statute, which authorizes the corporation to impose additional requirements on this type of amendment. Corp C §5342. There is no similar provision for mutual benefit or religious corporations.
- **Election to be governed by Nonprofit Corporation Law of 1980.** A few California nonprofit corporations created before 1980 have not amended their articles since the Nonprofit Corporation Law of 1980 (Corp C §§5000-10841). When amending the articles of incorporation for an older California corporation, practitioners might consider having the corporation elect to be governed by the 1980 law. See Corp C §9913(a).

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B. Required Authorizations or Approvals

§6.35 1. Incorporators

If a corporation's original articles do not name any directors, no directors have yet been appointed, and there are no members, the articles of incorporation may be amended by a writing signed by a majority of the incorporators. Corp C §§5811, 7811, 9620(a). See §6.42.

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§6.36 2. Board of Directors

If a corporation has no members, amendments to the articles may be adopted by the board. Corp C §§5812(b)(3), 7812(b)(3), 9620(a). If the corporation has members, the following types of amendments may be adopted by board approval alone:

- An amendment deleting the names and addresses of the corporation's first directors or initial agent (Corp C §§5812(b)(2), 7812(b)(2), 9620(a));
- For corporations organized before January 1, 1980, an amendment electing to be governed by all applicable provisions of the new Nonprofit Corporation Law, if no material changes are otherwise made to the articles (Corp C §§5812(b)(4), 7812(b)(4), 9620(a), 9913(d)-(f));
- For corporations organized before August 14, 1929, an amendment extending the corporate existence or making the existence perpetual (Corp C §§5812(b)(1), 7812(b)(1), 9620(a)).

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§6.37 3. Members and Other Specified Persons

Except as discussed in §§6.34-6.36, amendments to the articles must be approved by the members, if there are members, and by any other person whose approval is required by the articles. Corp C §§5812(a), 7812(a), 9620(a). "Approval of the members" ordinarily means approval or ratification by the affirmative vote of a majority of the votes represented and voting at a meeting at which a quorum is present (which affirmative votes also constitute a majority of the required quorum), or similar action by written ballot. Corp C §5034; see §10.35. A corporation's articles or bylaws may require a supermajority or a unanimous vote instead of the simple majority of Corp C §5034. See §10.41.

NOTE: Amendment of the articles of a corporation sole requires the approval of the religious organization run by the corporation sole, which may not be the same legal person as the chief officer of the corporation sole. *Berry v Society of St. Pius X* (1999) 69 CA4th 354, 81 CR2d 574. See §2.33.

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§6.38 4. Classes of Members

If the corporation has classes of members, class approval is required of any amendment to the articles that would materially and adversely affect the rights of that class as to voting or transfer (or, for mutual benefit corporations, dissolution or redemption) "in a manner different than such action affects another class." Corp C §§5813, 7813(a), 9620(a). Class approval is also required for mutual benefit corporations, if the amendment would:

- Materially and adversely affect the rights of one class by changing rights or conditions of another class (Corp C §7813(b));
- Increase or decrease the number of memberships authorized for the class (Corp C §7813(c)) or increase the number of members authorized for another class (Corp C §7813(d));
- Exchange, reclassify, or cancel all or part of the memberships of the class (Corp C §7813(e)); or
- Authorize a new class of memberships (Corp C §7813(f)).

Any amendment to provisions requiring approval of corporate actions by a particular class of members or by a supermajority vote requires approval by the specified class or specified larger vote. Corp C §§5812(c), 7812(c), 9620(a).

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§6.39 5. Amendment to Change Status

Occasionally, a nonprofit corporation may wish to change its status. A public benefit corporation may amend its status to that of a mutual benefit, religious, business, or cooperative corporation by complying with Corp C §5813.5. A mutual benefit corporation may amend its articles to change its status to that of a public benefit, religious, business, or cooperative corporation by complying with Corp C §7813.5. A religious corporation may amend its articles to change its status to a public benefit, mutual benefit, business, or cooperative corporation by complying with Corp C §§5810-5820. Corp C §9621. These amendments require notice to the California Registry of Charitable Trusts if the corporation is changing from a public benefit corporation to anything other than a religious corporation, and, in all cases, to the IRS and the Franchise Tax Board. See §§20.25-20.40.

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6. Attorney General

§6.40 a. Property Held in Charitable Trust

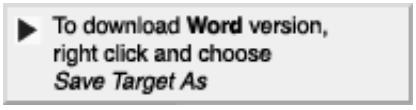
If a corporation holding assets in charitable trust contemplates adopting an amendment that would affect the terms of the trust or assets subject to the trust, the proposed amendment should be submitted in advance to the Attorney General for a ruling on whether the Attorney General may oppose it as inconsistent with, or prohibited by, the terms of the trust. See Corp C §§5820(b), 7820(b), 9620(a); see also 11 Cal Code Regs §§999.1-999.8.

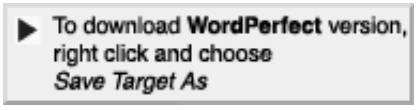
WARNING: The Attorney General considers all assets of public benefit corporations to be assets held in charitable trust and subject to Attorney General supervision. See Attorney General's Guide for Charities (rev 2005), available at http://www.caag.state.ca.us/charities/publications/guide_for_charities.pdf. See also Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7).

An amendment to the articles by itself does not abrogate any requirement or limitation that a trust imposes on the corporation or its assets. Corp C §§5820(a), 7820(a), 9620(a). See §20.30.

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§6.41 b. Checklist: Contents of Request for Approval





A request for the Attorney General's approval of an amendment to the articles affecting property held in charitable trust or the limitations or requirements imposed by such a trust should contain the following (11 Cal Code Regs §§999.2(d), 999.3(d)):

- A letter signed on the corporation's behalf, containing a detailed description of the proposed amendment and all material facts, including (1) the reasons for the amendment, (2) the benefit it would confer on the corporation, (3) whether the board has approved the amendment, and, if so, (4) the criteria used in evaluating and approving the amendment.
- A copy of the corporation's financial statement current to within 90 days before filing the request, if not already on file with the Registry of Charitable Trusts.
- A copy of the corporation's articles and bylaws as amended, if not already on file with the Registry of Charitable Trusts.
- Copies of the minutes of any board or committee meetings at which the proposed amendment was discussed.
- Any other information requested by the Attorney General.

For special rules relating to the transfer of assets by a nonprofit health facility, see Corp C §§5914-5925. Those provisions also apply to a proposed amendment to the articles converting a nonprofit health facility to a for-profit or mutual benefit corporation. 11 Cal Code Regs §999.5.

Submitting copies to IRS and FTB. After receiving the approval from the Attorney General and filing any amendments to the articles of incorporation, the corporation must supply certified copies to the IRS and the Franchise Tax Board (FTB). The amended documents can be attached to the annual information returns (IRS Form 990 and FTB Form 199). Alternatively, the amended documents can be sent to the IRS and the FTB directly. The current address for submitting copies of the documents to the IRS can be found in the FAQs of the IRS website at http://www.irs.gov/charities. The current address for submitting copies to the FTB is: Exempt Organizations Unit, MS F120, Franchise Tax Board, P.O. Box 1286, Rancho Cordova, CA 95741. The IRS will acknowledge receipt of the amended documents, but will not make a determination on the effect of the changes on the organization's exempt status. If the changes are material, the corporation will need to submit a formal request for a ruling pursuant to Rev Proc 2009-4, 2009-1 Int Rev Bull 118.

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C. Certificate of Amendment

§6.42 1. Requirements

All amendments to the articles of incorporation must be filed with the Secretary of State by means of a certificate of amendment. The certificate establishes the wording of the amendment or amended articles, by stating one of the following (Corp C §§5816, 7816, 9620(a)):

- The articles shall be amended to read as set forth in full in the certificate;
- A particular provision, identified by using the designation given it in the articles or by quoting the wording of the provision, is stricken from the articles or is amended to read as set forth in the certificate; or
- The provisions set forth in the certificate are added to the articles.

For suggestions on drafting amendments that will be acceptable to the Secretary of State, see the California Secretary of State's website at http://www.sos.ca.gov. The website also includes a sample of an officers' certificate of amendment.

Incorporators' certificate. An incorporators' certificate must be signed and verified by a majority of the incorporators, and it must state that (Corp C §§5815, 7815, 9620(a)):

- The signatories constitute at least a majority of the incorporators;
- Directors were not named in the original articles and have not been elected;
- The corporation has no members; and
- The signatories adopt the amendment or amendments set forth in the certificate.

Officers' certificate. An officers' certificate must be signed and verified by (1) the chair of the board, the president, or any vice president and (2) the secretary, treasurer, assistant secretary, assistant treasurer, or chief financial officer. Corp C §5062. The officers' certificate must state the wording of the amendment and that the board has approved the amendment. If the amendment is one for which the approval of the members is required, the certificate must also state that the amendment was approved by the required vote of members, and if the amendment is one that may be adopted by board approval alone, the certificate must state the facts entitling the board to act alone. If the amendment requires approval by other persons or classes, the certificate must state that their approval has been obtained. Corp C §§5814(a), 7814(a), 9620(a).

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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/ 2. Certificate of Amendment/§6.43 a. Form: Incorporators' Certificate of Amendment

2. Certificate of Amendment

§6.43 a. Form: Incorporators' Certificate of Amendment

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CERTIFICATE OF AMENDMENT OF ARTICLES OF INCORPORATION OF _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of incorporators*]_ _ **certify that:**

1. They constitute at least a majority of the incorporators of _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious*]_ _ **corporation.**

2. The corporation has no members.

3. Directors were not named in the articles of incorporation and have not been elected.

4. They adopt the following _ _[*amendments*]_ _ **to the articles of incorporation of the corporation:**

_ _[*Set forth amendments*]_ _**.**

__[*Signatures*]__
Name: _ _[*Typed names of incorporators*]_ _

Verification

Each of the undersigned declares under penalty of perjury under the laws of the State of California that the statements in the foregoing certificate are true and correct of his or her own knowledge and that this declaration was executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

__[*Signatures*]__
Name: _ _[*Typed names of incorporators*]_ _

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Source: Business Law/Advising California Nonprofit Corporations/6 Articles of Incorporation/§6.44 b. Form: Officers' Certificate of Amendment

§6.44 b. Form: Officers' Certificate of Amendment

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CERTIFICATE OF AMENDMENT OF ARTICLES OF INCORPORATION OF _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of officers*]_ _ **certify that:**

1. They are the _ _[*president/chair of the board/vice president*]_ _ **and the** _ _[*secretary/assistant secretary/chief financial officer/treasurer/assistant treasurer*]_ _**, respectively, of** _ _[*name of corporation*]_ _**, a California nonprofit corporation.**

2. The following amendment to the articles of incorporation of the corporation has been approved by the board of directors:

_ _[*Set forth amendment*]_ _**.**

[*Add one of the following alternatives*]

[*Alternative 1: Corporation has no members*]

3. The corporation has no members.

[*Alternative 2: Directors are the only members*]

3. The directors are the only members of the corporation.

[*Alternative 3: Approval by required vote of members*]

3. The amendment has been approved by the required vote of the members _ _[*and any class of members materially and adversely affected*]_ _**.**

[*Alternative 4: Approval solely by board*]

3. This amendment makes no changes in the articles other than _ _[*extending the corporate existence/making the corporate existence perpetual/deleting the names and addresses of the first directors/deleting the name and address of the initial agent for service of process/electing to be governed by all of the Nonprofit Corporation Law*]_ _**, and therefore it can be adopted by approval of the board alone under Corporations Code §_ _[*5812(b)/7812(b)*]_ _.**

[*Alternative 5: Approval by officers*]

3. As required by the articles of incorporation, this amendment has been approved by the following person(s):

_ _[*Copy name or description from articles*]_ _**.**

[Continue]

__[*Signature of officer*]__
Name: _ _[*Typed name*]_ _

__[*Signature of officer*]__
Name: _ _[*Typed name*]_ _

Verification

Each of the undersigned declares under penalty of perjury under the laws of the State of California that the statements in the foregoing certificate are true and correct of his or her own knowledge, and that this declaration was executed on _ _[*date*]_ _, at _ _[*city*]_ _, California.

__[*Signature of officer*]__
Name: _ _[*Typed name*]_ _

__[*Signature of officer*]__
Name: _ _[*Typed name*]_ _

Comment: If the amendment is by the incorporators, the certificate of amendment must be an "incorporators' certificate" (see §6.43); otherwise, it must be an "officers' certificate." If the amendment reclassifies, cancels, exchanges, or otherwise changes outstanding memberships, the amended articles must state the effect of the amendment on outstanding memberships. Corp C §§5816, 7816, 9620(a).

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§6.45 3. Filing Certificate of Amendment

The original, signed certificate of amendment and at least two copies must be filed with the Secretary of State. Corp C §§5051, 5814-5815, 5817, 7814-7815, 7817, 9620(a). The filing can be made only in Sacramento, at the following address (see http://www.sos.ca.gov/business/corp/pdf/amendments/corp-amdtnp.pdf):

Business Programs Division
1500 11th Street
Sacramento, CA 95814
Attention: Document Filing Support Unit

A $15 special handling fee applies for processing documents delivered in person at the public counter in the Sacramento office. Preclearance or expedited filing of eligible corporate documents may be requested in a specified time frame for an additional fee (in lieu of this $15 special handling fee).

Letter-size paper must be used, one side only. A three-inch square space should be left in the upper right-hand corner for the Secretary of State's filing stamp. Backing sheets are discouraged. The sheets should be stapled once in the upper left-hand corner. The document submitted may be sent electronically, and need not be the original document bearing the actual, manual signatures of the incorporators or officers. Counterpart signatures are not accepted; if multiple signatures are required, they must be on the same document.

The usual fee for filing a certificate of amendment is $30. Govt C §12186(p). If copies are submitted at the time of filing, the Secretary of State will certify up to two copies without charge; additional certifications are $8 each, and the cost for comparing a copy with an original is $3. Govt C §§12178.1(c), 12183, 12185. A current schedule of filing fees, a sample certificate of amendment, and other relevant information can be found on the California Secretary of State's website at http://www.sos.ca.gov.

The articles of incorporation are considered amended, and the resultant changes made, as of the date the certificate was duly filed with the Secretary of State. A delayed effective date, not to exceed 90 days after the date of submission, may be stated in the certificate of amendment. Corp C §5008. A copy of the certificate, certified by the Secretary, is prima facie evidence of the amendment's adoption. Corp C §§5817, 7817, 9620(a).

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§6.46 4. Restated Articles of Incorporation

A corporation that has amended its articles several times may wish to combine the amendments and the original articles into one document for easy reference by filing restated articles of incorporation. Restated articles supersede the original articles and all previously filed amendments. Corp C §§5819(c), 7819(c), 9620(a).

Except when the incorporator or the board may amend the articles, restated articles should be filed with the Secretary of State by means of an officers' certificate (see §6.44). Corp C §§5819(a), 7819(a), 9620(a).

The officers' certificate should set forth the articles as amended to the date of filing the restated articles, except that the following items should be omitted:

- Signatures and acknowledgments of incorporators;
- Any statements regarding the effect of prior amendments on memberships;
- Any provisions of a merger agreement other than amendments to the articles of the surviving corporation; and
- Names and addresses of the first directors and the initial agent for service of process (unless the initial Statement by Domestic Nonprofit Corporation under Corp C §6210 or §8210 has not yet been filed, in which case the initial agent and first directors should be included in the restatement). Corp C §§5819(a), 7819(a), 9620(a).

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7

Bylaws

Cynthia R. Rowland

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§7.1 I. SCOPE OF CHAPTER

This chapter discusses the bylaws requirements applicable to public benefit, mutual benefit, and religious corporations. The statutory requirements are similar in many respects. See Corp C §§5110-6910 (nonprofit public benefit corporations); (Corp C §§7110-8910) (nonprofit mutual benefit corporations); Corp C §§9110-9690 (nonprofit religious corporations). The chapter provides a set of forms that may be used to assemble bylaws for a public benefit corporation, a mutual benefit corporation, or a religious corporation with members. See §§7.3-7.110. Except when indicated, these bylaw provisions may be used for any of the three types of corporations. When applicable, citations to the authorizing Corporations Code sections are given for all three types of corporations. In addition, the chapter contains a complete set of model bylaws for a public benefit corporation without members. See §§7.123-7.171. The chapter also includes form clauses that may be used to amend a corporation's bylaws. See §§7.111-7.122.

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§7.2 II. PURPOSE OF BYLAWS

Purposes. The bylaws establish the procedures for governing and operating the corporation's activities and conduct. They serve three purposes:

- To provide rules for matters not covered by statute;
- To alter specific default rules that control by statute in the absence of a contrary bylaw; and
- To provide a ready reference to the governing laws and rules for the corporation's attorney, directors, and officers.

The third purpose usually requires restating at least some of the statutory requirements that apply unless a bylaw provision provides otherwise. The amount of detail included varies widely among attorneys and depends in part on the legal knowledge and sophistication of the corporation's officers and directors.

Requirements. General substantive requirements and descriptions of bylaws are in the Nonprofit Corporation Law. Corp C §§5151-5153, 7151-7153, 9151-9153. Bylaws must state the number of directors of the corporation unless it is stated in the articles. They must also contain housekeeping details such as the time, place, and method of calling meetings of members, directors, and committees; the duties and powers of directors; the method of election and qualification of directors; the length of directors' terms; the manner of appointment, duties, and tenure of officers; requirements of reports to members; the method of setting and collecting dues and assessments; rules for admitting and expelling members; and special requirements for the percentage of votes of the members and directors needed to take certain actions and to constitute a quorum.

The bylaws may delegate all or some of the members' authority and provide for their terms, duties, manner of selection, and removal of those delegates. Corp C §§5152, 7152, 9152. See §§7.12-7.21.

NOTE: The remainder of the Nonprofit Corporation Law refers to items that may and may not be specified, implemented, or altered by the bylaws. Before drafting any unusual bylaw, counsel should investigate to see whether its subject matter is covered by a specific code section. See generally Corp C §§5000-10841.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.2A III. TABLE: CORPORATIONS CODE DEFAULT PROVISIONS THAT MAY BE ALTERED IN BYLAWS OR ARTICLES OF INCORPORATION

§7.2A III. TABLE: CORPORATIONS CODE DEFAULT PROVISIONS THAT MAY BE ALTERED IN BYLAWS OR ARTICLES OF INCORPORATION

Provision	Public Benefit Corporation	Mutual Benefit Corporation	Religious Corporation
Bylaw amendments	A provision in the bylaws requiring a greater vote cannot be altered, amended, or repealed except by such greater vote. Corp C §5151(e).	Same as public benefit corporation. Corp C §7151(e).	Same as public benefit corporation. Corp C §9151(e).
Calling meetings	Meetings of the board may be called by the chair of the board, president, any vice president, secretary, or any two directors. Corp C §5211(a)(1).	Same as public benefit corporation. Corp C §7211(a)(1).	Same as public benefit corporation. Corp C §9211(a)(1).
Notice of meetings	Regular meetings of the board may be held without notice if the time and place of the meetings are fixed by the bylaws or the board. Special meetings of the board shall be held upon 4 days' notice by first-class mail or 48 hours' notice delivered personally or by telephone or by electronic transmission. (The articles or bylaws may not dispense with notice of a special meeting.) A notice, or waiver of notice, need not specify the purpose of any regular or special meeting of the board. Corp C §5211(a)(2).	Same as public benefit corporation. Corp C §7211(a)(2).	Same as public benefit corporation. Corp C §9211(a)(2).
Waiver of notice	Notice of a meeting need not be given to a director who provides a waiver of notice, consent to holding the meeting, or an approval of the minutes in writing or who attends the meeting without protesting lack of notice. These waivers, consents, and approvals shall be filed with the corporate records or made a part of the minutes of the meetings. Corp C §5211(a)(3).	Same as public benefit corporation. Corp C §7211(a)(3).	Same as public benefit corporation. Corp C §9211(a)(3).
Adjournment of meeting	A majority of the directors present may adjourn any meeting to another time and place. If the meeting is adjourned for more than 24 hours, notice of an adjournment shall be given prior to the time of the adjourned meeting to the directors who were not present. Corp C §5211(a)(4).	Same as public benefit corporation. Corp C §7211(a)(4).	A majority of the directors present may adjourn any meeting to another time and place. Corp C §9211(a)(4).
Place of meeting	Meetings of the board may be held at a place designated in the notice of the meeting or, if not stated in the notice or there is no notice, designated in the bylaws or by resolution of the board. Corp C §5211(a)(5).	Same as public benefit corporation. Corp C §7211(a)(5).	Same as public benefit corporation. Corp C §9211(a)(5).
Telecommunications	Directors may participate in a meeting through use of conference telephone, electronic video screen communication, or electronic transmission. Participation in a meeting through use of conference telephone or electronic video screen communication constitutes presence in person as long as all directors are able to hear one another. Participation in a meeting through use of electronic transmission constitutes	Same as public benefit corporation. Corp C §7211(a)(6).	Same as public benefit corporation. Corp C §9211(a)(6).

	presence in person if each director can communicate with all of the other directors concurrently and each director is provided the means of participating in all matters. Corp C §5211(a)(6).		
Quorum	A majority of the number of directors authorized in or pursuant to the articles or bylaws constitutes a quorum for the transaction of business. (The articles or bylaws may not provide that a quorum shall be less than one-fifth the number of directors authorized in or pursuant to the articles or bylaws, or less than two, whichever is larger, unless the number of directors authorized in or pursuant to the articles or bylaws is one, in which case one director constitutes a quorum.) Corp C §5211(a)(7).	Same as public benefit corporation. Corp C §7211(a)(7).	Same as public benefit corporation (without parenthetical). Corp C §9211(a)(7).
Act of the board	Except as otherwise provided in this part, a decision made by a majority of the directors present at a duly held meeting at which a quorum is present is the act of the board. (The articles or bylaws may not provide that a lesser vote than a majority of the directors present at a meeting is the act of the board.) A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting, or a greater number required by this division, the articles, or bylaws. Corp C §5211(a)(8).	Same as public benefit corporation. Corp C §7211(a)(8).	Same as public benefit corporation. Corp C §9211(a)(8).
Board delegation	The board may delegate powers to any committee but may not delegate certain powers set forth in this Section. Corp C §5212(c).	Same as public benefit corporation. Corp C §7212(c).	Same as public benefit corporation. Corp C §9212(c).
Officers	The president, or if there is no president, the chair of the board is the general manager and chief executive officer of the corporation. If there is no chief financial officer, the treasurer is the chief financial officer. Any number of offices may be held by the same person (except that the secretary, the CFO, or the treasurer may not serve concurrently as the president or chair of the board). Corp C §5213(a).	Same as public benefit corporation (without parenthetical). Corp C §7213(a).	Same as public benefit corporation. Corp C §9213(a).
Election of officers	Officers shall be chosen by the board and serve at the pleasure of the board. Corp C §5213(b).	Same as public benefit corporation. Corp C §7213(b).	Same as public benefit corporation. Corp C §9213(b).
Officer term	The term of office of a member-elected officer shall be 1 year (term shall not exceed 3 years). Corp C §5213(c).		
Director term	Director terms shall be 1 year and the director shall hold office until the expiration of the term and until a successor has been elected and qualified, unless the director has been removed from office. Corp C §5220(a)-(b).	Same as public benefit corporation. Corp C §7220(a)-(b).	Same as public benefit corporation. Corp C §9220(b)-(c).
Removal of directors			The board by a majority vote may

			declare vacant the office of any director who fails to meet any required qualification. Corp C §9221(b).
Removal of designated directors	Any designated director may be removed without cause by the designator. The right to remove shall not apply if the designator has died or ceased to exist. Corp C §5222(f).	Same as public benefit corporation. Corp C §7222(f).	
Director vacancies	Vacancies on the board may be filled by approval of the board or, if the number of directors then in office is less than a quorum, by (1) unanimous written consent, (2) affirmative vote of a majority of the directors then in office, or (3) a sole remaining director. Corp C §5224(a).	Same as public benefit corporation. Corp C §7224(a).	Same as public benefit corporation. Corp C §9224(a).
Members	A corporation shall have no members. Corp C §5310(a).	Same as public benefit corporation. Corp C §7310(a).	Same as public benefit corporation. Corp C §9310(a).
Transfer of membership	No member may transfer a membership or any rights of membership and all rights of membership cease upon the member's death or dissolution (may not transfer membership for value). Corp C §5320(a)-(b).	Same as public benefit corporation except without parenthetical language. Corp C §7320(a).	Same as public benefit corporation. Corp C §9320(a)-(b).
Waiver of notice by members	Any written waiver of notice, consent to the holding of the meeting, or approval of the minutes does not need to specify the business to be transacted at or the purpose of any regular or special meeting of members. Corp C §5511(e).	Same as public benefit corporation. Corp C §7511(e).	
Electronic transmission of ballot	If approved by the board of directors, the ballot and any related material may be sent and responses may be returned to the corporation by electronic transmission. Corp C §5513(a).	Same as public benefit corporation. Corp C §7513(a).	Same as public benefit corporation. Corp C §9413(a).
Revocation of ballot	A written ballot may not be revoked. Corp C §5513(d).	Same as public benefit corporation. Corp C §7513(d).	
Irrevocable proxy		The irrevocable proxy of a member is irrevocable when it is held by (1) a person who has purchased the membership; or (2) a creditor of the corporation or the member; or (3) an employee of the corporation if required by the contract of employment. Corp C §7613(d).	
Election of directors	In any election of directors, the candidates receiving the highest number of votes are	Same as public benefit corporation.	

	elected (except for elections by cumulative voting). Corp C §5616(d).	Corp C §7615(d).	
Amendment of articles	Whenever the articles require the approval of a particular member class, or of a larger proportion of the votes of any class, or of a larger proportion of the directors than is otherwise required by this part, the provision in the articles requiring such greater vote shall not be altered except by such class or such greater vote. Corp C §5812(c).	Same as public benefit corporation. Corp C §7812(c).	
Member approval	No approval of the members shall be necessary for any mortgage, deed of trust, pledge, or other hypothecation of all or any part of the corporation's property for the purpose of securing the payment or performance of any contract or obligation. Corp C §5910.	Same as public benefit corporation. Corp C §7910.	Same as public benefit corporation. Corp C §9630.
Annual report	If approved by the board, the annual report may be sent by electronic transmission. Corp C §6321(a).	Same as public benefit corporation. Corp C §8321(a).	
Annual statement	If approved by the board, the statement of certain transactions and indemnifications may be sent by electronic transmission. Corp C §6322(a).	Same as public benefit corporation. Corp C §8322(a).	

Comment: Certain Corporations Code provisions are not absolute requirements but are merely default provisions. These provisions are often prefaced by "unless otherwise provided in the articles or bylaws." The table above lists such provisions that may be altered in some cases by the bylaws, in others by the articles of incorporation, or in many cases by both. Sometimes there are limitations placed on how these provisions may be customized. These limitations are noted in the table in parentheses. This list does not include provisions with the restrictive language "unless prohibited by" the articles or bylaws.

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IV. BYLAWS FOR PUBLIC BENEFIT, MUTUAL BENEFIT, AND RELIGIOUS CORPORATIONS

§7.3 A. Form: Heading

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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BYLAWS OF _ _[*NAME OF CORPORATION*]_ _ **A California Nonprofit** _ _[*Public Benefit/Mutual Benefit/Religious*]_ _ **Corporation**

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§7.4 B. Form: Name

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Corporate Name. **The name of this corporation is _ _**[*name*]**_ _.**

Comment: For discussion of corporate names, see §§5.4-5.8.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.5 C. Form: Principal Office of the Corporation

§7.5 C. Form: Principal Office of the Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Principal Office. **The principal office for the transaction of the activities and affairs of this corporation is located at _ _[*street address and city*]_ _, in _ _[*name*]_ _ County, California. The board of directors may change the location of the principal office. Any such change of location must be noted by the secretary on these bylaws opposite this Section; alternatively, this Section may be amended to state the new location.**

[*If appropriate, add*]

The board may at any time establish branch or subordinate offices at any place or places where this corporation is qualified to conduct its activities.

Comment: The street address of the principal office in California must be stated in the biennial statement filed with the California Secretary of State. The corporation's mailing address must also be included if different from the street address of the principal executive office, or if the corporation does not have a principal office in California. Corp C §§6210(a), 8210(a), 9660. The optional clause is indirectly authorized by Corp C §§5151(c), 7151(c), and 9660.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.6 D. Form: General and Specific Purposes; Limitations

§7.6 D. Form: General and Specific Purposes; Limitations

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Purpose. **The purpose of this corporation is to _ _**[*state purposes exactly as in the articles of incorporation*]**_ _. In the context of these general purposes, the corporation shall _ _**[*describe purposes more specifically*]**_ _. Also in the context of these purposes, the corporation shall _ _**[*repeat any limitations that appear in the articles of incorporation and add any other limitations that do not appear in the articles*]**_ _.**

Comment: Even though the purposes are stated in the articles (see §6.2; see also forms in §§6.10, 6.18, 6.25), they may be set forth again in the bylaws as a reminder to the directors and members. However, counsel should caution the corporation that changes to the purposes clause in the bylaws are not effective unless the changes are consistent with the purposes stated in the articles of incorporation. Federal and state tax considerations, such as seeking tax-exempt status, may affect the statement of purposes. Certain limitations must be set forth in the articles if the corporation wishes to be a tax-exempt organization. See §6.5.

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§7.7 E. Form: Construction and Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Construction; Definitions. **Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the California Nonprofit Corporation Law shall govern the construction of these bylaws. Without limiting the generality of the preceding sentence, the masculine gender includes the feminine and neuter, the singular includes the plural, the plural includes the singular, and the term "person" includes both a legal entity and a natural person.**

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.8 F. Form: Subordinate Corporation to Religious Entity

§7.8 F. Form: Subordinate Corporation to Religious Entity

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Subordinate Corporation. **This corporation is an integral subordinate of _ _**[*name of superior religious entity*]**_ _. The _ _**[*title of superior religious entity's governing document*]**_ _ now or hereafter in effect is incorporated by reference into these bylaws. If any conflict arises between the _ _**[*governing document*]**_ _ and these bylaws, the _ _**[*governing document*]**_ _ shall prevail. The secretary of the corporation shall keep a copy of the _ _**[*governing document*]**_ _ with these bylaws.**

Comment: This provision should be used only if the corporation is subordinate to a religious entity. In these bylaws, management of the corporation is largely under the power of the board of directors (see §7.50); if the management is to be within the power of a religious body, the bylaws should be revised accordingly. See Corp C §9210 on delegating management authority.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.9 G. Form: Supporting Organization Under IRC §509(a)(3)

§7.9 G. Form: Supporting Organization Under IRC §509(a)(3)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Supporting Corporation. **This corporation has been organized and shall operate exclusively to support** _ _[*name of supported public charity*]_ _ **and shall be** _ _[operated, supervised, or controlled by/supervised or controlled in connection with/operated in connection with]_ _ **that organization as specified in Internal Revenue Code §509(a)(3).**

If _ _[*name of supported organization*]_ _ **(1) shall cease to be an organization described in Internal Revenue Code §§170(b)(1)(A)(iv), 501(c)(3) and 509(a)(1) or 509(a)(2), or (2) shall substantially abandon the charitable and educational purposes that this corporation is organized to support, the directors shall designate a publicly supported educational or charitable organization as described in Internal Revenue Code §§170(b)(1)(A), 501(c)(3) and 509(a)(1) or 509(a)(2), in substitution for** _ _[*name of supported organization*]_ _**, for purposes of Article** _ _[*specify purposes clause*]_ _ **of the Articles of Incorporation and Section** _ _[*number*]_ _ **of these bylaws.**

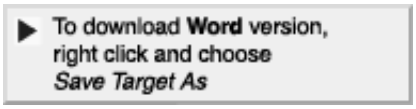
Comment: This provision should be used only if the corporation is organized as a supporting organization described in IRC §509(a)(3). See Treas Reg §1.509(a)-4(f)(2); see also §6.11.

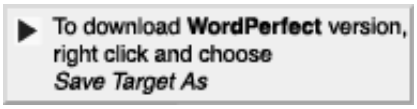
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.10 H. Form: Irrevocable Dedication of Assets

§7.10 H. Form: Irrevocable Dedication of Assets

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





Irrevocable Dedication of Assets. **This corporation's assets are irrevocably dedicated to _ _**[*public benefit/charitable/religious*]**_ _ purposes. No part of the net earnings, properties, or assets of the corporation, on dissolution or otherwise, shall inure to the benefit of any private person or individual, or to any director or officer of the corporation. On liquidation or dissolution, all properties and assets remaining after payment, or provision for payment, of all debts and liabilities of the corporation shall be distributed to a nonprofit fund, foundation, or corporation that is organized and operated exclusively for charitable purposes and that has established its exempt status under Internal Revenue Code §501(c)(3).**

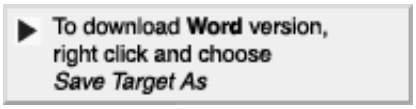
Comment: This provision should be omitted if the corporation is not intended to operate as described in IRC §501(c)(3).

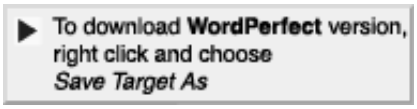
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.11 I. Form: Corporations Without Members

§7.11 I. Form: Corporations Without Members

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No Members. **This corporation shall have no voting members within the meaning of the Nonprofit Corporation Law. The corporation's board of directors may, in its discretion, admit individuals to one or more classes of nonvoting members; the class or classes shall have such rights and obligations as the board finds appropriate.**

Comment: The corporation need not have members. Corp C §§5310(a), 7310(a), 9310(a). If there is no provision for members in the articles or bylaws, the corporation is deemed to have no members. It is preferable, however, that the bylaws state whether there are to be members. If the corporation will not have members, the other bylaws should be modified or omitted as appropriate. For discussion of whether to have members and the effect of having no members, see §10.4. For form bylaws for a California nonprofit public benefit corporation without members, see §§7.123-7.171.

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§7.12 J. Corporations With Members

Only voting members are "members" as the term is used in the Nonprofit Corporation Law. Corp C §5056(a). See §10.2. The bylaws may state the classes of members, if any, and if more than one class should state the rights, preferences, restrictions, conditions, and privileges of each. See Corp C §§5151(c)(1), 7151(c)(1), 9310(a).

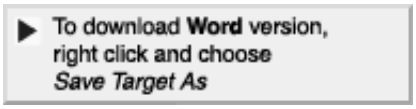
PRACTICE TIP: Voting rights should be restricted to classes that will be active in the organization or, if this is not feasible, the quorum requirement (see §7.31) should be set be low enough to ensure that the number of members who can reasonably be expected to vote by written ballot or attend meetings will constitute a quorum.

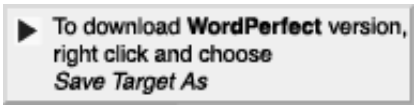
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.13 1. Form: Qualifications and Classes of Membership

§7.13 1. Form: Qualifications and Classes of Membership

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[*Add one of the following alternatives*]

[*Alternative 1: Bylaws specify classes and requirements*]

***Membership*. This corporation shall have _ _**[*e.g., two*]**_ _ classes of members, designated as _ _**[*e.g., regular and associate*]**_ _. Any person dedicated to the purposes of the corporation _ _**[*and*]**_ _ _ _**[*state other qualifications for each class of membership, including any requirement for approval by a membership committee*]**_ _ shall be eligible for membership on approval of the membership application by the board and on timely payment of such dues and fees as the board may fix from time to time.**

[*Alternative 2: Reference to governing document*]

Qualifications of members and classes and terms of membership shall be those described by the _ _[*governing document*]**_ _.**

Comment: For public benefit corporations, see Corp C §§5132(c)(2)-(3), 5151(c)(1); for mutual benefit corporations, see Corp C §§7132(c)(2)-(3), 7151(c)(1). For religious corporations, see Corp C §§9151(c)(1), 9310-9313, 9330-9332.

A nonprofit corporation may provide in its articles or bylaws that it will admit members or not have members. As a default, the corporation will not have members unless either the articles or bylaws so provide. Corp C §§5310(a), 7310(a), 9310(a). See §7.11. The bylaws may provide for consideration or for no consideration (see Corp C §§5311, 7311, 9311) and classes of memberships (see Corp C §§5330-5331, 7330-7331, 9330-9331). Bylaws may also provide for delegates that have some or all of the authority of members. Corp C §§5152-5153, 7152-7153, 9152-9153. See §7.15.

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§7.14 2. Form: Rights of Membership

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Membership Rights. _ _[*All/Specify, e.g., names of voting classes*]_ _ **members shall have the right to vote, as set forth in these bylaws, on the election of directors, on the disposition of all or substantially all of the corporation's assets, on any merger and its principal terms and any amendment of those terms, and on any election to dissolve the corporation. In addition, those members shall have all rights afforded members under the California Nonprofit Public Benefit Corporation Law.**

[*Alternative 2: Mutual benefit corporations*]

Membership Rights. _ _[*All/Specify, e.g., names of voting classes*]_ _ **members shall have the right to vote, as set forth in these bylaws, on the election of directors, on the disposition of all or substantially all of the assets of the corporation, on any merger and its principal terms and any amendment of those terms, and on any election to dissolve the corporation. In addition, those members shall have all rights afforded members under the California Nonprofit Mutual Benefit Corporation Law. If the corporation is dissolved, those members shall receive a prorata distribution of all assets, exclusive of those held in charitable trust, remaining after payment or provision for payment of the obligations and debts of the corporation and provision for any other payment required under applicable law.**

[*Alternative 3: Religious corporations*]

***Membership Rights*. Members of each class shall have the right to vote, as set forth in Section _ _**[*number; see §7.32*]**_ _ of these bylaws, on the election of directors, on the disposition of all or substantially all of the assets, on a merger and its principal terms and any amendment of those terms, and on an election to dissolve the corporation. In addition, the corporation may refer to persons associated with it as "members," even though those persons are not members as defined above. No such reference shall constitute anyone as a member within the meaning of Corporations Code §5056. References in these bylaws to "members" are not references to such associated persons.**

Comment: The bylaws may state the classes of members, if any, and if more than one class, the rights, preferences, restrictions, conditions, and privileges of each. It is recommended that voting rights be restricted to classes that will be active in the organization or, if this is not feasible, the quorum requirement (see §7.31) should be set low enough to ensure that the number of members who can reasonably be expected to vote by written ballot or attend meetings will constitute a quorum. If voting members will not share equally in the assets on dissolution, the bylaws should provide for sharing by classes, with each member sharing equally within the classes. See Corp C §§5132(c)(2)-(3), 5151(c)(1), 7132(c)(2)-(3), 7151(c)(1), 9151(c)(1), 9310-9313, 9330-9332.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.15 3. Form: Other Persons Associated With Corporation

§7.15 3. Form: Other Persons Associated With Corporation

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***Nonvoting Members*. This corporation may refer to persons of _ _[*names of nonvoting classes*]_ _ classes or other persons or entities associated with it as "members," even though those persons or entities are not voting members as set forth in Section _ _[*number*]_ _ of these bylaws, but no such reference shall constitute anyone as a member within the meaning of Corporations Code §5056 unless that person or entity shall have qualified for a voting membership under Section _ _[*number*]_ _ of these bylaws. References in these bylaws to "members" shall mean members as defined in Corporations Code §5056; *i.e.,* the members of the class(es) set forth in Section _ _[*number*]_ _ of these bylaws. By amendment of its articles of incorporation or of these bylaws, the corporation may grant some or all of the rights of a member of any class to any person or entity that does not have the right to vote on the matters specified in Section _ _[*number*]_ _ of these bylaws, but no such person or entity shall be a member within the meaning of Corporations Code §5056.**

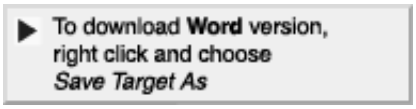
Comment: The bylaws may also provide for delegates having some or all the authority of members. See Corp C §§5152-5153, 7152-7153, 9152-9153. See also §7.2. To avoid possible confusion over the term "member" for persons who are not voting members, some corporations use titles such as "associate" for nonstatutory members.

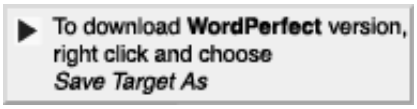
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.16 4. Form: Members' Dues, Fees, and Assessments

§7.16 4. Form: Members' Dues, Fees, and Assessments

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





***Dues, Fees, and Assessments*. Each member must pay, within the time and on the conditions set by the board, the dues, fees, and assessments in amounts to be fixed from time to time by the board. The dues, fees, and assessments shall be equal for all members of each class, but the board may, in its discretion, set different dues, fees, and assessments for each class.**

Comment: See Corp C §§5151(c)(8), 7151(c)(8), 9151(c)(8). This provision does not itself create a liability of the members. A member may avoid liability for specific dues, fees, and assessments by resigning promptly on learning of them. See Corp C §§5351, 7351, 9351; see also Corp C §§5350(b), 7350(b), 9350(b). See §10.125. Similar provisions may be included for persons (*e.g.,* "associates") who pay dues but are not statutory members. See §7.15.

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§7.17 5. Form: Members in Good Standing

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***Good Standing*. Members who have paid the required dues, fees, and assessments in accordance with these bylaws and who are not suspended shall be members in good standing.**

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§7.18 6. Form: Termination of Membership

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Termination of Membership*. A membership shall terminate on occurrence of any of the following events:**

(1) Resignation of the member;

(2) Expiration of the period of membership, unless the membership is renewed on the renewal terms fixed by the board;

(3) The member's failure to pay dues, fees, or assessments as set by the board within _ _[*period of time*]_ _ after they are due and payable;

(4) Any event that renders the member ineligible for membership, or failure to satisfy membership qualifications; or

(5) Termination of membership under Section _ _[*number*]_ _ of these bylaws based on the good faith determination by the board, or a committee or person authorized by the board to make such a determination, that the member has failed in a material and serious degree to observe the rules of conduct of the corporation, or has engaged in conduct materially and seriously prejudicial to the corporation's purposes and interests.

Comment: See Corp C §§5340-5341, 7340-7341, 9340(c)-(d). A member may resign at any time and written notice is not required. The Corporations Code does not specify substantive grounds for termination; the provisions here are merely suggested. Item (4) of this form applies to classes of membership for which ineligibility is based on age, occupation, residence, or other conditions subject to change. If members are not expected to become ineligible through change of status, this subsection may be deleted.

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§7.19 7. Form: Suspension of Membership

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***Suspension of Membership*. A member may be suspended, under Section _ _[*number*]_ _ of these bylaws, based on the good faith determination by the board, or a committee or person authorized by the board to make such a determination, that the member has failed in a material and serious degree to observe the corporation's rules of conduct, or has engaged in conduct materially and seriously prejudicial to the corporation's purposes and interests.**

A person whose membership is suspended shall not be a member during the period of suspension.

Comment: Procedures for expulsion, suspension, and termination are governed by Corp C §§5341, 7341, and 9340(d). On termination of membership, see §7.18.

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§7.20 8. Form: Termination or Suspension of Membership

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Procedure. **If grounds appear to exist for suspending or terminating a member under Sections _ _[*numbers*]_ _ of these bylaws, the following procedure shall be followed:**

(1) The board shall give the member at least 15 days' prior notice of the proposed suspension or termination and the reasons for the proposed suspension or termination. Notice shall be given by any method reasonably calculated to provide actual notice. Notice given by mail shall be sent by first-class or registered mail to the member's last address as shown on the corporation's records.

(2) The member shall be given an opportunity to be heard, either orally or in writing, at least five days before the effective date of the proposed suspension or termination. The hearing shall be held, or the written statement considered, by the board or by a committee or person authorized by the board to determine whether the suspension or termination should occur.

(3) The board, committee, or person shall decide whether the member should be suspended, expelled, or sanctioned in any way. The decision of the board, committee, or person shall be final.

(4) Any action challenging an expulsion, suspension, or termination of membership, including a claim alleging defective notice, must be commenced within one year after the date of the expulsion, suspension, or termination.

Comment: Procedures for expulsion, suspension, and termination are governed by Corp C §§5341, 7341, and 9340(d). See §§10.127-10.132.

Public benefit and mutual benefit corporations. The procedure must be fair and reasonable and performed in good faith. A procedure is presumed to be fair and reasonable when (Corp C §§5341(c), 7351(c)):

- The procedure is set forth in the articles or bylaws, or copies of the procedure are sent annually to all members as required by the articles or bylaws;
- The procedure provides for the giving of 15 days' notice before expulsion, suspension, or termination, and the reasons for the action; and
- The procedure provides an opportunity for the member to be heard, orally or in writing, at least 5 days before the effective date of the expulsion, suspension, or termination by a person or body authorized to reverse the decision.

Religious corporations. There is no "reasonableness" requirement for terminating membership in a religious corporation. See Corp C §9340(d).

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§7.21 9. Form: Transfer of Memberships

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[*Add one of the following alternatives*]

[*Alternative 1: Transfer generally free of conditions*]

***Transfer of Memberships*. A membership _ _[*or any right arising from membership*]_ _ may be transferred to a prospective member meeting the qualifications set forth in Section _ _[*number*]_ _ of these bylaws; provided, however, that no member may transfer a membership or any right arising from it for value. Under Section _ _[*number*]_ _ of these bylaws, all rights of membership cease on the member's death, suspension, termination, or dissolution.**

[*Alternative 2: Transfer subject to conditions*]

***Transfer of Memberships.* A membership _ _[*or any right arising from membership*]_ _ may be transferred to a prospective member meeting the qualifications set forth in Section _ _[*number*]_ _ of these bylaws; provided, however, that no member may transfer a membership or any right arising from it for value. The board may by resolution impose transfer fees or other conditions on the transferring party as it deems fit, provided that those fees and conditions are the same for similarly situated members. Under Section _ _[*number*]_ _ of these bylaws, all rights of membership cease on the member's death, suspension, termination, or dissolution.**

[*Alternative 3: Transfer not permitted*]

***Memberships as Not Transferable.* No membership or right arising from membership shall be transferred. Subject to Section _ _[*number*]_ _ of these bylaws, all membership rights cease on the member's death or dissolution.**

Comment: See Corp C §§5320, 7320, 9320. If desired, the articles or bylaws may provide that rights of membership not cease on a member's death or dissolution, in the case of a member that is an entity. For provisions on termination or suspension of membership, see §§7.18-7.20.

WARNING: Note that special rules on transfers of membership apply to a public benefit corporation that is a limited equity housing cooperative. See Corp C §5320(c).

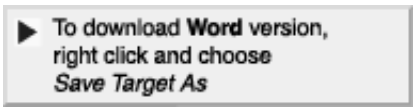
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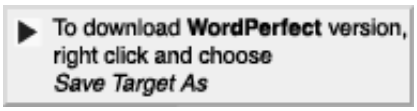
10. Meetings

a. General Meetings

§7.22 (1) Form: Annual Meeting

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





[*Add one of the following alternatives*]

[*Alternative 1: Meeting held on date certain*]

***Annual Meeting*. An annual meeting of members shall be held on the _ _**[*specific date/day, e.g., first Monday*]**_ _ of _ _**[*month*]**_ _ of each year at _ _**[*time*]**_ _, unless the board fixes another date or time and so notifies members as provided in Sections _ _**[*numbers*]**_ _ of these bylaws. If the scheduled date falls on a legal holiday, the meeting shall be held on the next full business day. At the meeting, directors shall be elected and other proper business may be transacted, subject to Sections _ _**[*numbers*]**_ _ of these bylaws.**

[*Alternative 2: Meetings held as specified by board*]

***Annual Meeting.* A general meeting of members shall be held at least annually at such time and place, and on such notice, if any, as the board may determine. Unless elected by written ballot, directors shall be elected at this meeting. Subject to Sections _ _**[*number*]**_ _ of these bylaws, any other proper business may be transacted at this meeting.**

Comment: Public and mutual benefit corporations must hold a general meeting to elect directors, and conduct other business, in every year in which directors are to be elected. Corp C §§5510(b), 7510(b). A good practice is to hold the annual meeting 2½-3 months after the end of the corporation's fiscal year because all financial reports for the prior year should be final by that time. See §§7.22-7.26.

For religious corporations, see Corp C §9411(a). The statute does not require annual meetings. For discussion, see §10.76.

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§7.23 (2) Form: Place of Meeting

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Location of Meetings. **Meetings of the members shall be held at any place within or outside California designated by the board or by the written consent of all members entitled to vote at the meeting, given before or after the meeting. In the absence of any such designation, members' meetings shall be held at the corporation's principal office. The board may authorize members who are not present in person to participate by electronic transmission or electronic video communication.**

[*If applicable, add the following option*]

[*Option: Electronic meetings*]

Authority for Electronic Meetings**. If authorized by the board in its sole discretion, and subject to the requirements of consent in Corporations Code §20(b) and guidelines and procedures the board may adopt, members not physically present in person (or, if proxies are allowed, by proxy) at a meeting of members may, by electronic transmission by and to the corporation or by electronic video screen communication, participate in a meeting of members, be deemed present in person (or, if proxies are allowed, by proxy), and vote at a meeting of members whether that meeting is to be held at a designated place or in whole or in part by means of electronic transmission by and to the corporation or by electronic video screen communication, subject to the requirements of these bylaws.**

Requirements for Electronic Meetings**. A meeting of the members may be conducted, in whole or in part, by electronic transmission by and to the corporation or by electronic video screen communication (1) if the corporation implements reasonable measures to provide members in person (or, if proxies are allowed, by proxy) a reasonable opportunity to participate in the meeting and to vote on matters submitted to the members, including an opportunity to read or hear the proceedings of the meeting substantially concurrently with those proceedings, and (2) if any member votes or takes other action at the meeting by means of electronic transmission to the corporation or electronic video screen communication, a record of that vote or action is maintained by the corporation. Any request by a corporation to a member pursuant to Corporations Code §20(b) for consent to conduct a meeting of members by electronic transmission by and to the corporation shall include a notice that absent consent of the member pursuant to Corporations Code §20(b), the meeting shall be held at a physical location in accordance with Section _ _[*number*]_ _ of these bylaws.**

Comment: See Corp C §§20-21, 5510(a), 7510(a).

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b. Special Meetings

§7.24 (1) Form: Authority to Call Special Meetings

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Special Meetings. **The board or the chair of the board, if any, or the president, _ _**[*specify additional persons, if any*]**_ _ or 5 percent or more of the members, may call a special meeting of the members for any lawful purpose at any time.**

Comment: See Corp C §§5510(e), 7510(e), 9411(b). For discussion, see §10.78.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.25 (2) Form: Calling Special Meetings

§7.25 (2) Form: Calling Special Meetings

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Special Meetings. **A special meeting called by any person entitled to call a meeting of the members shall be called by written request, specifying the general nature of the business proposed to be transacted, and addressed to the attention of and submitted to the chair of the board, if any, or the president or any vice president or the secretary of the corporation. The officer receiving the request shall cause notice to be given promptly to the members entitled to vote, under Sections _ _[*numbers*]_ _ of these bylaws, stating that a meeting will be held at a specified time and date fixed by the board.**

[*If public benefit or mutual benefit corporation, add the following*]

However, the meeting date shall be at least 35 but no more than 90 days after receipt of the request.

[*Continue*]

If the notice is not given within 20 days after the request is received, the person or persons requesting the meeting may give the notice. Nothing in this Section shall be construed as limiting, fixing, or affecting the time at which a meeting of members may be held when the meeting is called by the board.

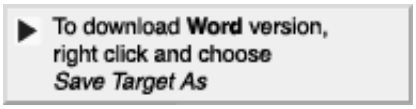
Comment: See Corp C §§5511(c), 7511(c), 9411(c).

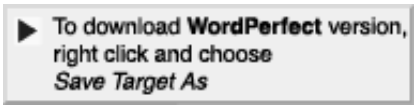
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.26 (3) Form: Proper Business of Special Meeting

§7.26 (3) Form: Proper Business of Special Meeting

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No business, other than the business that was set forth in the notice of the meeting, may be transacted at a special meeting.

Comment: See Corp C §§5511(a), 7511(a). There is no similar requirement for religious corporations.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 11. Notice/§7.27 a. Form: General Notice Requirements

11. Notice

§7.27 a. Form: General Notice Requirements

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***Written Notice Required*. Whenever members are required or permitted to take any action at a meeting, a written notice of the meeting shall be given, under Sections _ _[*numbers; see §§7.27-7.30*]_ _ of these bylaws, to each member entitled to vote at that meeting. The notice shall specify the place, date, and hour of the meeting, and the means of electronic transmission by and to the corporation or electronic video screen communication, if any, by which members may participate in the meeting. For the annual meeting, the notice shall state the matters that the board, at the time notice is given, intends to present for action by the members. For a special meeting, the notice shall state the general nature of the business to be transacted and shall state that no other business may be transacted. The notice of any meeting at which directors are to be elected shall include the names of all persons who are nominees when notice is given. _ _**[*Except as provided in Section _ _[number]_ _ of these bylaws, any proper matter may be presented at the meeting.*]_ _

Comment: If the bylaws of a public benefit or mutual benefit corporation set the quorum at less than one-third of the voting power, certain matters must be specifically noticed in the notice of a meeting. Therefore, if a quorum is less than one-third, the language in this form and the form in §7.28 must be included in the bylaws. See Corp C §§5511(a), 5512(b), 7511(a), 7512(b).

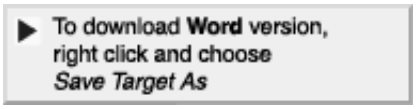
The articles or bylaws of religious corporations may provide any reasonable method of noticing meetings. Corp C §§9410(a), 9411(a).

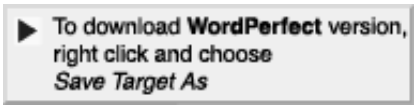
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.28 b. Form: Notice of Certain Agenda Items

§7.28 b. Form: Notice of Certain Agenda Items

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Notice of Certain Agenda Items*. Approval by the members of any of the following proposals, other than by unanimous approval by those entitled to vote, is valid only if the notice or written waiver of notice states the general nature of the proposal or proposals:**

(1) Removing a director without cause;

(2) Filling vacancies on the board;

(3) Amending the articles of incorporation; or

(4) Electing to wind up and dissolve the corporation.

[*If applicable, add the following option*]

[*Option: Additional notice for mutual benefit corporations*]

(5) Approving a contract or transaction between the corporation and one or more directors, or between the corporation and any entity in which a director has a material financial interest; or

(6) Approving a plan of distribution of assets, other than money, not in accordance with liquidation rights of any class or classes as specified in the articles or bylaws, when the corporation is in the process of winding up.

[*Alternative 2: Religious corporations*]

***Notice of Certain Agenda Items*. Approval by the members of any of the following proposals, other than by unanimous approval by those entitled to vote, is valid only if the notice or waiver of notice specifies the general nature of the proposal:**

(1) Removing a director without cause;

(2) Amending the articles of incorporation;

(3) Adopting, amending, or repealing bylaws;

(4) Disposing of corporate assets;

(5) Adopting or amending a merger agreement; or

(6) Electing to wind up and dissolve the corporation.

Comment: For public benefit corporations, see Corp C §5511(f). For mutual benefit corporations, see Corp C §7511(f), which applies only to a corporation with more than one class of membership. For religious corporations, see Corp C §9411(e); the requirements of §9411(e) may not be varied. Corp C §9410(b). See §10.85.

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§7.29 c. Form: Manner of Giving Notice

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***Notice Requirements*. Notice of any meeting of members shall be in writing and shall be given at least 10 but no more than 90 days before the meeting date. The notice shall be given either personally, by electronic transmission by the corporation, or by first-class, registered, or certified mail, or by other means of written communication, charges prepaid, and shall be addressed to each member entitled to vote, at the address of that member as it appears on the books of the corporation or at the address given by the member to the corporation for purposes of notice. If no address appears on the corporation's books and no address has been so given, notice shall be deemed to have been given if either (1) notice is sent to that member by first-class mail or facsimile or other written communication to the corporation's principal office or (2) notice is published at least once in a newspaper of general circulation in the county in which the principal office is located.**

[*If applicable, add the following option*]

[*Option: Electronic notice of meetings*]

***Electronic Notice*. Notice given by electronic transmission by the corporation shall be valid only if**

(1) Delivered by (a) facsimile telecommunication or electronic mail when directed to the facsimile number or electronic mail address, respectively, for that recipient on record with the corporation; (b) posting on an electronic message board or network that the corporation has designated for those communications, together with a separate notice to the recipient of the posting, which transmission shall be validly delivered on the later of the posting or delivery of the separate notice of it; or (c) other means of electronic communication;

(2) To a recipient who has provided an unrevoked consent to the use of those means of transmission for communications; and

(3) That creates a record that is capable of retention, retrieval, and review, and that may thereafter be rendered into clearly legible tangible form.

Notwithstanding the foregoing,

(1) An electronic transmission by this corporation to a member is not authorized unless, in addition to satisfying the requirements of this section, the consent to the transmission has been preceded by or includes a clear written statement to the recipient as to (a) any right of the recipient to have the record provided or made available on paper in nonelectronic form, (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the recipient must use to withdraw consent.

(2) Notice shall not be given by electronic transmission by the corporation after either of the following: (a) the corporation is unable to deliver two consecutive notices to the member by that means or (b) the inability so to deliver the notices to the member becomes known to the secretary, any assistant secretary, or any other person responsible for the giving of the notice.

Comment: See Corp C §§20, 5511(a)-(b), 7511(a)-(b), 9410. For discussion, see §§10.81-10.83.

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§7.30 d. Form: Affidavit of Mailing Notice

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Affidavit of Mailing. **An affidavit of the mailing of any notice of any members' meeting, or of the giving of such notice by other means, may be executed by the secretary, assistant secretary, or any transfer agent of the corporation, and if so executed, shall be filed and maintained in the corporation's minute book.**

Comment: The affidavit of mailing notice serves as evidence that notice of any meeting or report was given. See Corp C §§5511(b), 7511(b). This section may be omitted for religious corporations.

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§7.31 12. Form: Quorum

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

Quorum. **_ _**[*Specify rate*]**_ _ percent of the voting power shall constitute a quorum for the transaction of business at any meeting of members.**

[*If applicable, add either or both of the following options to Alternative 1*]

[*Option 1: If above percentage is less than one-third, add the following*]

If, however, the attendance at any general or annual meeting, whether in person or by proxy, is less than one-third of the voting power, the members may vote only on matters as to which notice of their general nature was given under Section _ _[*number*]**_ _ of these bylaws.**

[*Option 2: Transaction of business after withdrawal leaves less than quorum*]

Except as otherwise required by law, the articles, or these bylaws, the members present at a duly called or held meeting at which a quorum is present may continue to transact business until adjournment, even if enough members have withdrawn to leave less than a quorum, if any action taken (other than adjournment) is approved by at least a majority of the members required to constitute a quorum.

[*Alternative 2: Percentage required for quorum for religious corporations*]

Quorum. **_ _**[*Specify*]**_ _ percent of the members shall constitute a quorum for the transaction of business at a meeting of the members.**

Comment: This provision establishes a quorum for the transaction of business at any meeting of members.

Public benefit and mutual benefit corporations. As a default, Corp C §§5512(a) and 7512(a) provide that one-third of the voting power, represented in person or by proxy, constitutes a quorum at a meeting of the members. The bylaws may provide for any percentage of the voting power to be a quorum. Because of the difficulty in obtaining active participation by the members of nonprofit corporations, a quorum of less than one-third of the voting power is permitted if the quorum is stated in a bylaw provision. A quorum set lower than one-third of the voting power, however, must meet the special requirements of Corp C §§5512(b) and 7512(b) as reflected in option 1 to alternative 1. See §10.96.

The bylaws may also allow members to continue to conduct business if members have left a meeting at which a quorum was present but less than a quorum remains. In that event, a majority (or other required percentage) of a quorum must approve any matters subject to vote. Corp C §§5512(c), 7512(c).

Religious corporations. As a default, Corp C §9412(a) provides that one-third of the voting power constitutes a quorum if the bylaws do not provide otherwise. The bylaws may make any other reasonable provision. Corp C §§9410(a), §9412(b).

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13. Voting

§7.32 a. Form: Eligibility to Vote

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Eligibility to Vote*. Subject to the California Nonprofit _ _**[*Public Benefit/Mutual Benefit*]**_ _ Corporation Law, _ _**[*names of classes*]**_ _ members in good standing on the record date as determined under Sections _ _**[*numbers*]**_ _ of these bylaws shall be entitled to vote at any meeting of members.**

[*Alternative 2: Religious corporations*]

***Eligibility to Vote*. Each member entitled to vote may cast one vote on each matter submitted to a vote of the members. Members may not cumulate votes for the election of directors.**

Comment: For public benefit and mutual benefit corporations, see Corp C §§5610, 7610. For discussion of voting structures, see §§10.49-10.54. For religious corporations, see Corp C §9415. Other reasonable provisions may be used. Corp C §9410(a).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.33 b. Form: Manner of Voting

§7.33 b. Form: Manner of Voting

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Manner of Voting*. Voting may be by voice or by ballot, except that any election of directors must be by ballot if demanded before the voting begins by any member at the meeting.**

Comment: See Corp C §§5616(e), 7615(e), 9410(a). For religious corporations, any reasonable method of casting votes may be used.

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§7.34 c. Form: Number of Votes

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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Number of Votes. **Each member entitled to vote may cast one vote on each matter submitted to a vote of the members.**

Comment: See Corp C §§5610, 7610, 9615. Cumulative voting to elect directors is allowed only if it is authorized in the articles or bylaws. If cumulative voting is desired, this provision should be revised accordingly. Cumulative voting allows each member entitled to vote to accumulate the member's vote and give to one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which the member is entitled, or to distribute the member's votes on the same principle among as many candidates as the member desires. Cumulative voting is subject to specific limitations that should be consulted before drafting bylaw provisions on cumulative voting for electing directors. See Corp C §§5616, 7615, 9615.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.35 d. Form: Approval by Majority Vote

§7.35 d. Form: Approval by Majority Vote

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Majority Approval. **If a quorum is present, the affirmative vote of a majority of the voting power represented at the meeting, entitled to vote and voting on any matter, shall be deemed the act of the members unless the vote of a greater number, or voting by classes, is required by the California Nonprofit _ _**[*Public Benefit/Mutual Benefit/Religious*]**_ _ Corporation Law or by the articles of incorporation.**

Comment: See Corp C §§5512(a), 7512(a), 9412(a).

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§7.36 e. Form: Waiver of Notice or Consent

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***Waiver of Notice or Consent*. The transactions of any meeting of members, however called or noticed and wherever held, shall be as valid as though taken at a meeting duly held after standard call and notice, if (1) a quorum is present either in person or by proxy, and (2) either before or after the meeting, each member entitled to vote, not present in person or by proxy, signs a written waiver of notice, a consent to the holding of the meeting, or an approval of the minutes of the meeting. The waiver of notice, consent, or approval need not specify either the business to be transacted or the purpose of the meeting except that, if action is taken or proposed to be taken for approval of any matter specified in Section _ _[*number*]_ _ of these bylaws, the waiver of notice, consent, or approval shall state the general nature of the proposal. All such waivers, consents, or approvals shall be filed with the corporate records or made a part of the minutes of the meeting.**

A member's attendance at a meeting shall also constitute a waiver of notice of and presence at that meeting unless the member objects at the beginning of the meeting to the transaction of any business because the meeting was not lawfully called or convened. Also, attendance at a meeting is not a waiver of any right to object to the consideration of matters required to be included in the notice of the meeting but not so included, if that objection is expressly made at the meeting.

Comment: See Corp C §§5511(e), 7511(e), 9411(d). For discussion, see §§10.90-10.91.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 14. Actions Without Meetings/§7.37 a. Form: Action by Unanimous Written Consent

14. Actions Without Meetings

§7.37 a. Form: Action by Unanimous Written Consent

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Action by Unanimous Written Consent*. Any action required or permitted to be taken by the members may be taken without a meeting, if all members consent in writing to the action. The written consent or consents shall be filed with the minutes of the meeting. The action by written consent shall have the same force and effect as a unanimous vote of the members.**

Comment: See Corp C §§5516, 7516, 9420. For discussion, see §10.73.

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§7.38 b. Form: Action by Written Ballot

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Action by Written Ballot*. Any action _ _[*except election of directors*]_ _ that members may take at any meeting of members may also be taken without a meeting by complying with Sections _ _[*numbers*]_ _ of these bylaws.**

[*Alternative 2: Religious corporations*]

***Action by Written Ballot*. Any action that members may take at any general meeting or special meeting of members may be taken without a meeting if (1) the written ballot of every member is solicited, (2) the required number of signed approvals setting forth the action so taken is received, and (3) the requirements of Sections _ _[*numbers*]_ _ of these bylaws are satisfied.**

Comment: The right to use written ballots may be limited or prohibited by the articles or bylaws. See Corp C §§5513-5514, 7513-7514, 9413. On written ballots, see §§10.66-10.71.

A public benefit or mutual benefit corporation that has cumulative voting may not elect directors by written ballot. Corp C §§5513(e), 7513(e). If such an entity has cumulative voting, the bylaws must except the election of directors from the written ballot provision.

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§7.39 c. Form: Solicitation of Written Ballots

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Solicitation of Ballots*. This corporation shall distribute one written ballot to each member entitled to vote on the matter. The ballot and any related material may be sent by electronic transmission by the corporation, and responses may be returned to the corporation by electronic transmission that meets the requirements of Section _ _[*numbers*]_ _ of these bylaws. All solicitations of votes by written ballot shall (1) state the number of responses needed to meet the quorum requirement; (2) state, with respect to ballots other than for election of directors, the percentage of approvals necessary to pass the measure or measures; and (3) specify the time by which the ballot must be received in order to be counted. Each ballot so distributed shall (1) set forth the proposed action; (2) give the members an opportunity to specify approval or disapproval of each proposal; and (3) provide a reasonable time in which to return the ballot to the corporation.**

[*If appropriate, add*]

If the corporation has 100 or more members, any written ballot distributed to ten or more members shall provide that, subject to reasonable specified conditions, if the person solicited specifies a choice in any such matter, the vote shall be cast according to that specification.

[*If applicable, add the following option to Alternative 1*]

[*Option: Election of directors*]

In any election of directors, a written ballot that a member marks "withhold," or otherwise marks in a manner indicating that authority to vote is withheld, shall not be voted either for or against the election of a director.

[*Alternative 2: Religious corporation*]

***Solicitation of Ballots*. All solicitations of written ballots shall indicate the time by which the ballot must be returned in order to be counted.**

Comment: The right to use written ballots may be limited or prohibited by the articles or bylaws. See Corp C §§5513-5514, 7513-7514, 9413(b).

A public benefit or mutual benefit corporation that has cumulative voting may not elect directors by written ballot. Corp C §§5513(e), 7513(e). If the bylaws allow for cumulative voting for directors, this form should be modified accordingly. See Comment to §7.34.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.40 d. Form: Number of Votes and Approvals Required

§7.40 d. Form: Number of Votes and Approvals Required

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Approval Requirements. **Approval by written ballot shall be valid only when (1) the number of votes cast by ballot (including ballots that are marked "withhold" or otherwise indicate that authority to vote is withheld) within the time specified equals or exceeds the quorum required to be present at a meeting authorizing the action, and (2) the number of approvals equals or exceeds the number of votes that would be required for approval at a meeting at which the total number of votes cast was the same as the number of votes cast by written ballot without a meeting.**

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.41 e. Form: Revoking Ballots

§7.41 e. Form: Revoking Ballots

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Written Ballots As Irrevocable. **A written ballot may not be revoked.**

Comment: Unless the articles or bylaws provide otherwise, written ballots may not be revoked. Corp C §§5513(d), 7513(d), 9413(d). Possible methods of revocation that may be specified are those provided for revoking proxies. See §7.48.

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§7.42 f. Form: Filing Ballots

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***Filing Ballots*. All written ballots shall be filed with the secretary of the corporation and maintained in the corporate records for at least _ _[*number*]_ _ years.**

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 15. Record Date/§7.43 a. Form: Record Date for Notice, Voting, Written Ballots, and Other Board Actions

15. Record Date

§7.43 a. Form: Record Date for Notice, Voting, Written Ballots, and Other Board Actions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Record Date*. For purposes of establishing the members entitled to receive notice of any meeting, entitled to vote at any meeting, entitled to vote by written ballot, or entitled to exercise any rights in any lawful action, the board of directors may, in advance, fix a record date. The record date so fixed for**

(1) Sending notice of a meeting shall be no more than 90 nor less than 10 days before the date of the meeting;

(2) Voting at a meeting shall be no more than 60 days before the date of the meeting;

(3) Voting by written ballot shall be no more than 60 days before the day on which the first written ballot is mailed or solicited; and

(4) Taking any other action shall be no more than 60 days before that action.

Comment: See Corp C §§5611, 7611. See also §10.45. Although religious corporations have no specific requirement for a record date (see Corp C §9410(a)), a provision such as this can still be helpful.

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§7.44 b. Form: Record Date for Actions Not Set by Board

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Record Date. **If not otherwise fixed by the board, the record date for determining members entitled to receive notice of a meeting of members shall be the next business day preceding the day on which notice is given or, if notice is waived, the next business day preceding the day on which the meeting is held. If not otherwise fixed by the board, the record date for determining members entitled to vote at the meeting shall be the day on which the meeting is held.**

If not otherwise fixed by the board, the record date for determining members entitled to vote by written ballot shall be the day on which the first written ballot is mailed or solicited.

If not otherwise fixed by the board, the record date for determining members entitled to exercise any rights with respect to any other lawful action shall be the date on which the board adopts the resolution relating to that action, or the 60th day before the date of that action, whichever is later.

For purposes of Sections _ _[*numbers*]_ _ of these bylaws, a person holding a membership at the close of business on the record date shall be a member of record.

Comment: See Corp C §§5611, 7611, 9410(a).

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16. Proxies

§7.45 a. Form: Members' Proxy Rights

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Proxies. **Each member entitled to vote shall have the right to do so either in person or by one or more agents authorized by a written proxy, signed by the member and filed with the secretary of the corporation. A proxy shall be deemed signed if the member's name is placed on the proxy by the member or the member's attorney-in-fact, whether by manual signature, typewriting, facsimile transmission, or otherwise.**

Comment: See Corp C §§5069, 5613(a), 7613(a), 9417(a). Voting by proxy is allowed unless it is specifically prohibited by the articles or bylaws.

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§7.46 b. Form: Solicited Proxies

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Solicited Proxies. **If the corporation has 100 or more members, any form of proxy distributed to 10 or more members shall give the member an opportunity to specify a choice between approval and disapproval of each matter or group of related matters and, subject to reasonable specified conditions, shall provide that, when the person solicited specifies a choice in any such matter, the vote shall be cast according to that specification. In an election of directors, any form of proxy that a member marks "withhold," or otherwise marks in a manner indicating that authority to vote for the election of directors is withheld, shall not be voted either for or against the election of a director.**

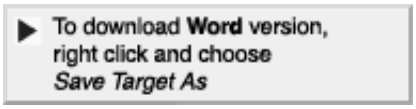
Comment: See Corp C §§5514(a)-(b), 7514(a)-(b). Religious corporations may include this section if desired. See §7.47.

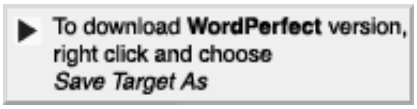
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.47 c. Form: Subject Matter of Proxy to Be Stated

§7.47 c. Form: Subject Matter of Proxy to Be Stated

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

***Subject Matter of Proxy to Be Stated*. Any proxy covering matters for which a vote of the members is required shall not be valid unless the proxy sets forth the general nature of the matter to be voted on or, in an election of directors, the proxy lists the persons who have been nominated at the time the notice of the vote is given to the members. Such matters include amendments of the articles of incorporation or bylaws changing proxy rights; certain other amendments of the articles of incorporation; removal of directors without cause; filling vacancies on the board of directors; the sale, lease, exchange, conveyance, transfer, or other disposition of all or substantially all corporate assets, unless the transaction is in the usual and regular course of the corporation's activities; the principal terms of a merger or the amendment of a merger agreement; or the election to dissolve the corporation.**

[*Alternative 2: Mutual benefit corporations*]

***Subject Matter of Proxy to Be Stated.* Any revocable proxy covering matters for which a vote of the members is required shall not be valid unless the proxy sets forth the general nature of the matter to be voted on. Such matters include amendments to the articles of incorporation; amendments to the articles or bylaws changing proxy rights; removal of directors without cause; filling vacancies on the board of directors; the sale, lease, exchange, conveyance, transfer, or other disposition of all or substantially all corporate assets unless the transaction is in the usual and regular course of the corporation's activities; the principal terms of a merger or the amendment of a merger agreement; the election to dissolve the corporation; contracts or transactions between the corporation and one or more directors or between the corporation and an entity in which a director has a material financial interest; or a plan of distribution of assets other than money to members when the corporation is in the process of winding up, when the distribution is not in accordance with liquidation rights of any class or classes.**

[*Alternative 3: Religious corporations*]

***Subject Matter of Proxy to Be Stated.* Any proxy covering matters for which a vote of the members is required shall not be valid unless the proxy sets forth the general nature of the matter to be voted on. Such matters include approval of amendments to the articles of incorporation; the principal terms of a merger agreement or any amendment of those terms; the sale, lease, exchange, conveyance, transfer, or other disposition of all or substantially all corporate assets unless the transaction is in the regular course of business; or the election to voluntarily dissolve the corporation.**

Comment: See Corp C §§5613(f), 7613(g), 9417(e). The language in §9417(e) may not be varied. Corp C §9410(b).

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§7.48 d. Form: Revocability of Proxies

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Expiration and Revocability of Proxies. **No proxy shall be valid after the expiration of 11 months from the date of the proxy, unless provided otherwise in the proxy, except that the maximum term of a proxy shall be 3 years after the date of execution. A validly executed proxy shall continue in full force and effect until either**

(1) It is revoked by the member executing it, before the vote is cast under that proxy, (a) by a writing delivered to the corporation stating that the proxy is revoked, or (b) by a subsequent proxy executed by that member and presented to the meeting, or (c) as to any meeting, by that member's personal attendance and voting at the meeting; or

(2) Written notice of the death or incapacity of the maker of the proxy is received by the corporation before the vote under that proxy is counted. A proxy may not be irrevocable.

[*Alternative 2: Mutual benefit corporations*]

Expiration and Revocability of Proxies. **No proxy shall be valid after the expiration of 11 months from the date of the proxy, unless provided otherwise in the proxy, except that the maximum term of a proxy shall be 3 years after the date of execution. The revocability of a proxy that states on its face that it is irrevocable shall be governed by Corporations Code §7613. A validly executed proxy that does not state that it is irrevocable shall continue in full force and effect until either**

(1) It is revoked by the member executing it before the vote is cast under that proxy, (a) by a writing delivered to the corporation stating that the proxy is revoked, (b) by a subsequent proxy executed by that member and presented to the meeting, or (c) as to any meeting, by the member's personal attendance and voting at the meeting, or

(2) Written notice of the death or incapacity of the maker of the proxy is received by the corporation before the vote under the proxy is counted.

[*Alternative 3: Religious benefit corporations*]

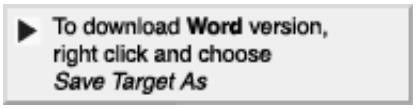
Expiration and Revocability of Proxies. **No proxy shall be valid after the expiration of 11 months from the date of the proxy, unless provided otherwise in the proxy, except that the maximum term of the proxy shall be 3 years after the date of execution. A validly executed proxy shall continue in full force and effect until it is revoked by the member executing it, before the vote is cast under that proxy, (1) by a writing delivered to the corporation stating that the proxy is revoked, (2) by a subsequent proxy executed by that member and presented to the meeting, or (3) as to any meeting, by that member's personal attendance and voting at the meeting. A proxy may not be irrevocable.**

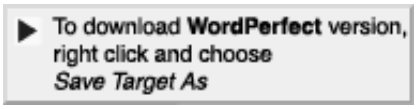
Comment: See Corp C §§5613(b)-(d), 7613(b)-(d), 9417(b)-(d). This provision is not mandatory. See §10.56.

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§7.49 17. Form: Adjournment and Notice of Adjourned Meetings

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

Adjournment; Notice. **Any members' meeting, whether or not a quorum is present, may be adjourned from time to time by the vote of the majority of the members represented at the meeting, either in person or by proxy. No meeting may be adjourned for more than 45 days. When a members' meeting is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place to which the meeting is adjourned (or the means of electronic transmission by and to the corporation or electronic video screen communication, if any, by which members may participate) are announced at the meeting at which adjournment is taken. If after adjournment a new record date is fixed for notice or voting, a notice of the adjourned meeting shall be given to each member who, on the record date for notice of the meeting, is entitled to vote at the meeting. At the adjourned meeting, the corporation may transact any business that might have been transacted at the original meeting.**

[*Alternative 2: Religious corporations*]

Adjournment; Notice. **Any members' meeting, whether or not a quorum is present, may be adjourned from time to time by the vote of the majority of the members represented at the meeting, either in person or by proxy.**

Comment: See Corp C §§5511(d), 5512(d), 7511(d), 7512(d), 9412(c).

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§7.50 K. Board of Directors

Each corporation must have a board of directors. The directors are charged with conducting the activities and affairs of the corporation, subject only to certain member approval requirements in applicable law, the articles of incorporation, or the bylaws. Because each director serves as a fiduciary, a director may not appoint a proxy, substitute, or alternate to act in his or her place as a director. Similarly, a director of a nonprofit corporation who is appointed by an individual or an entity is not a "representative" of the person who makes the appointment when serving on the board, but must act in the best interests of the corporation. These rules must be kept in mind by counsel preparing bylaws for a nonprofit corporation. On duties of directors, see §§9.2-9.4.

The board may delegate management of corporate activities as long as the board maintains ultimate responsibility and authority. Corp C §§5210, 7210, 9210. See §9.4.

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1. General and Specific Powers of Board

§7.51 a. Form: General Powers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

General Powers of Board. **Subject to the provisions and limitations of the California Nonprofit _ _[*Public/Mutual*]_ _ Benefit Corporation Law and any other applicable laws, and subject to any limitations of the articles of incorporation or bylaws regarding actions that require approval of the members, the corporation's activities and affairs shall be managed, and all corporate powers shall be exercised, by or under the direction of the board.**

[*Alternative 2: Religious corporations*]

General Powers of Board. **Subject to the provisions and limitations of the California Nonprofit Religious Corporation Law and any other applicable laws, and subject to any limitations in the articles of incorporation or bylaws relating to action requiring approval by the members, _ _[*and in accordance with the religious principles of the _ _[name of superior religious entity*]_ _,]_ _ the corporation's temporal activities, business, and affairs shall be managed, and all corporate powers shall be exercised, by or under the direction of the board.**

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.52 b. Form: Specific Powers

§7.52 b. Form: Specific Powers

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

Specific Powers of Board. **Without prejudice to the general powers set forth in Section _ _[*number*]_ _ of these bylaws, but subject to the same limitations, the board shall have the power to do the following:**

(1) Appoint and remove, at the pleasure of the board, all corporate officers, agents, and employees; prescribe powers and duties for them as are consistent with the law, the articles of incorporation, and these bylaws; fix their compensation; and require from them security for faithful service.

(2) Change the principal office or the principal business office in California from one location to another; cause the corporation to be qualified to conduct its activities in any other state, territory, dependency, or country; conduct its activities in or outside California; and designate a place in or outside California for holding any meeting of members.

(3) Borrow money and incur indebtedness on the corporation's behalf and cause to be executed and delivered for the corporation's purposes, in the corporate name, promissory notes, bonds, debentures, deeds of trust, mortgages, pledges, hypothecations, and other evidences of debt and securities.

[*If appropriate, add*]

(4) Adopt and use a corporate seal; prescribe the forms of membership certificates; and alter the forms of the seal and certificates.

[*Alternative 2: Religious corporations*]

Specific Powers of Board. **Without prejudice to the general powers set forth in Section _ _[*number*]_ _ of these bylaws, but subject to the same limitations, the board shall have the power to do the following:**

(1) Appoint and remove, at the pleasure of the board, all corporate officers, agents, and employees; prescribe powers and duties for them as are consistent with the law, the articles of incorporation, and these bylaws; fix their compensation; and require from them security for faithful service.

(2) Conduct, manage, and control the corporation's temporal affairs and activities and make such rules and regulations for this purpose, consistent with law, the articles of incorporation, and these bylaws, as the board deems best.

(3) Borrow money and incur indebtedness on the corporation's behalf, and cause to be executed and delivered for the corporation's purposes, in the corporation's name, promissory notes, bonds, debentures, deeds of trust, mortgages, pledges, hypothecations, and other evidences of debt and securities.

(4) To exercise all other powers conferred by the California Nonprofit Religious Corporation Law, or other applicable laws, consistent with _ _[*name of governing document*]_ _.

[*If appropriate, add*]

(5) Adopt and use a corporate seal, and alter the form of the seal.

Comment: For public benefit and mutual benefit corporations, see Corp C §§5140, 5210, 7140, 7210. For religious benefit corporations, see Corp C §§9140, 9210, 9630. See §§9.2-9.3.

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§7.53 2. Form: Number of and Qualifications for Directors

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[*Add one of the following alternatives*]

[*Alternative 1: Fixed number of and qualifications for directors*]

Number and Qualifications of Directors. **The authorized number of directors shall be _ _[*number*]_ _. The qualifications for directors are _ _[*specify*]_ _.**

[*Alternative 2: Variable number of and qualifications for directors*]

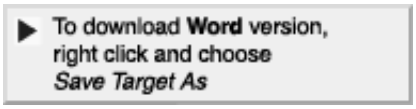
Number and Qualifications of Directors. **The board of directors shall consist of at least _ _[*number*]_ _ but no more than _ _[*number*]_ _ directors unless changed by amendment to these bylaws. The exact number of directors shall be fixed, within those limits, by a resolution adopted by the board of directors. The qualifications for directors are _ _[*specify*]_ _.**

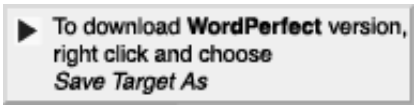
Comment: See Corp C §§5151, 7151, 9151. The corporation must have at least one director, but there is no maximum number. As a practical matter, counsel should consider recommending a minimum of three directors for a nonprofit that is intended to be exempt under IRC §5101(c)(3), because the IRS often insists on at least three. The bylaws may set forth the method of determining the number of directors or may require that the number of directors be within a stated minimum and maximum, with the exact number to be fixed by the board or the members. See §9.15.

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§7.54 3. Form: Restriction on Interested Persons as Directors (Public Benefit Corporations)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





Interested Persons as Directors. **No more than 49 percent of the persons serving on the board may be "interested persons." An interested person is (1) any person compensated by the corporation for services rendered to it within the previous 12 months, whether as a full-time or part-time employee, independent contractor, or otherwise, excluding any reasonable compensation paid to a director as director; and (2) any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law of such person. However, any violation of this paragraph shall not affect the validity or enforceability of transactions entered into by the corporation.**

Comment: This provision is required only for public benefit corporations and should not be used by mutual benefit or religious corporations. See Corp C §5227. For discussion, see §9.25. If the 49-percent limitation will be a problem, either the corporation may be incorporated in another state or a trust could be used instead of a corporation. Both alternatives may have other undesirable consequences that counsel should carefully consider. See §§2.20-2.25, 2.35.

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§7.55 4. Form: Designated Directors

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Designated Directors*. _ _[*All/Specify number, e.g., twelve*]_ _ directors shall be designated by _ _[*name*]_ _. Each director shall hold office for _ _[*number*]_ _ years and until a successor director has been designated and qualified.**

Comment: All or any portion of the authorized number of directors of a mutual benefit, public benefit, or religious corporation may hold office by virtue of designation or selection, and for the terms prescribed by the articles or bylaws. Corp C §§5220(d), 7220(d), 9220(a). On designated directors, see §9.28.

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§7.56 5. Nominations and Elections of Directors

Terms. The articles or bylaws may provide for directors to be elected for terms of up to 3 years for public benefit corporations and 4 years for mutual benefit corporations, but public benefit or mutual benefit corporations *without members* may elect directors for terms of up to 6 years. The bylaws may also provide for staggering the directors' terms. The terms of office of each group, and the number of directors in each group, need not be uniform. Corp C §§5220(a), 7220(a).

NOTE: If the articles and bylaws do not specify a term, the director's term is 1 year. No amendment of the articles or bylaws may extend the term of a director beyond that for which the director was elected. Any bylaw provision increasing the term of directors may only be adopted with the approval of the members. Corp C §§5220(a), 7220(a).

Selection. No statutory method of choosing directors for religious corporations is specified in the Nonprofit Corporation Law; this matter is left to the articles and bylaws. Corp C §9220. See Corp C §§5220, 7220. Directors may be elected by members, selected by certain members of the religious entity, designated as provided in the governing document, or chosen by another method or a combination of these methods. The provisions in §§7.63-7.69 may be used or adapted by a religious corporation for this purpose. If directors are not to be elected by the members, the bylaw provisions on electing directors should be modified accordingly.

Public and mutual benefit corporations. All public benefit and mutual benefit corporations with voting members must provide a reasonable nomination and election procedures given their nature, size, and operations. Corp C §§5520(a), 7520(a). Corporations with 500 or more members must allow nomination by any method authorized in the bylaws or, if no method is set forth in the bylaws, by any method authorized by the board. Some attorneys prefer not to establish a procedure in the bylaws, leaving the issue to be established (and changed if appropriate) by board resolution. This approach also avoids the need to amend the bylaws as the number of members increases. Corp C §§5521, 7521.

NOTE: If a corporation complies with all of the provisions of Corp C §§5521-5524 or §§7521-7524, respectively, applicable to a corporation with the same number of members, the nomination and election procedures of that corporation, will be deemed reasonable. However, those statutes do not prescribe the exclusive means of establishing reasonable procedures for nomination and election of directors. A corporation may make available to the members other reasonable nomination and election procedures given the nature, size, and operations of the corporation. Corp C §§5520(b), 7520(b).

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§7.57 a. Form: Nominations by Committee

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Nominations by Committee*. The chair of the board or, if none, the president, shall appoint a committee to nominate qualified candidates for election to the board at least _ _[*number*]_ _ days before the date of any election of directors. The nominating committee shall make its report at least _ _[*number*]_ _ days before the date of the election, _ _[*or at such other time as the board may set,*]_ _ and the secretary shall forward to each member, with the notice of meeting required by these bylaws, a list of all candidates nominated by committee.**

Comment: See Corp C §§5520-5521, 7520-7521. This section is not required by law and is merely an example of a possible nomination procedure. The nomination procedures for corporations with 500 or more members apply to all elections except when directors are elected by delegates (see Corp C §§5152, 7152) or by chapter, unit, region, or other geographic grouping (see Corp C §§5153, 7153). See §§9.31-9.36.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.58 b. Form: Nominations by Members of Corporations With 500 to 4999 Members

§7.58 b. Form: Nominations by Members of Corporations With 500 to 4999 Members

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***Nominations by Members*. Members representing 2 percent of the voting power may nominate candidates for directors by petition. The petition must be signed by those members within 11 months preceding the next time directors are to be elected, and delivered to an officer of the corporation. On timely receipt of the petition signed by the required number of members, the secretary shall cause the names of the candidates named on it to be placed on the ballot along with the names of the candidates chosen by the nominating committee.**

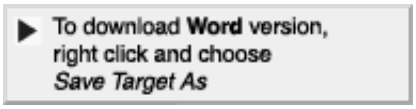
Comment: See Corp C §§5521, 7521. This procedure is presumed to be reasonable for corporations with 500 to 4999 members, but it may be omitted for corporations with fewer than 500 members. See Corp C §§5520(b), 7520(b). For discussion, see §§9.33-9.34.

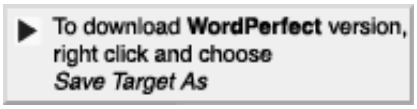
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.59 c. Form: Nominations by Members of Corporations With 5000 or More Members

§7.59 c. Form: Nominations by Members of Corporations With 5000 or More Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.





***Nominations by Members*. Members representing 1/20 of 1 percent of the voting power, but at least 100 and no more than 500 members, may nominate candidates for directors by petition. The petition must be signed by those members no earlier than the 120th day or no later than the 50th day before the time directors are to be elected, and delivered to an officer of the corporation. No nominations for the board can be made after the date set for the close of nominations. On timely receipt of the petition signed by the required number of members, the secretary shall cause the names of the candidates named on it to be placed on the ballot along with the names of candidates named by the nominating committee.**

Comment: See Corp C §§5521-5522, 7521-7522. The bylaws may specify other reasonable means of nomination procedure for public benefit and mutual benefit corporations. The forms in §7.58 and this section are presumed to be reasonable, but the bylaws may specify other reasonable means for nomination. Corp C §§5520(b), 5521, 7520(b), 7521. See §9.31.

This provision must also be revised to qualify for the presumption of a reasonable method if the mutual benefit corporation has 1 million or more members engaged primarily in retail merchandising of consumer goods. See Corp C §7521. For discussion, see §9.57.

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§7.60 d. Form: Floor Nominations

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***Floor Nominations*. When a meeting is held for the election of directors, any member present at the meeting in person or by proxy may place names in nomination.**

Comment: See Corp C §§5521, 7521. This provision satisfies the presumption of reasonableness for corporations with 500 or more members and may be omitted for corporations with fewer than that number. For discussion, see §7.56 and the form in §7.58. This nomination method has often been used by nonprofit corporations.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.61 e. Form: Nominee's Right to Solicit Votes

§7.61 e. Form: Nominee's Right to Solicit Votes

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***Nominee's Right to Solicit Votes*. The board shall formulate procedures that allow a reasonable opportunity for a nominee to communicate to members the nominee's qualifications and the reasons for the nominee's candidacy, a reasonable opportunity for the nominee to solicit votes, and a reasonable opportunity for all members to choose among the nominees.**

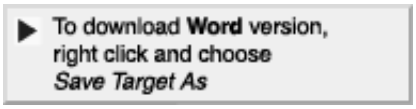
Comment: See Corp C §§5520, 7520. For nominees' rights regarding election materials, see Corp C §§5523-5524, 7523-7524.

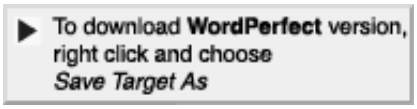
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.62 f. Form: Use of Corporate Funds to Support Nominee

§7.62 f. Form: Use of Corporate Funds to Support Nominee

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***Use of Corporate Funds*. If more people have been nominated for director than can be elected, no corporate funds may be expended to support a nominee without the board's authorization.**

Comment: See Corp C §§5526, 7526.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.63 g. Form: Election of Directors (Religious Corporation)

§7.63 g. Form: Election of Directors (Religious Corporation)

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Election of Directors. _ _[*All/Specify number, e.g., twelve*]_ _ **directors shall be elected at each annual members' meeting, to hold office until the next annual meeting. However, if directors are not elected at an annual meeting, they may be elected at any special members' meeting held for that purpose or by written ballot. Each director, including a director elected to fill a vacancy or elected at a special members' meeting or by written ballot, shall hold office until expiration of the term for which elected and until a successor is elected and qualified.**

Comment: In the case of public benefit and mutual benefit corporations, except for directors who hold office by designation, directors may be elected for the terms stated in the articles of bylaws, but not longer than 4 years. Corp C §§5220(a), 7220(a). A religious corporation has complete freedom to adopt whatever provision it wishes for directors' terms. Corp C §9220(a). In the absence of a specific provision in the bylaws, the term of office is 1 year. Corp C §§5220(a), 7220(a), 9220(b).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 6. Vacancies on Board of Directors/§7.64 a. Form: Events Causing Vacancies on Board

6. Vacancies on Board of Directors

§7.64 a. Form: Events Causing Vacancies on Board

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Vacancies on Board. **A vacancy or vacancies on the board of directors shall occur in the event of (1) the death, removal, or resignation of any director; _ _**[*provided, however, that a director who was designated as a director, rather than elected by the members, may be removed by the person or persons who designated that director, and may not be removed without the written consent of that person or persons;*]**_ _ (2) the declaration by resolution of the board of a vacancy in the office of a director who has been convicted of a felony, declared of unsound mind by a court order, or found by final order or judgment of any court to have breached a duty under California Nonprofit Public Benefit Corporation Law, Chapter 2, Article 3; (3) the vote of the members or, if the corporation has fewer than 50 members, the vote of a majority of all members, to remove the director(s);** _ _[*provided that any director elected by the vote of members of a class or members within an organizational unit or geographic grouping, voting as such, rather than by the members of the corporation, may be removed only by the vote of that class, unit, or grouping;*]**_ _ (4) the increase of the authorized number of directors; or (5) the failure of the members, at any meeting of members at which any director or directors are to be elected, to elect the number of directors required to be elected at such meeting.**

[*Alternative 2: Mutual benefit corporations*]

***Vacancies on Board*. A vacancy or vacancies on the board of directors shall occur in the event of (1) the death, removal, or resignation of any director; _ _**[*provided, however, that a director who was designated as a director, rather than elected by the members, may be removed by the person or persons who designated that director and may not be removed without the written consent of that person or persons;*]**_ _ (2) the declaration by board resolution of a vacancy in the office of a director who has been declared of unsound mind by a court order, convicted of a felony, or, if the corporation holds assets in charitable trust, found by a final order or judgment of any court to have breached a duty arising under Corporations Code §7238; (3) the vote of the members or, if the corporation has fewer than 50 members, the vote of a majority of all members, to remove any director(s);** _ _[*provided that any director elected by the vote of members of a class or members within an organizational unit or geographic grouping, voting as such, rather than by the members of the corporation, may be removed only by the vote of that class, unit, or grouping;*]**_ _ (4) an increase in the authorized number of directors; or (5) a failure of the members, at any meeting of members at which any director or directors are to be elected, to elect the number of directors required to be elected at that meeting.**

[*Alternative 3: Religious corporations*]

Vacancies on Board. **A vacancy or vacancies on the board of directors shall occur in the event of (1) the death, removal, or resignation of any director; _ _**[*provided that a director who was designated as a director, rather than elected by the members, may be removed by the person or persons who designated that director and may not be removed without the written consent of that person or persons;*]**_ _ (2) the declaration by board resolution of a vacancy of the office of a director who has been convicted of a felony or declared of unsound mind by a court order; (3) the removal of a director for fraudulent acts in an action in Superior Court under Corporations Code §9223; (4) the vote of the members to remove a director, provided that, if any provision of the articles or bylaws entitles the members of a class or members within an organization unit or geographic grouping, voting as such, to elect one or more directors, those directors may be removed only by vote of the members of that class, unit, or grouping; (5) the increase of the authorized number of directors; or (6) the failure of the members, at any meeting of members at which any director or directors are to be elected, to elect the number of directors to be elected at that meeting.**

Comment: See Corp C §§5221-5222, 5224, 7221-7222, 7224, 9221-9223. Provisions on cumulative voting should be included if the corporation allows cumulative voting. See Comment in §7.34. The bylaws may also provide that a director's failure to attend a specified number of board meetings is cause for removal. Moreover, if the articles or bylaws prescribe qualifications of directors, the board, by a majority vote of the directors who meet all qualifications to be a director, may declare vacant the office of any director who fails or ceases to meet any required qualification that was in effect at the beginning of that director's current term of office. See Corp C §§5221(b), 7221(b), 9221(b). In certain situations members, directors, or the Attorney General may sue to remove a director. See Corp C §§5223, 7223, 9223. See §§9.47-9.53.

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§7.65 b. Form: Resignation of Directors

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Resignation of Directors*. Except as provided below, any director may resign by giving written notice to the chair of the board, if any, or to the president or the secretary of the board. The resignation shall be effective when the notice is given unless it specifies a later time for the resignation to become effective. If a director's resignation is effective at a later time, the board may elect a successor to take office as of the date when the resignation becomes effective.**

[*Public benefit and religious corporations, add*]

Except on notice to the California Attorney General, no director may resign if the corporation would be left without a duly elected director or directors.

Comment: See Corp C §§5224(c), 5226, 7224, 9224, 9226.

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§7.66 c. Form: Removal of Directors

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***Removal of Directors*. If the corporation has no members, any director may be removed, with or without cause, by the vote of the majority of the members of the entire board of directors at a special meeting called for that purpose, or at a regular meeting, provided that notice of that meeting and of the removal questions are given as provided in Section _ _[*insert appropriate section number*]_ _. However, a director who was designated as a director rather than elected by the members may be removed without cause by the person or persons who designated that director, and may not be removed without the written consent of that person or persons. Any vacancy caused by the removal of a director shall be filled as provided in Section _ _[*insert appropriate section number*]_ _.**

Any director who does not attend three successive board meetings will automatically be removed from the board without board resolution unless:

(A) The director requests a leave of absence for a limited period of time, and the leave is approved by the directors at a regular or special meeting. If such leave is granted, the number of board members will be reduced by one in determining whether a quorum is or is not present;

(B) The director suffers from an illness or disability which prevents him or her from attending meetings and the board by resolution waives the automatic removal procedure of this subsection; or

(C) The board by resolution of the majority of board members agrees to reinstate the director who has missed three meetings.

Comment: For rules regarding removal of directors by the members in a corporation with voting members, see Corp C §§5221-5223, 7221-7223, 9221-9223.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ d. Filling Vacancies on Board of Directors/ §7.67 (1) Form: Vacancies Filled by Board

d. Filling Vacancies on Board of Directors

§7.67 (1) Form: Vacancies Filled by Board

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***Vacancies Filled by Board*. Except for a vacancy created by the removal of a director by the members, vacancies on the board may be filled by approval of the board or, if the number of directors then in office is less than a quorum, by (1) the unanimous written consent of the directors then in office, (2) the affirmative vote of a majority of the directors then in office at a meeting held according to notice or waivers of notice complying with Corporations Code §_ _[*5211/7211/9211*]_ _, or (3) a sole remaining director. _ _[*The members may fill any vacancy not filled by the directors.*]_ _**

Public and mutual benefit corporations. Vacancies occurring by reason of the removal of a director may only be filled by the approval of the members (Corp C §5034) unless the articles or a bylaw approved by the members provides that the board may fill these vacancies or unless the corporation has no members. Corp C §§5224(a), 7224(a). In general, the members may elect a director at any time to fill any vacancy not filled by the directors. Corp C §§5224(b), 7224(b); however, the members of a public benefit or mutual benefit corporation that has appointed directors (Corp C §§5220(d), 7220(d)) may not elect a new director if the articles or bylaws provide for the designation of a successor director. See §9.50.

Religious corporations. The members may elect a director at any time to fill any vacancy not filled by the directors, subject to any provision in the articles or bylaws. Corp C §9224(b).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.68 (2) Form: Vacancies Filled by Members

§7.68 (2) Form: Vacancies Filled by Members

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***Vacancies Filled by Members*. The members may elect a director or directors at any time to fill any vacancy or vacancies not filled by the directors.**

Comment: See Corp C §§5224(b), 7224(b), 9224(b). A religious corporation may vary the wording of this provision.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.69 e. Form: No Vacancy on Reduction of Number of Directors

§7.69 e. Form: No Vacancy on Reduction of Number of Directors

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Any reduction of the authorized number of directors shall not result in any director's being removed before his or her term of office expires.

Comment: Neither a reduction in the authorized number of directors nor any amendment reducing the number of classes of directors operates to remove any director before the expiration of the director's term of office, unless the reduction or amendment also provides for the removal of specified directors. Corp C §§5222(c), 7222(c), 9222(c).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 7. Meetings of Board of Directors/§7.70 a. Form: Place of Board Meetings

7. Meetings of Board of Directors

§7.70 a. Form: Place of Board Meetings

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***Location of Board Meetings*. Meetings of the board shall be held at any place within or outside California that has been designated by resolution of the board or in the notice of the meeting or, if not so designated, at the principal office of the corporation.**

Comment: See Corp C §§5211(a)(5), 7211(a)(5), 9211(a)(5). The wording of this provision may be varied.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.71 b. Form: Meetings by Telephone or Other Telecommunications Equipment

§7.71 b. Form: Meetings by Telephone or Other Telecommunications Equipment

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Meetings by Telecommunication. **Any board meeting may be held by conference telephone, video screen communication, or other communications equipment. Participation in a meeting under this Section shall constitute presence in person at the meeting if both the following apply:**

(1) Each member participating in the meeting can communicate concurrently with all other members.

(2) Each member is provided the means of participating in all matters before the board, including the capacity to propose, or to interpose an objection to, a specific action to be taken by the corporation.

Comment: The wording of the bylaw may vary. The statutory provisions are default provisions that apply unless the articles or bylaws provide otherwise. See Corp C §§5211(a)(6), 7211(a)(6), 9211(a)(6); see also Corp C §§20-21.

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§7.72 c. Form: Annual and Other Meetings

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***Annual Meeting of Board*. Immediately after each annual meeting of members, the board shall hold a general meeting for purposes of organization, election of officers, and transaction of other business. Notice of this meeting is not required.**

Other general meetings of the board may be held without notice at such time and place as the board may fix from time to time.

Comment: See Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2). For discussion, see §§9.66-9.67. Although an annual meeting of directors is not specifically required, a provision such as this is recommended.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ d. Special Meetings/§7.73 (1) Form: Authority to Call Special Meetings

d. Special Meetings

§7.73 (1) Form: Authority to Call Special Meetings

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***Special Meetings*. Special meetings of the board for any purpose may be called at any time by the chair of the board, if any, the president or any vice president, the secretary, or any two directors.**

Comment: See Corp C §§5211(a)(1), 7211(a)(1), 9211(a)(1). This provision reflects the statutory language, which may be changed by the articles or bylaws.

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§7.74 (2) Form: Notice of Special Meetings

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***Notice of Special Meetings*. Notice of the time and place of special meetings shall be given to each director by (1) personal delivery of written notice; (2) first-class mail, postage prepaid; (3) telephone, including a voice messaging system or other system or technology designed to record and communicate messages, or by electronic transmission, either directly to the director or to a person at the director's office who would reasonably be expected to communicate that notice promptly to the director; (4) facsimile; (5) electronic mail; or (6) other electronic means. All such notices shall be given or sent to the director's address or telephone number as shown on the corporation's records.**

Notices sent by first-class mail shall be deposited in the United States mails at least _ _[*e.g., 4*]_ _ days before the time set for the meeting. Notices given by personal delivery, telephone, or electronic transmission shall be delivered, telephoned, or sent, respectively, at least _ _[*e.g., 48 hours*]_ _ before the time set for the meeting.

The notice shall state the time of the meeting and the place, if the place is other than the corporation's principal office. The notice need not specify the purpose of the meeting.

Comment: See Corp C §§5015, 5211(a)(2), 7211(a)(2), 9211(a)(2). The wording of these provisions may be varied, but they may not omit giving notice of special meetings. See §9.68.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.75 e. Form: Quorum

§7.75 e. Form: Quorum

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

***Quorum*. A majority of the authorized number of directors shall constitute a quorum for the transaction of any business except adjournment. Every action taken or decision made by a majority of the directors present at a duly held meeting at which a quorum is present shall be an act of the board, subject to the more stringent provisions of the California Nonprofit Public Benefit Corporation Law, including, without limitation, those provisions relating to (1) approval of contracts or transactions in which a director has a direct or indirect material financial interest, (2) approval of certain transactions between corporations having common directorships, (3) creation of and appointments to committees of the board, and (4) indemnification of directors. A meeting at which a quorum is initially present may continue to transact business, despite the withdrawal of some directors from that meeting, if any action taken or decision made is approved by at least a majority of the required quorum for that meeting.**

[*Alternative 2: Mutual benefit corporations*]

***Quorum.* A majority of the authorized number of directors shall constitute a quorum for the transaction of any business except adjournment. Every action taken or decision made by a majority of the directors present at a duly held meeting at which a quorum is present shall be an act of the board, subject to the more stringent provisions of the California Nonprofit Mutual Benefit Corporation Law, including, without limitation, the provisions on (1) approval of contracts or transactions between this corporation and one or more directors or between this corporation and any entity in which a director has a material financial interest, (2) creation of and appointments to committees of the board, and (3) indemnification of directors. A meeting at which a quorum is initially present may continue to transact business, despite the withdrawal of some directors, if any action taken or decision made is approved by at least a majority of the required quorum for that meeting.**

[*Alternative 3: Religious corporations*]

***Quorum.* A majority of the authorized number of directors shall constitute a quorum for the transaction of any business except adjournment. Every action taken or decision made by a majority of the directors present at a duly held meeting at which a quorum is present shall be an act of the board. A meeting at which a quorum is initially present may continue to transact business, despite the withdrawal of some directors, if any action taken or decision made is approved by at least a majority of the required quorum for that meeting.**

Comment: See Corp C §§5211(a)(7)-(8), 5212, 5234, 5236, 5238, 7211(a)(7)-(8), 7212, 7233-7235, 7237, 9211(a)(7)-(8). The wording of this provision may be varied.

Public and mutual benefit corporations: Neither the articles nor the bylaws may provide for a quorum of less than one-fifth the authorized number of directors or less than two, whichever is larger, unless the authorized number is one, in which case one director constitutes a quorum. See §§9.79, 9.81.

Religious corporations: Neither the articles nor the bylaws may provide that a vote of less than a majority of the directors present at the meeting is an act of the board.

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§7.76 f. Form: Waiver of Notice

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***Waiver of Notice*. Notice of a meeting need not be given to any director who, either before or after the meeting, signs a waiver of notice, a written consent to the holding of the meeting, or an approval of the minutes of the meeting. The waiver of notice or consent need not specify the purpose of the meeting. All waivers, consents, and approvals shall be filed with the corporate records or made a part of the minutes of the meetings. Notice of a meeting need not be given to any director who attends the meeting and who, before or at the beginning of the meeting, does not protest the lack of notice to him or her.**

Comment: See Corp C §§5211(a)(2)-(3), 7211(a)(2)-(3), 9211(a)(2)-(3). For discussion, see §§9.74-9.77.

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§7.77 g. Form: Adjournment

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***Adjournment*. A majority of the directors present, whether or not a quorum is present, may adjourn any meeting to another time and place.**

Comment: See Corp C §§5211(a)(4), 7211(a)(4), 9211(a)(4).

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§7.78 h. Form: Notice of Adjourned Meeting

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***Notice of Adjourned Meeting*. Notice of the time and place of holding an adjourned meeting need not be given unless the original meeting is adjourned for more than 24 hours. If the original meeting is adjourned for more than 24 hours, notice of any adjournment to another time and place shall be given, before the time of the adjourned meeting, to the directors who were not present at the time of the adjournment.**

Comment: See Corp C §§5211(a)(4), 7211(a)(4), 9211(a)(4)-(5). The articles or bylaws may vary this provision. Because the Corporations Code does not provide a similar 24-hour default provision for notice of an adjourned meeting of a religious corporation, religious corporations may omit this provision.

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§7.79 8. Form: Action Without a Meeting

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations and mutual benefit corporations holding assets in charitable trust*]

Board Action Without Meeting. **Any action that the board is required or permitted to take may be taken without a meeting if all board members consent in writing to the action; provided, however, that the consent of any director who has a material financial interest in a transaction to which the corporation is a party and who is an "interested director" as defined in Corporations Code §5233 shall not be required for approval of that transaction. Such action by written consent shall have the same force and effect as any other validly approved action of the board. All such consents shall be filed with the minutes of the proceedings of the board.**

[*Alternative 2: Religious corporations and mutual benefit corporations not holding assets in charitable trust*]

Board Action Without Meeting. **Any action that the board is required or permitted to take may be taken without a meeting if all board members consent in writing to the action. Such action by written consent shall have the same force and effect as any other validly approved board action. All such consents shall be filed with the minutes of the proceedings of the board.**

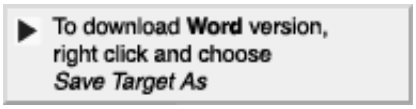
Comment: See Corp C §§5211(b), 7211(b), 9211(b). Listed in Corp C §5233 are several situations in which a director of a public benefit corporation who has a financial interest is nevertheless not an "interested director" and whose vote is therefore counted. If a mutual benefit corporation holds assets in charitable trust, the conduct of its directors is, with respect to those assets held in charitable trust, subject to the standards of conduct prescribed for public benefit corporations. Corp C §7238; see Corp C §§5230-5239.

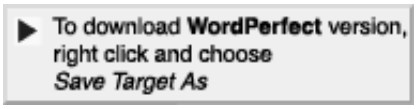
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.80 9. Form: Compensation and Reimbursement

§7.80 9. Form: Compensation and Reimbursement

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***Director Compensation*. Directors _ _**[*and members of committees of the board*]**_ _ may receive such compensation, if any, for their services as directors or officers, and such reimbursement of expenses, as the board may establish by resolution to be just and reasonable as to the corporation at the time that the resolution is adopted.**

Comment: See Corp C §§5235(a), 7233(a). The Nonprofit Mutual Benefit Corporation Law does not explicitly refer to compensation of directors, while the Nonprofit Public Benefit Corporation Law does. The Nonprofit Religious Corporation Law has no provisions on directors' compensation.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 10. Committees of Board of Directors/§7.81 a. Form: Creation and Powers of Committees

10. Committees of Board of Directors

§7.81 a. Form: Creation and Powers of Committees

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***Board Committees*. The board, by resolution adopted by a majority of the directors then in office, may create one or more committees, each consisting of two or more directors and no one who is not a director, to serve at the pleasure of the board. Appointments to committees of the board shall be by majority vote of the _ _[*directors then in office/authorized number of directors*]_ _. The board may appoint one or more directors as alternate members of any such committee, who may replace any absent member at any meeting. Any such committee shall have all the authority of the board, to the extent provided in the board resolution, except that no committee may do the following:**

(1) Take any final action on any matter that, under the California Nonprofit _ _[*Public Benefit/Mutual Benefit/Religious*]_ _ Corporation Law, also requires approval of the members or approval of a majority of all members;

(2) Fill vacancies on the board or any committee of the board;

(3) Fix compensation of the directors for serving on the board or on any committee;

(4) Amend or repeal bylaws or adopt new bylaws;

(5) Amend or repeal any resolution of the board that by its express terms is not so amendable or repealable; _ _[*or*]_ _

(6) Create any other committees of the board or appoint the members of committees of the board; _ _[*or*]_ _

[*If applicable, add either or both of the following options*]

[*Option 1: Use of funds for nominee when there are more nominees than directorships (public and mutual benefit corporations)*]

(7) Expend corporate funds to support a nominee for director if more people have been nominated for director than can be elected; _ _[*or*]_ _

[*Option 2(a): Approval of transaction in which director has financial interest (public benefit corporation)*]

(8) Approve any contract or transaction to which the corporation is a party and in which one or more of its directors has a material financial interest, except as special approval is provided for in Corporations Code §5233(d)(3).

[*Option 2(b): Approval of transaction in which director has financial interest (mutual benefit corporation)*]

(9) With respect to any assets held in charitable trust, approve any contract or transaction between this corporation and one or more of its directors or between this corporation and an entity in which one or more of its directors have a material financial interest, subject to the approval provisions of Corporations Code §5233(d)(3).

Comment: See Corp C §§5212, 7212, 9212(a). For discussion of board committees, see §§9.5-9.10. It is generally preferable to address only committees of the board in the bylaws. Advisory committees (see §9.6) should instead be established and dissolved by board action.

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§7.82 b. Form: Audit Committee

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Audit Committee*. The corporation shall have an audit committee consisting of at least _ _**[*number, e.g., one*]**_ _ _ _**[*director/directors*]**_ _, and may include nonvoting advisors. Directors who are employees or officers of the corporation or who receive, directly or indirectly, any consulting, advisory, or other compensatory fees from the corporation (other than for service as director) may not serve on the audit committee. The audit committee shall perform the duties and adhere to the guidelines set forth in the corporation's audit committee charter as amended from time to time by the board. Such duties include, but are not limited to:**

(1) Assisting the board in choosing an independent auditor and recommending termination of the auditor, if necessary;

(2) Negotiating the auditor's compensation;

(3) Conferring with the auditor regarding the corporation's financial affairs; and

(4) Reviewing and accepting or rejecting the audit.

Members of the audit committee shall not receive compensation for their service on the audit committee in excess of that provided to directors for their service on the board. If the corporation has a finance committee, a majority of the members of the audit committee may not concurrently serve as members of the finance committee, and the chair of the audit committee may not serve on the finance committee.

Comment: Nonprofit public benefit corporations subject to the oversight of the California Attorney General that have gross revenue for the year of $2 million or more must obtain an annual audit from an independent certified public accountant. Organizations that expect to have gross revenue of $2 million should include audit committee appointment and charter provisions in the bylaws. See Govt C §12586(e). Nonprofits that solicit charitable contributions from residents of other states should check the registration and audit requirements in all such jurisdictions. Some states require an audit if gross revenues exceed only $250,000.

A CEO or CFO of the corporation must be excluded from the Audit Committee whether or not compensated if he or she is "staff." See FAQ No. 13 under "Charities-Nonprofit Integrity Act of 2004" on the California Attorney General's website at http://www.ag.ca.gov/charities/faq.php.

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§7.83 c. Form: Compensation Committee

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Compensation Committee*. The corporation shall have a compensation committee consisting of at least three directors and no one who is not a director. Directors who are also employees of the corporation may not serve on the compensation committee. Pursuant to Government Code §12586(g) and the applicable provisions of federal law, the compensation committee shall review the compensation of the _ _**[*president/chief executive officer*]**_ _, _ _**[*treasurer/chief financial officer*]**_ _, and such other officers of the corporation the compensation committee determines appropriate, annually and whenever a modification in compensation is proposed. The review shall include an evaluation of the performance of the officers and an analysis of appropriate comparability data. Based on its review, the compensation committee shall recommend just and reasonable compensation amounts for the officers to the board. At the request of the president or the board, the compensation committee shall review any issue involving staff compensation and benefits, including but not limited to, housing, health, and retirement plans.**

Comment: Compensation review requirements in the Government Code apply to all nonprofit public benefit corporations. However, these requirements do not supersede the existing fiduciary duties of officers, directors, and trustees in managing charitable organizations. The board members have a continuing duty to pay compensation to officers and directors that does not exceed what is fair and reasonable to the organization, and they may incur personal liability for paying excessive compensation. Therefore, the payment of excessive compensation at any time is a violation of the law. Corp C §5235; Govt C §12586(g). Mutual benefit corporations and religious corporations may, but are not required to, have a compensation committee. It is a good practice to have a compensation committee if the corporation pays compensation.

If a staff member actually performs the duties and functions of a president or CEO or a treasurer or CFO, a charity may not avoid the compensation review required by giving that person a different job title. See 11 Cal Code Regs §312.1. The board may delegate the review obligations to a compensation committee; if it does, these duties of the compensation committee should be set forth in the bylaws.

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§7.84 d. Form: Executive Committee

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Executive Committee*. Pursuant to Section _ _[*number*]_ _ of these bylaws, the board may appoint two or more directors of the corporation to serve as the executive committee of the board. The executive committee, unless limited by a resolution of the board, shall have and may exercise all the authority of the board in the management of the business and affairs of the corporation between meetings of the board; provided, however, that the executive committee shall not have the authority of the board in reference to those matters enumerated in Section _ _[*number*]_ _. All actions of the executive committee shall be reported to and ratified by the full board at the next duly scheduled board meeting.**

Comment: The corporation is not required to have an executive committee; however, most nonprofits with any substantial amount of day-to-day activity use an executive committee of the board to provide more frequent board oversight and assistance to the officers. On executive committees, see §§9.5-9.10.

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§7.85 e. Form: Investment Committee

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Investment Committee*. This corporation shall have an investment committee comprised of not less than three directors. The committee shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. Individual investments shall be considered as part of an overall investment strategy. The committee shall consider present and future financial requirements, expected total return, general economic conditions, the appropriate level of risk, appropriate levels of income, growth and long-term net appreciation, and the probable safety of the funds. The committee may retain professional money managers, and shall develop an investment policy that shall be reconsidered at least annually, in light of the changing needs of the corporation, economic conditions, and any other factors that may affect the corporation's tolerance of risk and need for income. The committee may recommend the retention of property contributed by a donor (whether or not it produces income), and a donor's request should be a factor in making the determination of whether to sell a particular asset contributed by a donor.**

Comment: See Corp C §§5231, 5240, 7231, 9241. See also the provisions of California law applicable to management of investments, codified as the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510), and discussed in chap 16.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.86 f. Form: Meetings and Action of Committees

§7.86 f. Form: Meetings and Action of Committees

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Committee Meetings*. Meetings and actions of committees of the board shall be governed by, held, and taken under the provisions of these bylaws concerning meetings and other board actions, except that the time for general meetings of board committees and the calling of special meetings of board committees may be set either by board resolution or, if none, by resolution of the committee. Minutes of each meeting shall be kept and shall be filed with the corporate records. The board may adopt rules for the governance of any committee as long as the rules are consistent with these bylaws. If the board has not adopted rules, the committee may do so.**

Comment: See Corp C §§5211(d), 6320(a)(2), 7211(d), 8320(a)(2), 9211(d), 9212.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ L. Officers of the Corporation/§7.87 1. Form: Offices Held

L. Officers of the Corporation

§7.87 1. Form: Offices Held

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Officers*. The officers of this corporation shall be a president, a secretary, and a chief financial officer. The corporation, at the board's discretion, may also have a chair of the board, one or more vice presidents, one or more assistant secretaries, one or more assistant treasurers, and such other officers as may be appointed under Section _ _[*number*]_ _ of these bylaws.**

[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and religious corporations*]

Any number of offices may be held by the same person, except that neither the secretary nor the chief financial officer may serve concurrently as either the president or the chair of the board.

[*Alternative 2: Mutual benefit corporations*]

Any number of offices may be held by the same person.

Comment: See Corp C §§5213(a), 7213(a), 9213(a). On officers of the corporation, see §§9.11-9.14.

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§7.88 2. Form: Election of Officers

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***Election of Officers*. The officers of this corporation, except any appointed under Section _ _[*number*]_ _ of these bylaws, shall be chosen _ _[*annually*]_ _ by the board and shall serve at the pleasure of the board, subject to the rights of any officer under any employment contract.**

Comment: The articles or bylaws may provide for other methods for election of the officers. See Corp C §§5213(b), 7213(b), 9213(b). For public benefit corporations, if the articles or bylaws provide for the election of any officers by the members, the term of office of the elected officer will be 1 year unless the articles or bylaws provide for a different term that may not exceed 3 years. Corp C §5213(c).

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§7.89 3. Form: Appointment of Other Officers

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***Additional Officers*. The board may appoint and authorize the chair of the board, the president, or another officer to appoint any other officers that the corporation may require. Each appointed officer shall have the title and authority, hold office for the period, and perform the duties specified in the bylaws or established by the board.**

Comment: See Corp C §§5213, 7213, 9213.

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§7.90 4. Form: Removal of Officers

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***Removal of Officers*. Without prejudice to the rights of any officer under an employment contract, the board may remove any officer with or without cause. An officer who was not chosen by the board may be removed by any other officer on whom the board confers the power of removal.**

Comment: See Corp C §§5213(b), 7213(b), 9213(b).

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§7.91 5. Form: Resignation of Officers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Resignation of Officers*. Any officer may resign at any time by giving written notice to the board. The resignation shall take effect on the date the notice is received or at any later time specified in the notice. Unless otherwise specified in the notice, the resignation need not be accepted to be effective. Any resignation shall be without prejudice to any rights of the corporation under any contract to which the officer is a party.**

Comment: See Corp C §§5213(b), 7213(b), 9213(b).

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§7.92 6. Form: Vacancies in Office

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***Vacancies*. A vacancy in any office because of death, resignation, removal, disqualification, or any other cause shall be filled in the manner prescribed in these bylaws for normal appointments to that office. However, vacancies need not be filled on an annual basis.**

Comment: There are no statutes governing this issue.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ 7. Responsibilities of Officers/§7.93 a. Form: Chair of the Board

7. Responsibilities of Officers

§7.93 a. Form: Chair of the Board

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***Responsibilities of Board Chair*. If a chair of the board of directors is elected, he or she shall preside at board meetings and shall exercise and perform such other powers and duties as the board may assign from time to time. If there is no president, the chair of the board shall also be the chief executive officer and shall have the powers and duties of the president of the corporation set forth in these bylaws.**

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.94 b. Form: President

§7.94 b. Form: President

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***Responsibilities of President*. Subject to such supervisory powers as the board may give to the chair of the board, if any, and subject to the control of the board, the president shall be the general manager of the corporation and shall supervise, direct, and control the corporation's activities, affairs, and officers. The president shall preside at all members' meetings and, in the absence of the chair of the board, or if none, at all board meetings. The president shall have such other powers and duties as the board or the bylaws may require.**

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§7.95 c. Form: Vice Presidents

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***Responsibilities of Vice Presidents*. If the president is absent or disabled, the vice presidents, if any, in order of their rank as fixed by the board, or, if not ranked, a vice president designated by the board, shall perform all duties of the president. When so acting, a vice president shall have all powers of and be subject to all restrictions on the president. The vice presidents shall have such other powers and duties as the board or the bylaws may require.**

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§7.96 d. Form: Secretary

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Responsibilities of Secretary*. The secretary shall keep or cause to be kept, at the corporation's principal office or such other place as the board may direct, a book of minutes of all meetings, proceedings, and actions of the board, of committees of the board, and of members' meetings. The minutes of meetings shall include the time and place that the meeting was held; whether the meeting was annual, general, or special, and, if special, how authorized; the notice given; the names of persons present at board and committee meetings; and the number of members present or represented at members' meetings.**

The secretary shall keep or cause to be kept, at the principal California office, a copy of the articles of incorporation and bylaws, as amended to date.

The secretary shall keep or cause to be kept, at the corporation's principal office or at a place determined by resolution of the board, a record of the corporation's members, showing each member's name, address, and class of membership.

The secretary shall give, or cause to be given, notice of all meetings of members, of the board, and of committees of the board that these bylaws require to be given. The secretary shall keep the corporate seal, if any, in safe custody and shall have such other powers and perform such other duties as the board or the bylaws may require.

Comment: See Corp C §§5160, 6320(a)(3), 7160, 8320. There are no similar requirements for religious corporations, but the foregoing may be used or adapted as appropriate for a religious corporation.

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§7.97 e. Form: Chief Financial Officer

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***Responsibilities of Chief Financial Officer*. The chief financial officer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and accounts of the corporation's properties and transactions. The chief financial officer shall send or cause to be given to the members and directors such financial statements and reports as are required to be given by law, by these bylaws, or by the board. The books of account shall be open to inspection by any director at all reasonable times.**

The chief financial officer shall (1) deposit, or cause to be deposited, all money and other valuables in the name and to the credit of the corporation with such depositories as the board may designate; (2) disburse the corporation's funds as the board may order; (3) render to the president, chair of the board, if any, and the board, when requested, an account of all transactions as chief financial officer and of the financial condition of the corporation; and (4) have such other powers and perform such other duties as the board or the bylaws may require.

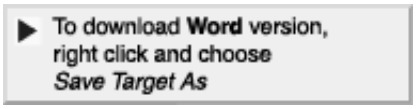
If required by the board, the chief financial officer shall give the corporation a bond in the amount and with the surety or sureties specified by the board for faithful performance of the duties of the office and for restoration to the corporation of all of its books, papers, vouchers, money, and other property of every kind in the possession or under the control of the chief financial officer on his or her death, resignation, retirement, or removal from office.

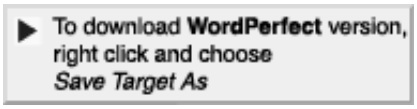
Comment: See Corp C §§6320(a)(1), 8320(a)(1) (books and records of account), §§6321-6322 and §§8321-8322 (annual reports), §§6334, 8334 (directors' right of inspection). This statement of official duties is not required by statute, but it may be helpful to the officers and directors.

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§7.98 M. Form: Contracts With Directors

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Contracts with Directors. **No director of this corporation nor any other corporation, firm, association, or other entity in which one or more of this corporation's directors are directors or have a material financial interest, shall be interested, directly or indirectly, in any contract or transaction with this corporation unless (1) the material facts regarding that director's financial interest in such contract or transaction or regarding such common directorship, officership, or financial interest are fully disclosed in good faith and noted in the minutes, or are known to all members of the board prior to the board's consideration of such contract or transaction; (2) such contract or transaction is authorized in good faith by a majority of the board by a vote sufficient for that purpose without counting the votes of the interested directors; (3) before authorizing or approving the transaction, the board considers and in good faith decides after reasonable investigation that the corporation could not obtain a more advantageous arrangement with reasonable effort under the circumstances; and (4) the corporation for its own benefit enters into the transaction, which is fair and reasonable to the corporation at the time the transaction is entered into.**

This Section does not apply to a transaction that is part of an educational or charitable program of this corporation if it (1) is approved or authorized by the corporation in good faith and without unjustified favoritism and (2) results in a benefit to one or more directors or their families because they are in the class of persons intended to be benefited by the educational or charitable program of this corporation.

[*Alternative 2: Mutual benefit corporations*]

Contracts with Directors**. No director of this corporation nor any other corporation, firm, association, or other entity in which one or more of this corporation's directors are directors or have a material financial interest, shall be interested, directly or indirectly, in any contract or other transaction with this corporation unless (1) the material facts as to the transaction and such director's interest are fully disclosed or known to the members and such contract or transaction is approved by the members in good faith, with any membership owned by any interested director not being entitled to vote thereon, or (2) the material facts regarding such director's financial interest in such contract or transaction or regarding such common directorship, officership, or financial interest are fully disclosed in good faith and are noted in the minutes or are known to all board members before consideration by the board of such contract or transaction, and such contract or transaction is authorized in good faith by a majority of the board by a vote sufficient for that purpose without counting the vote of the interested director.**

[*Alternative 3: Religious corporations*]

Contracts with Directors. **No director of this corporation nor any other corporation, firm, association, or other entity in which one or more of this corporation's directors are directors or have a material financial interest, shall be interested, directly or indirectly, in any contract or other transaction with this corporation unless (1) the transaction is approved or ratified in good faith by the members other than the directors, after notice and disclosure to the members of the material facts concerning the transaction and the director's interest in the transaction, or (2) (a) the material facts regarding such director's financial interest in such contract or transaction or regarding such common directorship, officership, or financial interest are fully disclosed in good faith and are noted in the minutes, or are known to all board members before consideration by the board of such contract or transaction; (b) such contract or transaction is authorized in good faith by a majority of the directors then in office, or if greater, by a vote sufficient for that purpose without counting the vote of the interested directors; (3) before authorizing or approving the transaction, the board considers and in good faith decides after reasonable investigation that the corporation could not obtain a more advantageous arrangement with reasonable effort under the circumstances, or the transaction was in furtherance of the corporation's religious purposes; and (4) this corporation enters into the transaction for its own benefit or for**

the benefit of the organization, and the transaction is fair and reasonable to this corporation or was in furtherance of its religious purposes at the time the transaction is entered into.

This Section does not apply to a transaction that is part of a public, charitable, or religious program of this corporation if it (1) is approved or authorized by the corporation in good faith and without unjustified favoritism and (2) results in a benefit to one or more directors or their families because they are in the class of persons intended to be benefited by the public, charitable, or religious program of this corporation.

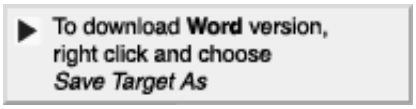
Comment: See Corp C §§5233, 7233(a), 9243. Note that these statutes may not apply to a transaction between a nonprofit corporation and an entity in which a director has a material financial interest. See 3 Ballantine & Sterling, California Corporation Laws §406.02[1][b] (4th ed 1962). It is a better practice, however, to retain the more restrictive language in these provisions to establish a policy that will promote compliance with the private foundation prohibition on self-dealing under IRC §4941 and the public charity prohibition on excess benefit transactions under IRC §4958.

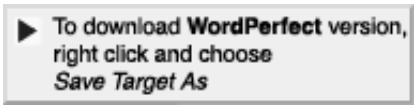
In addition, to promote compliance with Corp C §§5234, 7233(b), and 9244, these provisions are drafted to require approval by a disinterested majority when a director sits on a board of another corporation that is a party to the transaction, even if the director does not have a material financial interest in the transaction. However, these provisions do not address insider transactions involving all "disqualified persons," which are subject to substantial penalties under IRC §4941 (for private foundations) and IRC §4958 (for public charities and IRC §501(c)(4) and §501(c)(5) organizations). Counsel should strongly recommend a comprehensive conflict-of-interest policy to avoid exposing insiders to penalties. These policies generally should not be included in the bylaws. For discussion of transactions between nonprofit corporations and their directors, officers, and other "disqualified persons" generally, see §§9.131-9.150.

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§7.99 N. Form: Loans to Directors and Officers

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Loans to Directors and Officers. **This corporation shall not lend any money or property to or guarantee the obligation of any director or officer without the approval of the California Attorney General, provided, however, that the corporation may advance money to a director or officer of the corporation for expenses reasonably anticipated to be incurred in the performance of his or her duties if that director or officer would be entitled to reimbursement for such expenses by the corporation.**

[*Alternative 2: Mutual benefit corporations*]

Loans to Directors and Officers. **This corporation shall not lend any money or property to, or guarantee the obligation of, any director or officer of the corporation _ _[*or of its parent, affiliate, or subsidiary*]_ _ unless (1) the board decides that the loan or guaranty may reasonably be expected to benefit the corporation, and (2) before consummating the transaction or any part of it, the loan or guaranty is approved by either the members, without counting the vote of the director or officer, if a member, or the vote of a majority of the directors then in office, without counting the vote of the director who is to receive the loan or guaranty.**

Comment: See Corp C §§5236, 7235. For discussion of loans and guaranties, see §§9.146-9.149.

Public benefit corporations: Alternative 1 tracks the statutory language of Corp C §5236(a), barring loans or guarantees unless approved by the Attorney General and permitting advancement of reasonably anticipated job expenses. Corporations Code §5236(b)-(c) expressly excepts the payment of life insurance premiums for officers and directors, and loans deemed necessary to provide financing to purchase an officer's residence, under specified conditions. The section may be amended accordingly.

Mutual benefit corporations: The articles or bylaws may prohibit loans to or guaranties for the benefit of directors or officers of mutual benefit corporations. Corp C §7235(a). A mutual benefit corporation may advance money to a director or an officer of the corporation for reasonable business expenses provided that the director or officer would be entitled to reimbursement. Corp C §7235(b). Moreover, Corp C §7235(a)-(b) does not apply to credit unions or to the payment of certain life insurance premiums, or to loans permitted under a statute regulating any special class of corporations. Corp C §7235(c). Note that if a mutual benefit corporation holds assets in charitable trust, the conduct of its directors is, with respect to those assets, subject to the standards of conduct prescribed for public benefit corporations. Corp C §7238; see Corp C §5230-5239.

Religious corporations: The self-dealing provisions do not apply to compensation of directors or officers of a religious corporation or to lending money or property to, or guaranteeing the obligation of, any director or officer of a religious corporation. See Corp C §9243(b)(1).

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§7.100 O. Form: Indemnification

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.3-7.110.

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***Indemnification*. To the fullest extent permitted by law, this corporation shall indemnify its directors and officers, and may indemnify employees and other persons described in Corporations Code §_ _[*5238(a)/7237(a)/9246(a)*]_ _, including persons formerly occupying any such positions, against all expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred by them in connection with any "proceeding," as that term is used in that section, and including an action by or in the right of the corporation, by reason of the fact that the person is or was a person described in that section. "Expenses," as used in this bylaw, shall have the same meaning as in that section of the Corporations Code.**

On written request to the board by any person seeking indemnification under Corporations Code §_ _[*5238(b)/7237(b)/9246(b)*]_ _ or §_ _[*5238(c)/7237(c)/9246(c)*]_ _, the board shall promptly decide under Corporations Code §_ _[*5238(e)/7237(e)/9246(e)*]_ _ whether the applicable standard of conduct set forth in Corporations Code §_ _[*5238(b)/7237(b)/9246(b)*]_ _ or §_ _[*5238(c)/7237(c)/9246(c)*]_ _ has been met and, if so, the board shall authorize indemnification. If the board cannot authorize indemnification, because the number of directors who are parties to the proceeding with respect to which indemnification is sought prevents the formation of a quorum of directors who are not parties to that proceeding, the board shall promptly call a meeting of members. At that meeting, the members shall determine under Corporations Code §_ _[*5238(e)/7237(e)/9246(e)*]_ _ whether the applicable standard of conduct has been met and, if so, the members present at the meeting in person or by proxy shall authorize indemnification.

To the fullest extent permitted by law and except as otherwise determined by the board in a specific instance, expenses incurred by a person seeking indemnification under Sections _ _[*numbers*]_ _ of these bylaws in defending any proceeding covered by those Sections shall be advanced by the corporation before final disposition of the proceeding, on receipt by the corporation of an undertaking by or on behalf of that person that the advance will be repaid unless it is ultimately found that the person is entitled to be indemnified by the corporation for those expenses.

Comment: See Corp C §§5238, 7237, 9246. If the corporation will not have a continuing relationship with an attorney, the detailed indemnification requirements in Corp C §5238, §7237, or §9246 (as applicable) should be set forth, rather than merely referred to, in the bylaws. See §§9.156-9.162. See also the indemnification provisions of Lab C §2802 that generally require indemnification of employees.

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§7.101 P. Form: Insurance

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***Insurance*. This corporation shall have the right, and shall use its best efforts, to purchase and maintain insurance to the full extent permitted by law on behalf of its officers, directors, employees, and other agents, to cover any liability asserted against or incurred by any officer, director, employee, or agent in such capacity or arising from the officer's, director's, employee's, or agent's status as such.**

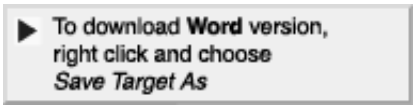
Comment: See Corp C §§5238(i), 7237(i), 9246(i). For discussion, see §9.162. In certain circumstances involving nonprofit corporations, a volunteer director may be protected from personal liability for his or her negligence as a director or officer if, among other things, the board has made all reasonable efforts in good faith to obtain liability insurance. See §§9.151-9.155.

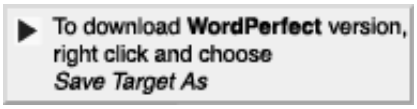
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.102 Q. Form: Maintenance of Corporate Records

§7.102 Q. Form: Maintenance of Corporate Records

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***Corporate Records*. This corporation shall keep the following:**

(1) Adequate and correct books and records of account;

(2) Minutes of the proceedings of its members, board, and committees of the board; and

(3) A record of each member's name, address, and class of membership.

The minutes and other books and records shall be kept either in written form or in any other form capable of being converted into clearly legible tangible form or in any combination of the two.

Comment: See Corp C §§6320, 8320, 9510. For discussion, see §10.109.

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R. Inspection Rights

1. Members' Right to Inspect

§7.103 a. Form: Membership Records

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Members' Inspection Rights*. Unless the corporation provides a reasonable alternative as provided below, any member may do either or both of the following for a purpose reasonably related to the member's interest as a member:**

(1) Inspect and copy the records containing members' names, addresses, and voting rights during usual business hours on 5 days' prior written demand on the corporation, which must state the purpose for which the inspection rights are requested; or

(2) Obtain from the secretary of the corporation, on written demand and tender of a reasonable charge, a list of names, addresses, and voting rights of members who are entitled to vote for directors as of the most recent record date for which that list has been compiled, or as of the date, after the date of demand, specified by the member. The demand shall state the purpose for which the list is requested. The secretary shall make this list available to the member on or before the later of 10 days after the demand is received or the date specified in the demand as the date as of which the list is to be compiled.

The corporation may, within 10 business days after receiving a demand under this Section, make a written offer of an alternative method of reasonable and timely achievement of the proper purpose specified in the demand without providing access to or a copy of the membership list. Any rejection of this offer must be in writing and must state the reasons the proposed alternative does not meet the proper purpose of the demand.

If the corporation reasonably believes that the information will be used for a purpose other than one reasonably related to a person's interest as a member, or if it provides a reasonable alternative under this Section, it may deny the member access to the membership list.

Any inspection and copying under this Section may be made in person or by the member's agent or attorney. The right of inspection includes the right to copy and make extracts. This right of inspection extends to the records of any subsidiary of the corporation.

[*Alternative 2: Religious corporations*]

***Members' Inspection Rights.* Any member of this corporation may inspect and copy the records containing the members' names, addresses, and voting rights at reasonable times, on 5 business days' prior written demand to the corporation for a purpose reasonably related to the member's interest as a member.**

Comment: See Corp C §§6311-6312, 6330-6332, 8311-8312, 8330-8332. If an authorized number (see Corp C §5036) of members of a public benefit or mutual benefit corporation request inspection for a purpose reasonably related to their interest as members, the corporation may not simply deny the request as it may for "any member" under this section but must petition the superior court for an order setting aside the demand. See Corp C §§6330(b)(2), 6331(a), 8330(b)(2), 8331(a). The inspection rights of members of a public benefit or mutual benefit corporation may not be limited by contract, the articles, or the bylaws. Corp C §§6313, 8313. If a public benefit corporation furnishes a

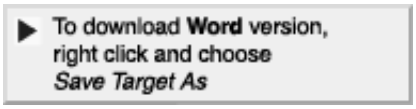
list of members under Corp C §6330, the list must be in alphabetical order. Corp C §6330(a)(2).

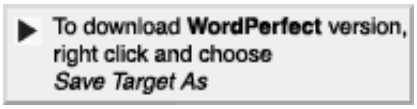
The alternative provision for religious corporations may be altered if desired. See Corp C §9511. The rights of members of a religious corporation may be limited, eliminated, or expanded in the articles or bylaws. See also §7.14.

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§7.104 b. Form: Accounting Records and Minutes

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***Inspection of Accounting Records and Minutes*. On written demand on the corporation, any member may inspect, copy, and make extracts of the accounting books and records and the minutes of the proceedings of the members, the board of directors, and committees of the board at any reasonable time for a purpose reasonably related to the member's interest as a member. Any such inspection and copying may be made in person or by the member's agent or attorney. This right of inspection extends to the records of any subsidiary of the corporation.**

Comment: See Corp C §§6311-6312, 6333, 8311-8312, 8333, 9512. These rights may be limited, eliminated, or expanded in the articles or bylaws. On members' rights to inspection, see §§10.108-10.120. See also §7.14 and the form in §7.106.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.105 c. Form: Maintenance and Inspection of Articles and Bylaws

§7.105 c. Form: Maintenance and Inspection of Articles and Bylaws

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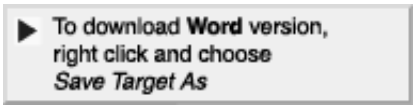
***Inspection of Articles and Bylaws*. This corporation shall keep at its principal California office the original or a copy of the articles of incorporation and bylaws, as amended to the current date, that shall be open to inspection by the members at all reasonable times during office hours. If the corporation has no business office in California, the secretary shall, on the written request of any member, furnish to that member a copy of the articles of incorporation and bylaws, as amended to the current date.**

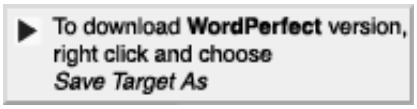
Comment: See Corp C §§5160, 7160, 9160. On members' rights to inspection, see §§10.108-10.120.

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§7.106 2. Form: Directors' Right to Inspect

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit and mutual benefit corporations*]

***Directors' Inspection Rights*. Every director shall have the absolute right at any reasonable time to inspect the corporation's books, records, and documents of every kind, and to inspect the physical properties of the corporation. _ _**[*Every director shall have the right to inspect the records of each subsidiary.*]**_ _ The inspection may be made in person or by the director's agent or attorney. The right of inspection includes the right to copy and make extracts of books, records, and documents of every kind.**

[*Alternative 2: Religious corporations*]

***Directors' Inspection Rights*. Every director shall have the right at any reasonable time to inspect and copy all books, records, and documents of every kind and to inspect the physical properties of the corporation for a purpose reasonably related to the director's interests as a director.**

Comment: See Corp C §§6311-6312, 6334, 8311-8312, 8334, 9513. On directors' rights to inspection, see §§9.163-9.164.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ S. Required Reports/§7.107 1. Form: Annual Report

S. Required Reports

§7.107 1. Form: Annual Report

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Annual Report. **The board shall cause an annual report to be sent to the members and directors within 120 days after the end of the corporation's fiscal year. That report shall contain the following information, in appropriate detail:**

(1) The assets and liabilities, including the trust funds, of the corporation as of the end of the fiscal year;

(2) The principal changes in assets and liabilities, including trust funds;

(3) The corporation's revenue or receipts, both unrestricted and restricted to particular purposes;

(4) The corporation's expenses or disbursements for both general and restricted purposes;

(5) Any information required by Section _ _[*number*]_ _ of these bylaws; and

(6) An independent accountants' report or, if none, the certificate of an authorized officer of the corporation that such statements were prepared without audit from the corporation's books and records.

This requirement of an annual report shall not apply if the corporation receives less than $25,000 in gross receipts during the fiscal year, provided, however, that the information specified above for inclusion in an annual report must be furnished annually to all directors and to any member who requests it in writing. If the board approves, the corporation may send the report and any accompanying material sent pursuant to this section by electronic transmission.

[*Alternative 2: Mutual benefit corporations*]

Annual Report. **The board shall cause an annual report to be prepared within 120 days after the end of the corporation's fiscal year. That report shall contain the following information in appropriate detail:**

(1) A balance sheet as of the end of the fiscal year, an income statement, and statement of cashflows for the fiscal year, accompanied by an independent accountant's report or, if none, by the certificate of an authorized officer of the corporation that they were prepared without audit from the corporation's books and records;

(2) A statement of the place where the names and addresses of current members are located; and

(3) Any information required by Section _ _[*number*]_ _ of these bylaws.

This corporation shall annually notify each member of the member's right to receive a copy of the financial report under this Section. Except as provided in the next paragraph of this bylaw, on written request by a member, the board shall promptly cause the most recent annual report to be sent to the requesting member. If the board approves, the corporation may send the report and any accompanying material sent pursuant to this section by electronic transmission.

This Section shall not apply if the corporation receives less than $10,000 in gross revenues or receipts

during the fiscal year.

Comment: See Corp C §§6321, 8321. A public benefit corporation that solicits, in writing, contributions from 500 or more persons need not send the report if it complies with Corp C §6321(f). Unless otherwise provided in the articles or bylaws, a public benefit corporation that has provided for general meetings of members less often than annually must send this report only as often as general meetings are required. The report must, however, be given annually to directors and members who request it in writing. Corp C §6321(d)-(e). On reports to members and directors generally, see §§12.43-12.87.

Religious corporations are not required to prepare an annual report.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.108 2. Form: Annual Statement of Certain Transactions and Indemnifications

§7.108 2. Form: Annual Statement of Certain Transactions and Indemnifications

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Annual Statement. **As part of the annual report to all members, or as a separate document if no annual report is issued, the corporation shall, within 120 days after the end of the corporation's fiscal year, annually prepare and mail, deliver, or send by electronic transmission to each member and furnish to each director a statement of any transaction or indemnification of the following kind:**

(1) Any transaction (a) in which the corporation, or its parent or subsidiary, was a party, (b) in which an "interested person" had a direct or indirect material financial interest, and (c) that involved more than $50,000 or was one of several transactions with the same interested person involving, in the aggregate, more than $50,000. For this purpose, an "interested person" is either

(i) Any director or officer of the corporation, its parent, or subsidiary (but mere common directorship shall not be considered such an interest); or

(ii) Any holder of more than 10 percent of the voting power of the corporation, its parent, or its subsidiary.

The statement shall include a brief description of the transaction, the names of interested persons involved, their relationship to the corporation, the nature of their interest in the transaction, and, if practicable, the amount of that interest, provided that if the transaction was with a partnership in which the interested person is a partner, only the interest of the partnership need be stated.

(2) Any indemnifications or advances aggregating more than $10,000 paid during the fiscal year to any officer or director of the corporation under Sections _ _[*numbers*]_ _ of these bylaws, unless that indemnification has already been approved by the members under Corporations Code §5238(e)(2).

[*Alternative 2: Mutual benefit corporations*]

Annual Statement. **As part of the annual report to all members, or as a separate document if no annual report is issued, the corporation shall annually prepare and mail, deliver, or send by electronic transmission to its members and furnish to its directors a statement of any transaction or indemnification of the following kinds within 120 days after the end of the corporation's fiscal year:**

(1) Unless approved by members under Corporations Code §7233(a), any transaction (a) to which the corporation, its parent, or its subsidiary was a party, (b) which involved more than $50,000 or was one of a number of such transactions with the same person involving, in the aggregate, more than $50, 000, and (c) in which either of the following interested persons had a direct or indirect material financial interest (a mere common directorship is not a material financial interest):

(i) Any director or officer of the corporation, its parent, or its subsidiary;

(ii) Any holder of more than 10 percent of the voting power of the corporation, its parent, or its subsidiary.

The statement shall include a brief description of the transaction, the names of interested persons involved, their relationship to the corporation, the nature of their interest in the transaction, and, when practicable, the amount of that interest, except that, in a partnership in which such person is a partner, only the partnership

interest need be stated.

(2) A brief description of the amounts and circumstances of any loans, guaranties, indemnifications, or advances aggregating more than $10,000 paid during the fiscal year to any officer or director of the corporation under Sections _ _[*numbers*]_ _ of these bylaws, unless the loan, guaranty, indemnification, or advance has already been approved by the members under Corporations Code §5034, or the loan or guaranty is not subject to Corporations Code §7235(a).

Comment: Under Corp C §§6322 and 8322, this report is required as part of the annual report of public benefit and mutual benefit corporations, if one is given. See Corp C §§6321(a)(5), 8321(a)(3). For discussion of reports to members and directors generally, see §§12.43-12.87.

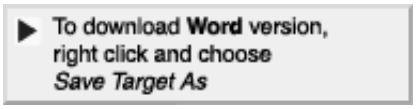
Religious corporations are not required to prepare an annual report.

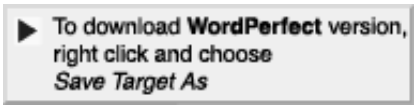
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.109 T. Form: Private Foundation Restrictions

§7.109 T. Form: Private Foundation Restrictions

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***Private Foundation Restrictions*. This corporation shall distribute its income for each taxable year at such time and in such manner as not to become subject to the tax on undistributed income imposed by Internal Revenue Code §4942, shall not engage in any act of self-dealing as defined in Internal Revenue Code §4941(d), shall not retain any excess business holdings as defined in Internal Revenue Code §4943(c), shall not make any investments in a manner as to subject it to tax under Internal Revenue Code §4944, and shall not make any taxable expenditures as defined in Internal Revenue Code §4945(d).**

Comment: See Corp C §§5260, 9260. This section is required for public benefit corporations or religious corporations that are "private foundations" within the meaning of IRC §509(a). See §§4.23-4.55.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.109A U. Form: Supporting Organization Restrictions

§7.109A U. Form: Supporting Organization Restrictions

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Supporting Organization Restrictions. **This Corporation shall not accept any contribution from any "prohibited person." For purposes of this Section, a "prohibited person" is: (1) a person who controls, directly or indirectly, either alone or with persons listed described in (2) and (3) below, the governing body of this Corporation or any successor organization designated pursuant to Section _ _[*section number*]_ _ of these Bylaws; (2) a member of the family of an individual listed in (1) above; or (3) a corporation, partnership, trust, or estate more than 35 percent of which is actually or constructively controlled by persons described in (1) or (2) above. For purposes of this Section, a member of an individual's family includes his or her spouse, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren, as well as the individual's brothers and sisters, by whole or half blood, and their spouses.**

Comment: This provision should be used only if the corporation is organized as a supporting organization described in IRC §509(a)(3). See Treas Reg §1.509(a)-4(f)(2).

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§7.110 V. Form: Certificate of Secretary

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CERTIFICATE OF SECRETARY

I certify that I am the duly elected and acting Secretary of _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious*]_ _ **corporation; that these bylaws, consisting of** _ _[*number*]_ _ **pages, are the bylaws of this corporation as adopted by the board of directors on** _ _[*date*]_ _**; and that these bylaws have not been amended or modified since that date.**

Executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

__[*Signature*]__
_ _[*Typed name*]_ _
Secretary

Comment: This certificate is prima facie evidence of adoption of the bylaws. Corp C §§5215, 7215, 9215.

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V. BYLAW AMENDMENTS

§7.111 A. Prohibited Amendments

Bylaws may not be amended to include any provision that conflicts with law or with the corporation's articles. Corp C §§5151(c), 7151(c), 9151(c). For example, in a religious corporation, a bylaw amendment purporting to authorize irrevocable proxies would be ineffective because such proxies are prohibited by Corp C §9417(d). For matters that can be dealt with only in the articles, not the bylaws, see §6.4.

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B. Required Approvals to Amendment

§7.112 1. Board of Directors' Approval

Except for certain matters discussed in §§7.111-7.115, the bylaws may ordinarily be amended or repealed by the board without action by the members. Corp C §§5150(a), 7150(a), 9150(b). For public benefit corporations, the board may act alone unless the action would materially and adversely affect the rights of members as to voting or transfer. Corp C §5150(a). For mutual benefit corporations, the board may act alone unless the action would materially and adversely affect the rights of members as to voting, dissolution, redemption, or transfer; increase or decrease the number of members authorized in total or for any class; effect an exchange, reclassification, or cancellation of all or part of the memberships; or authorize a new class of membership. Corp C §7150(a).

Board action ordinarily requires a majority vote of the directors present at a meeting at which a quorum is present. Corp C §§5211(a)(8), 7211(a)(8), 9211(a)(8); see §9.79. The articles or bylaws of a particular corporation, however, may set higher voting requirements or otherwise restrict or eliminate the board's power to adopt, amend, or repeal the bylaws. Corp C §§5150(c), 7150(c), 9150(b). Amending or repealing a provision in the articles or bylaws requires approval by the specified larger proportion of the board unless the bylaws provide otherwise. Corp C §§5151(e), 7151(e), 9151(e). The bylaws may also provide that repeal or amendment of any bylaw may occur only with the written approval of a specified person other than the board or the members. Corp C §§5150(d), 7150(d), 9132(b)(4), 9150(b), 9151(c)(1). However, unless the bylaws specify otherwise, this approval requirement does not apply if the specified person has died or if the office or status that created the right or entitlement has ceased to exist. Corp C §§5150(d)(1)-(2), 7150(d)(1)-(2).

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§7.113 2. Members' Approval

The bylaws may be adopted, amended, or repealed by approval of the members. Corp C §§5150(b), 7150(b), 9150(b). "Approved by the members" usually means approval by a majority of the members' votes represented and voting. Corp C §5034.

The following types of bylaw changes require membership approval (if the corporation has members):

- **Number of directors.** A bylaw amendment specifying or changing a fixed number of directors, or changing from a fixed to a variable number of directors or vice versa, requires membership approval if members have been admitted. Corp C §§5151(b), 7151(b), 9151(b). In religious corporations, the members' right to vote on these matters can be eliminated by a provision in the articles or bylaws. Corp C §9151(b).
- **Membership approval requirements.** A bylaw requiring that approval by the members or a class of members be unanimous or by a greater proportion than that required by law can be altered, amended, or repealed only by the specified vote, unless the bylaws provide otherwise. Corp C §§5151(e), 7151(e), 9151(e).
- **Increase in directors' terms.** In public benefit and mutual benefit corporations, a bylaw amendment increasing the length of directors' terms requires membership approval. Corp C §§5220(a), 7220(a). There is no similar requirement for religious corporations.
- **Selection of designated directors.** In public benefit and mutual benefit corporations, a bylaw providing for selection of directors by designation (see §7.55) can be adopted, amended, or repealed only with membership approval. Corp C §§5220(d), 7220(d). There is no similar requirement for religious corporations.
- **Replacement of removed directors.** In public benefit and mutual benefit corporations, a bylaw amendment authorizing the board to fill vacancies created by the removal of directors (see §§7.67-7.68) requires membership approval. Corp C §§5224(a), 7224(a). There is no similar requirement for religious corporations.
- **Members' voting rights.** In public benefit and mutual benefit corporations, membership approval is required for any bylaw amendment that would change the number necessary for a quorum at membership meetings (Corp C §§5512, 7512), create or change proxy rights (Corp C §§5613(e), 7613(f)), or change or repeal cumulative voting rights (Corp C §§5616, 7615). There are no similar requirements for religious corporations.
- **Termination of all memberships (public benefit corporations).** An amendment of a public benefit corporation's bylaws that would terminate all memberships or any class of memberships requires membership approval and is subject to special procedures. Corp C §5342. These is no similar requirement for mutual benefit or religious corporations.
- **Other amendments.** The corporation's articles or bylaws may require membership approval of any bylaw amendment. Corp C §§5150(c), 7150(c), 9150(c).

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§7.114 3. Class Approval: Public Benefit and Mutual Benefit Corporations

In public benefit and mutual benefit corporations, certain bylaw amendments may require not only board and membership approval but also approval of one or more classes of members. Corp C §§5150(b), 7150(b). For definition of "class," see Corp C §5041. See also §10.9.

Class approval is required if a proposed bylaw amendment (or repeal) would materially and adversely affect the rights of that class on voting or transfer in a manner different from the way it affects another class. Corp C §§5150(b), 7150(b)(1).

EXAMPLE: A public benefit corporation might classify its members, according to the size of their contributions, as associate members, junior members, and senior members, with the associate members authorized to elect two of the corporation's 12 directors, the junior members four, and the senior members six. A proposed bylaw amendment that increases the number of directors elected by junior or senior members, while leaving the number elected by associate members unchanged, would require approval of the associate members.

Mutual benefit corporations. Class approval is specifically required of any bylaw amendment (or repeal) that would (Corp C §7150(b)(2)-(6)):

- Materially and adversely affect the voting, dissolution, redemption, or transfer rights of the class by changing the rights, privileges, preferences, restrictions, or conditions of another class;
- Increase or decrease the number of memberships authorized for the class;
- Increase the number of memberships authorized for another class;
- Exchange, reclassify, or cancel any memberships of the class; or
- Authorize a new class of memberships.

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§7.115 4. Other Approvals

In corporations with bylaws entitling specified persons to designate directors (see §7.55), the bylaws may require the specified persons' approval of any change in those bylaws. Corp C §§5150(d), 5220(d), 7150(d), 9132(b)(4), 9151(c). However, unless the bylaws specify otherwise, this approval requirement does not apply if the specified person has died or if the office or status that created the right or entitlement has ceased to exist. Corp C §§5150(d)(1)-(2), 7150(d)(1)-(2).

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§7.116 C. Records of Bylaws and Amendments

Every California nonprofit corporation is required to keep a current copy of its bylaws at its principal California office. Corp C §§5160, 7160, 9160. A copy of the bylaws should be kept up to date by filing copies of amendments as they are adopted by resolutions of the board or members. If a significant number of bylaws have been amended or if an amendment is significant (*e.g.,* changing from a nonmembership structure to membership), the bylaws should be restated altogether.

Submitting copies of amendments to IRS and FTB. As with amendments to the articles of incorporation (see §6.41), amendments to the bylaws must be reported to the IRS and the Franchise Tax Board (FTB). The amended documents can be attached to the annual information returns (IRS Form 990 and FTB Form 199). Alternatively, the amended documents can be sent to the IRS and the FTB directly. The current address for submitting copies of the documents to the IRS can be found in the FAQs of the IRS website at http://www.irs.gov/charities. The current address for submitting copies to the FTB is: Exempt Organizations Unit, MS F120, Franchise Tax Board, P.O. Box 1286, Rancho Cordova, CA 95741. The IRS will acknowledge receipt of the amended documents, but will not make a determination on the effect of the changes on the corporation's exempt status. If the changes are material, the corporation will need to submit a formal request for a ruling pursuant to Rev Proc 2009-4, 2009-1 Int Rev Bull 118.

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D. Amendments to Bylaws

§7.117 1. Form: Amendment by Board Subject to Limitation by Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.117-7.122.

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[*Add one of the following alternatives*]

[*Alternative 1: Public benefit corporations*]

Board Amendment of Bylaws. **Subject to the members' rights under Section _ _[*number*]_ _ of these bylaws and the limitations set forth below, the board may adopt, amend, or repeal bylaws unless doing so would materially and adversely affect the members' rights as to voting or transfer. The board may not extend a director's term beyond that for which the director was elected.**

[*Alternative 2: Mutual benefit corporations*]

Board Amendment of Bylaws**. Subject to the members' rights under Sections _ _[*numbers*]_ _ of these bylaws, the board may adopt, amend, or repeal bylaws unless doing so would**

(1) Materially and adversely affect the members' rights as to voting, dissolution, redemption, or transfer;

(2) Increase or decrease the number of members authorized in total or for any class;

(3) Effect an exchange, reclassification, or cancellation of all or part of the memberships; or

(4) Authorize a new class of membership.

Comment: See Corp C §§5150, 5220(a), 7150. The board's power may be restricted or eliminated, subject to Corp C §7151(e). See §§7.51-7.52.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.118 a. Form: Changes to Number of Directors

§7.118 a. Form: Changes to Number of Directors

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.117-7.122.

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Changes to Number of Directors. **Once members have been admitted to the corporation, the board may not, without the members' approval, specify or change any bylaw that would**

(1) Fix or change the authorized number of directors;

(2) Fix or change the minimum or maximum number of directors; or

(3) Change from a fixed number of directors to a variable number of directors or vice versa.

Comment: See Corp C §§5150, 5151(b), 7150, 7151(b). If the articles or bylaws provide for a variable number of directors within specified limits, the directors may, subject to the other limitations of this section, adopt, amend, or repeal a bylaw fixing the exact number of directors within those limits. For discussion of amending bylaws, see §§7.117-7.121. There are no similar provisions for religious corporations. See §7.122.

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§7.119 b. Form: Greater Vote Requirement

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***Amending Supermajority Requirements*. If any provision of these bylaws requires the vote of a larger proportion of the board than is otherwise required by law, that provision may not be altered, amended, or repealed except by that greater vote.**

Comment: See Corp C §§5151(e), 7151(e). This public benefit and mutual benefit corporation bylaw may be varied. There are no similar provisions for religious corporations. See §7.122.

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§7.120 c. Form: Members' Approval Required

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***When Members' Approval Required*. Without the approval of the members, the board may not adopt, amend, or repeal any bylaw that would**

(1) Increase or extend the terms of directors;

(2) Allow any director to hold office by designation or selection rather than by election by the members;

(3) Increase the quorum for members' meetings;

(4) Repeal, restrict, create, expand, or otherwise change proxy rights; or

(5) Authorize cumulative voting.

Comment: See Corp C §§5220(a), (d), 5512(a), 5613(e), 5616(a), 7220(a), (d), 7512(a), 7613(f)(1), 7615(a).

The articles or bylaws of public benefit and mutual benefit corporations may restrict or eliminate the board's power to adopt, amend, or repeal bylaws, subject to any provision requiring the vote of a larger proportion of directors. See Corp C §§5150(c), 5151(e), 7150(c), 7151(e). The bylaws may provide that the repeal or amendment of the bylaws, or the repeal or amendment of specified portions of the bylaws, may occur only with the approval in writing of a specified person or persons other than the board or the members. Corp C §§5150(d), 7150(d). However, unless the bylaws specify otherwise, this approval requirement does not apply if the specified person has died or if the office or status that created the right or entitlement has ceased to exist. Corp C §§5150(d)(1)-(2), 7150(d)(1)-(2).

There are no similar provisions for religious corporations. See §7.122.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.121 2. Form: Amendment by Members

§7.121 2. Form: Amendment by Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.117-7.122.

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[Add one of the following alternatives]

[Alternative 1: Public benefit corporations]

Members May Adopt, Amend, or Repeal Bylaws. **New bylaws may be adopted, or these bylaws may be amended or repealed, by approval of the members, provided, however, that if the corporation has more than one class of voting members, any amendment that would materially and adversely affect the rights of a class as to voting or transfer, in a manner different from how the action affects another class, must be approved by the members of that adversely affected class. Any provision of these bylaws that requires the vote of a larger proportion of the members than otherwise is required by law may not be altered, amended, or repealed except by the vote of that greater number. No amendment may extend the term of a director beyond that for which the director was elected.**

[*If applicable, add the following option to Alternative 1*]

[*Option: Designation of directors*]

Any provision of these bylaws providing for the designation or selection, rather than election, of any director or directors may be adopted, amended, or repealed only by approval of the members, subject to the consent of the person or persons entitled to designate or select any such directors.

[Alternative 2: Mutual benefit corporations]

Members May Adopt, Amend, or Repeal Bylaws**. New bylaws may be adopted or these bylaws may be amended or repealed by approval of the members, provided, however, that any such adoption, amendment, or repeal also requires approval by the members of a class if that action would**

(1) Materially and adversely affect the rights, privileges, preferences, restrictions, or conditions of that class as to voting, dissolution, redemption, or transfer in a manner different than the action affects another class;

(2) Materially and adversely affect that class as to voting, dissolution, redemption, or transfer by changing the rights, privileges, preferences, restrictions, or conditions of another class;

(3) Increase or decrease the number of memberships authorized for that class;

(4) Increase the number of memberships authorized for another class;

(5) Effect an exchange, reclassification, or cancellation of all or part of the memberships of that class; or

(6) Authorize a new class of memberships.

Any provision of these bylaws that requires the vote of a larger proportion of the members than otherwise is required by law may not be altered, amended, or repealed except by vote of that greater number. No amendment may extend a director's term beyond that for which the director was elected.

Any provision of these bylaws providing for the designation or selection, rather than election, of any director or directors may be adopted, amended, or repealed only by approval of the members, subject to the consent of the person or persons entitled to designate or select any such directors.

Comment: See Corp C §§5150, 5220(d), 7150, 7220(d). There is no similar requirement for religious corporations. See §7.122.

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§7.122 3. Form: Amendments to Religious Corporation's Bylaws

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Adoption, Amendment, or Repeal of Bylaws. **Bylaws may be adopted, amended, or repealed by approval of the members or the board, except that**

(1) Once members have been admitted, a bylaw specifying or changing a fixed number of directors or the maximum or minimum number or changing from a fixed to a variable board or vice versa may only be adopted by approval of the members; and

(2) Any bylaw that requires the vote of a larger proportion of, or all of, the members or the members of any class, unit, or grouping of members, or the vote of a larger proportion of, or all of, the directors than is otherwise required by the California Nonprofit Religious Corporation Law, shall not be altered, amended, or repealed except by that greater vote.

Comment: Other provisions for adopting, amending, or repealing bylaws may be used. The requirements of this section are those that would apply in the absence of any provision in the articles or bylaws. Corp C §§9150-9151. For discussion of amending bylaws, see §§7.117-7.122.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ VI. BYLAWS FOR PUBLIC BENEFIT CORPORATION WITHOUT MEMBERS/§7.123 A. Form: Heading; Principal Office

VI. BYLAWS FOR PUBLIC BENEFIT CORPORATION WITHOUT MEMBERS

§7.123 A. Form: Heading; Principal Office

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BYLAWS OF

_ _[*NAME OF CORPORATION*]_ _**, A California Nonprofit Public Benefit Corporation**

ARTICLE 1: OFFICES

Section 1.1 Principal Office

The principal office for the transaction of the business of the Corporation shall be located at _ _[*street address and city*]_ _**, in _ _**[*name*]_ _ **County, California. The Directors may change the principal office from one location to another, and this section shall be amended accordingly.**

Section 1.2 Other Offices

The Board of Directors may at any time establish branch offices, either within or outside the State of California, in order to advance the proper purposes of the Corporation.

Comment: For discussion of corporate names, see §§5.4-5.8.

The street address of the principal office in California must be stated in the biennial statement filed with the California Secretary of State. The corporation's mailing address must also be included if different from the street address of the principal executive office, or if the corporation does not have a principal office in California. Corp C §6210(a).

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§7.124 B. Form: Objectives and Purposes

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ARTICLE 2: OBJECTIVES AND PURPOSES

This Corporation has been formed under the California Nonprofit Public Benefit Corporation Law for the purposes stated in the Articles of Incorporation.

Comment: Even though the purposes are stated in the articles (see §6.2; see also forms in §§6.10, 6.18, 6.25), they may be set forth again in the bylaws as a reminder to the directors. However, counsel should caution the corporation that changes to the purposes clause in the bylaws are not effective unless the changes are consistent with the purposes stated in the articles of incorporation. Federal and state tax considerations, such as seeking tax-exempt status, may affect the statement of purposes. Certain limitations must be set forth in the articles if the corporation wishes to be a tax-exempt organization. See §6.5.

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§7.125 C. Form: Dedication of Assets

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ARTICLE 3: DEDICATION OF ASSETS

The properties and assets of this nonprofit Corporation are irrevocably dedicated to public benefit and/or charitable purposes. No part of the net earnings, properties, or assets of this Corporation, on dissolution or otherwise, shall inure to the benefit of any private person or individual, or any Director or Officer of this Corporation. On liquidation or dissolution, all properties and assets remaining after payment, or provision for payment, of all debts and liabilities of this Corporation shall be distributed to a nonprofit fund, foundation, or corporation which is organized and operated exclusively for charitable purposes and which has established its exempt status under Internal Revenue Code §501(c)(3).

Comment: This provision should be included only if there is a specific concern about private benefit and the drafter feels that the board would benefit from having the reminder in the bylaws. Otherwise, such language is stated only in the articles of incorporation. This provision should be omitted if the corporation is not intended to operate as described in IRC §501(c)(3).

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D. Directors

§7.126 1. Form: General and Specific Powers of Directors

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ARTICLE 4: DIRECTORS

Section 4.1 Powers

(a) *General Corporate Powers*. The business and affairs of the Corporation shall be managed, and all corporate powers shall be exercised, by or under the direction of the Board of Directors.

(b) *Specific Powers*. Without prejudice to their general powers, the Directors shall have the power to:

(i) Select and remove the Officers of the Corporation; prescribe any powers and duties for them that are consistent with the law, with the Articles of Incorporation, and with these Bylaws; and fix their compensation, if any.

(ii) Change the principal executive office or the principal business office in the State of California from one location to another; cause the Corporation to be qualified to do business in any other state, territory, dependency, or country, and conduct business within or outside the State of California; and designate any place within or outside the State of California for the holding of any meeting.

(iii) Adopt, make, and use a corporate seal and alter the form of the seal.

(iv) Borrow money and incur indebtedness on behalf of the Corporation and cause to be executed and delivered for the Corporation's purposes, in the Corporate name, promissory notes, bonds, debentures, deeds of trust, mortgages, pledges, hypothecations, and other evidences of debt.

Comment: See Corp C §§5140, 5210. See also §§9.2-9.3.

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§7.127 2. Form: Number of Directors

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Section 4.2 Number of Directors

The number of Directors shall be not less than _ _[*number*]_ _ nor more than _ _[*number*]_ _, with the exact authorized number of Directors to be determined by the Board from time to time.

Comment: See Corp C §5151. The corporation must have at least one director, but there is no maximum number. As a practical matter, counsel should consider recommending a minimum of three directors for a nonprofit that is intended to be exempt under IRC §5101(c)(3), because the IRS often insists on at least three. The bylaws may set forth a method of determining the number of directors or may require that the number of directors be within a stated minimum and maximum, with the exact number to be fixed by the board or the members. See §9.15.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.128 3. Form: Appointment and Term of Office of Directors

§7.128 3. Form: Appointment and Term of Office of Directors

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Section 4.3 Appointment and Term of Office of Directors

(a) The members of the Board of Directors as of the initial meeting of the Board shall be those persons whose names are attached to these Bylaws as Exhibit A.

[Add one of the following alternatives]

[Alternative 1: Initial directors serve until annual meeting; subsequent election by directors]

Initial members of the Board of Directors shall each serve until the later of the date of Annual Meeting designated beside his or her name in Exhibit A, or the date his or her successor is elected. Subsequent Directors shall be elected by a majority vote of the Directors at each annual meeting, including the vote(s) of any Director whose term of office expires with that meeting.

[Alternative 2: Individual designator]

Until the death of _ _[*name*]_ _, he or she shall be entitled to designate _ _[all/*number*]_ _ of the Directors of this Corporation, each to serve for a term of _ _[*number*]_ _ years. Thereafter, subsequent Directors shall be elected by a majority vote of the Directors at each annual meeting, including the vote(s) of any Director whose term of office expires with that meeting. All Directors shall serve terms of three years, arranged so that not more than one-third plus one of the Directors' terms shall expire in any year. Directors may serve any number of consecutive terms.

[*Alternative 3: Corporate designator*]

Until its dissolution or liquidation, _ _[*name*]_ _ shall be entitled to designate_ _[all/*number*]_ _ of the Directors of this Corporation, each to serve for a term of _ _[*number*]_ _ years. All Directors shall serve terms of 3 years, arranged so that not more than one-third plus one of the Directors' terms shall expire in any year. Directors may serve any number of consecutive terms.

[Continue]

(b) The Chair of the Board shall be selected by a majority vote of the Directors following the appointment or election of Directors at each annual meeting.

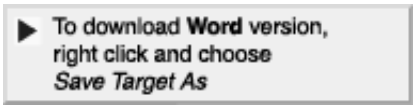
Comment: In the case of public benefit corporations without members, and except for directors who hold office by designation, directors may be elected for the terms stated in the articles or bylaws, but not longer than 6 years. Corp C §5220. In the absence of a specific provision in the articles or bylaws, the default term is 1 year. Corp C §5220(a).

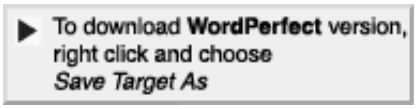
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.129 4. Form: Qualifications of Board Members

§7.129 4. Form: Qualifications of Board Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.123-7.171.





Section 4.4 Qualifications of Board Members

Any person 18 years of age or older may be nominated or elected to serve as a Director. Directors need not be residents of the State of California. _ _[*Add any other qualification.*]_ _

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§7.130 5. Form: Vacancies

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Section 4.5 Vacancies

(a) *Events Causing Vacancy*. A vacancy on the Board of Directors shall be deemed to exist at the occurrence of any of the following:

(i) The death, resignation, or removal of any Director.

(ii) The declaration by resolution of the Board of Directors of a vacancy in the office of a Director who has been declared of unsound mind by court order or convicted of a felony, or who has been found by final order or judgment of any court to have breached a duty under Corporation Code §5231 and following of the California Nonprofit Corporation Law.

[*Add one of the following alternatives*]

[*Alternative 1: Failure by board to elect or appoint*]

(iii) The failure of the Board, at any meeting of the Board at which any Director(s) is to be appointed or elected, to appoint or elect the Director(s) to be appointed or elected at that meeting pursuant to the provisions of Section 4.3(a).

[*Alternative 2: Failure by designator to elect or appoint*]

(iii) The failure of the designator to appoint or elect any Director(s) pursuant to the provisions of Section 4.3(a).

[*Continue*]

(iv) The increase of the authorized number of Directors.

(b) *Resignation*. Except as provided in this paragraph, any Director may resign, which resignation shall be effective upon receipt of written notice by the Chair of the Board, the President, or the Secretary, unless the notice specifies a later effective date for the resignation. No Director may resign when the Corporation would then be left without a duly elected Director or Directors in charge of its affairs.

(c) *Removal.*

(i) Any Director may be removed, with or without cause, by the vote of the majority of the members of the entire Board of Directors at a special meeting called for that purpose, or at a regular meeting, provided notice of that meeting and of the removal questions are given as provided in Section 4.9. Any vacancy caused by the removal of a Director shall be filled as provided in Section 4.5. _ _[*If appropriate, add language regarding designator name.*]**_ _**

(ii) Any Director who does not attend three successive Board meetings will automatically be removed from the Board without Board resolution unless:

(A) The Director requests a leave of absence for a limited period of time, and the leave is approved by the Directors at a regular or special meeting. If such leave is granted, the number of Board members will be reduced by one in determining whether a quorum is or is not present.

(B) The Director suffers from an illness or disability which prevents him or her from attending meetings

and the Board by resolution waives the automatic removal procedure of this subsection (ii).

(C) The Board by resolution of the majority of Board members agrees to reinstate the Director who has missed three meetings.

(d) *Filling of Vacancies*. Any vacancy caused by the death, resignation, or removal of a Director shall be filled in accordance with the provisions of Section 4.3(a).

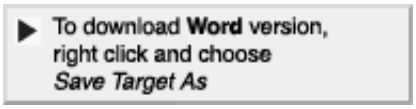
Comment: See Corp C §§5221-5222, 5224. Provisions on cumulative voting should be included if the corporation allows cumulative voting. See §7.34. The bylaws may also provide that a director's failure to attend a specified number of board meetings is cause for removal. Moreover, if the articles or bylaws prescribe qualifications of directors, the board, by a majority vote of the directors who meet all qualifications to be a director, may declare vacant the office of any director who fails or ceases to meet any required qualification that was in effect at the beginning of that director's current term of office. See Corp C §§5221(b), 7221(b), 9221(b). In certain situations officers, directors, or the Attorney General may sue to remove a director. See Corp C §§5223, 7223, 9223. See §§9.47-9.53.

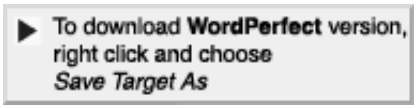
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.131 6. Form: Place of Meeting; Meeting by Telephone or Other Telecommunications Equipment

§7.131 6. Form: Place of Meeting; Meeting by Telephone or Other Telecommunications Equipment

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.123-7.171.





Section 4.6 Place of Meeting; Meeting by Telephone

Regular meetings of the Board of Directors may be held at any place within or outside the State of California, as designated from time to time by resolution of the Board. In the absence of such designation, regular meetings shall be held at the principal office of the Corporation. Special meetings of the Board shall be held at any place within or outside of the State of California, as designated in the notice of meeting or, if not stated in the notice or if there is no notice, at the principal office of the Corporation. Notwithstanding the above provisions of this Section 4.6, a regular or special meeting of the Board of Directors may be held at any place consented to in writing by all Board members, either before or after the meeting. Directors may participate in a meeting through use of conference telephone, electronic video screen communication, or similar communications equipment, so long as all of the following apply: (a) each Board member participating in the meeting can communicate with all the other members concurrently; (b) each member is provided the means of participating in all matters before the board, including the capacity to propose, or to interpose an objection to, a specific action to be taken by the corporation; and (c) the corporation adopts and implements means of verifying both of the following: (i) a person communicating by telephone, electronic video equipment, or other communications equipment is a director entitled to participate in the board meeting; and (ii) all statements, questions, actions, or votes were made by that director and not by another person not permitted to participate as a director. Participation in a meeting pursuant to this bylaw shall constitute presence in person at such meeting.

Comment: See Corp C §5211(a)(5). The wording of this provision may be varied. With respect to the provisions for meeting by telecommunication equipment, the statutory provisions are default provisions that apply unless the articles or bylaws provide otherwise. See Corp C §§5211(a)(6); see also Corp C §§20-21.

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§7.132 7. Form: Annual Meeting

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Section 4.7 Annual Meeting

The Board of Directors shall hold a meeting _ _[*e.g., at least once a year/*_ _[*date*]_ _ *of each year*]_ _ at a time and place designated by the Board of Directors for purposes of electing officers, designating committees, and transacting regular business. Notice of these meetings shall be in accordance with Section 4.9.

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§7.133 8. Form: Special Meetings

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Section 4.8 Special Meetings

Special meetings of the Board of Directors for any purpose may be called at any time by the Chair of the Board, the President, or any two Directors. Notice of these meetings shall be in accordance with Section 4.9.

Comment: See Corp C §5211(a)(1). This provision reflects the statutory language, which may be changed by the articles or bylaws.

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§7.134 9. Form: Notice of Meetings

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Section 4.9 Notice

Notice of any meeting of the Board of Directors shall be given to all Directors at least 4 days in advance if given by first-class mail or at least 48 hours in advance if given by notice delivered personally, by telephone, or by electronic transmission in compliance with Section 15.2 of these Bylaws, provided that such notice may be waived by any Director as set forth in Section 4.10. Notice shall not be given by electronic transmission if the corporation is unable to deliver two consecutive notices to a Director by that means, or if the inability to deliver the notice becomes known to the Secretary or other person responsible for giving such notice.

Comment: See Corp C §§5015, 5211(a)(2). The wording of these provisions may be varied, but they may not omit giving notice of special meetings. See §9.68.

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§7.135 10. Form: Waiver of Notice

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Section 4.10 Waiver of Notice

The transactions of any meeting of the Board of Directors, however called and noticed and wherever held, shall be as valid as though taken at a meeting duly held after regular call and notice if (a) a quorum is present and (b) either before or after the meeting, each of the Directors not present signs a written waiver of notice, a consent to holding of the meeting, or an approval of the minutes. The waiver of notice or consent need not specify the purpose of the meeting. All waivers, consents, and approvals shall be filed with the corporate records or made a part of the minutes of the meeting. Notice of a meeting shall also be deemed given to any Director who attends the meeting without protesting before or at its commencement about lack of adequate notice.

Comment: See Corp C §5211(a)(2)-(3). For discussion, see §9.74-9.76.

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§7.136 11. Form: Quorum

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Section 4.11 Quorum

A majority of the Board of Directors shall constitute a quorum for the transaction of business, except to adjourn as provided in Section 4.12. Every act or decision done or made by a majority of the Directors present at a meeting held at which a quorum is present shall be regarded as the act of the Board of Directors, subject to the provisions of the California Nonprofit Corporation Law. A meeting at which a quorum is initially present may continue to transact business, notwithstanding the withdrawal of any Director, if any action taken is approved by at least a majority of the quorum required for the meeting.

Comment: See Corp C §§5211(a)(7)-(8), 5212, 5234, 5236, 5238. The wording of this provision may be varied. Neither the articles nor the bylaws may provide for a quorum of less than one-fifth the authorized number of directors or less than two, whichever is larger, unless the authorized number is one, in which case one director constitutes a quorum. See §§9.79, 9.81.

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§7.137 12. Form: Adjournment

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Section 4.12 Adjournment

A majority of the Directors present, whether or not constituting a quorum, may adjourn any meeting to another time and place.

Comment: See Corp C §5211(a)(4).

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§7.138 13. Form: Notice of Adjournment

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Section 4.13 Notice of Adjournment

Notice of the time and place of holding an adjourned meeting need not be given, unless the meeting is adjourned for more than 24 hours, in which case notice of the time and place shall be given before the time of the adjourned meeting to the Directors who were not present at the time of the adjournment. This notice may be waived in the same manner as set forth under Section 4.10.

Comment: See Corp C §5211(a)(4). The articles or bylaws may vary this provision.

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§7.139 14. Form: Action Without Meeting

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Section 4.14 Action Without Meeting

Any action required or permitted to be taken by the Board of Directors may be taken without a meeting if all members of the Board, individually or collectively, consent in writing to that action. Such action by written consent shall have the same force and effect as a unanimous vote of the Board of Directors. Such written consent or consents shall be filed with the minutes of the proceedings of the Board.

Comment: See Corp C §5211(b). Listed in Corp C §5233 are several situations in which a director of a public benefit corporation who has a financial interest is nevertheless not an "interested director" and whose vote is therefore counted.

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§7.140 15. Form: Compensation of Directors

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Section 4.15 Compensation of Directors

The Board may authorize the advance or reimbursement of actual reasonable expenses incurred by a director or member of a committee in carrying out his or her duties.

[*If appropriate, add*]

[*Alternative 1: No other compensation*]

Directors shall not otherwise be compensated.

[*Alternative 2: Board may authorize reasonable compensation*]

The Board also may authorize the payment to a director of reasonable compensation for services as a director.

Comment: See Corp C §5235(a). Although the Nonprofit Mutual Benefit Corporation Law does not explicitly refer to compensation of directors, the Nonprofit Public Benefit Corporation Law does.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.141 16. Form: Restriction on Interested Directors

§7.141 16. Form: Restriction on Interested Directors

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Section 4.16 Restriction on Interested Directors

Not more than 49 percent of the persons serving on the Board of Directors at any time may be interested persons. An interested person is (a) any person compensated by the Corporation for services rendered to it within the previous 12 months, whether as a full-time or part-time employee, independent contractor, or otherwise; (b) any shareholder, employee or officer of any corporation, or partner or employee of any partnership, which has rendered compensated services to the Corporation within the previous 12 months; and (c) any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, mother-in-law, or father-in-law of any person described in (a) or (b) of these Bylaws. Any violation of the provisions of this paragraph shall not, however, affect the validity or enforceability of any transaction entered into by the Corporation.

Comment: The 49-percent limitation is required by law. Corp C §5227. A corporation could adopt a lower limit but that is not recommended and would tend to confuse board members who are aware of the statutory limit.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ E. Committees/§7.142 1. Form: Creation and Powers of Committees

E. Committees

§7.142 1. Form: Creation and Powers of Committees

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ARTICLE 5: COMMITTEES

Section 5.1 Committees of Directors

The Board of Directors may, by resolution adopted by a majority of the Directors then in office, designate one or more committees consisting of two or more Directors, and only of directors, to serve at the pleasure of the Board. Any member of any committee may be removed, with or without cause, at any time by the Board. Any committee, to the extent provided in the resolution of the Board, shall have all or a portion of the authority of the Board, except that no committee, regardless of the Board resolution, may:

(a) Fill vacancies on the Board of Directors or on any committee;

(b) Amend or repeal the Articles of Incorporation or Bylaws or adopt new Bylaws;

(c) Amend or repeal any resolution of the Board;

(d) Designate any other committee of the Board or appoint the members of any committee;

(e) Approve any transaction (i) to which the Corporation is a party and as to which one or more Directors has a material financial interest, or (ii) between the Corporation and one or more of its Directors or between the Corporation and any corpora\tion or firm in which one or more of its Directors has a material financial interest.

Comment: See Corp C §5212. For discussion of board committees, see §9.5-9.10. It is generally preferable to address only committees of the board in the bylaws. Advisory committees (see §9.6) should instead be established and dissolved by board action.

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§7.143 2. Form: Executive Committee

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Section 5.2 Executive Committee

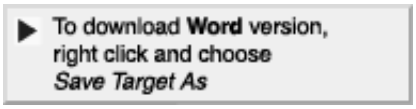
Pursuant to Section 6.1, the Board may appoint 2 or more Directors and the Chair of the Board of the Corporation, to serve as the Executive Committee of the Board. The Chair of the Board shall serve as chair of the Executive Committee. The Executive Committee, unless limited by a resolution of the Board, shall have and may exercise all the authority of the Board in the management of the business and affairs of the Corporation between meetings of the Board; provided, however, that the Executive Committee shall not have the authority of the Board in reference to those matters enumerated in Section 5.1.

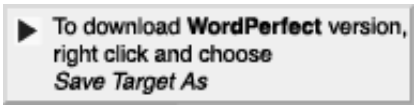
Comment: The corporation is not required to have an executive committee; however, most nonprofits with any substantial amount of day-to-day activity use an executive committee of the board to provide more frequent board oversight and assistance to the officers. On executive committees, see §§9.5-9.10.

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§7.144 3. Form: Compensation Committee

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Section 5.3 Compensation Committee and Compensation Review

At any time this Corporation compensates its President or Treasurer, the Corporation shall have a Compensation Committee consisting of at least three Directors and exclusively of Directors. Directors who are also employees of the Corporation may not serve on the Compensation Committee. The Compensation Committee shall review the compensation of the President, Treasurer, Vice President (if any) and Chief Investment Officer (if any), as well as of such other Officers of the Corporation as the Compensation Committee determines appropriate. This review shall occur when such officer is hired, when the term of employment of such officer is renewed or extended, and when the compensation of such officer is modified, unless the modification applies to substantially all of the employees of this corporation. Based on its review, the Compensation Committee shall recommend just and reasonable compensation amounts to the Board. At the request of the President or the Board, the Compensation Committee shall review any issue involving staff compensation and benefits, including but not limited to housing, health, and retirement plans.

Comment: Compensation review requirements in the Government Code apply to all nonprofit public benefit corporations. However, these requirements do not supersede the existing fiduciary duties of officers, directors, and trustees in managing charitable organizations. The board members have a continuing duty to pay compensation to officers and directors that does not exceed what is fair and reasonable to the organization, and they may incur personal liability for paying excessive compensation. Therefore, the payment of excessive compensation at any time is a violation of the law. Corp C §5235; Govt C §12586(g).

If a staff member actually performs the duties and functions of a president or CEO or a treasurer or CFO, a charity may not avoid the compensation review required by giving that person a different job title. See 11 Cal Code Regs §312.1. The board may delegate the review obligations to a compensation committee; if it does, these duties of the compensation committee should be set forth in the bylaws.

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§7.145 4. Form: Advisory Committees

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Section 5.4 Advisory Committees

The Board may establish one or more Advisory Committees to the Board. The members of any Advisory Committee may consist of directors or nondirectors. Advisory committees may not exercise the authority of the Board to make decisions on behalf of the corporation, but shall be limited to making recommendations to the Board or the Board's authorized representatives and to implementing Board decisions and policies. Advisory Committees shall be subject to the supervision and control of the Board.

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§7.146 5. Form: Audit Committee

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Section 5.5 Audit Committee

At all times that this Corporation is required by applicable law to have an independent audit, or at any time the Corporation voluntarily chooses to do so, the Corporation shall have an Audit Committee consisting of at least two Directors and which may include nonvoting advisors. Directors who are employees of the Corporation or who receive, directly or indirectly, any consulting, advisory, or other compensatory fees from the Corporation (other than for service as Director) may not serve on the Audit Committee. The President and Treasurer, if also Directors, may serve on the Audit Committee only if such persons are volunteers and are not compensated by this Corporation. The Audit Committee shall perform the duties and adhere to the guidelines set forth from time to time by the Board. These duties include, but are not limited to: (i) assisting the Board in choosing an independent auditor and recommending termination of the auditor, if necessary, (ii) negotiating the auditor's compensation, (iii) conferring with the auditor regarding the Foundation's financial affairs, and (iv) reviewing and accepting or rejecting the audit. Members of the Audit Committee shall not receive compensation for their service on the Audit Committee in excess of that provided to Directors for their service on the Board. If the Corporation has a Finance Committee, a majority of the members of the Audit Committee may not concurrently serve as members of the Finance Committee, and the Chair of the Audit Committee may not serve on the Finance Committee.

Comment: This form should be included if the corporation is expected to have gross revenues greater than $2 million or to operate in a state that has a lower audit trigger. Some states require charities with revenues as low as $250,000 to obtain audits.

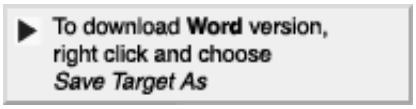
A CEO or CFO of the corporation must be excluded from the Audit Committee whether or not compensated if he or she is "staff." See FAQ No. 13 under "Charities-Nonprofit Integrity Act of 2004" on the California Attorney General's website at http://www.ag.ca.gov/charities/faq.php.

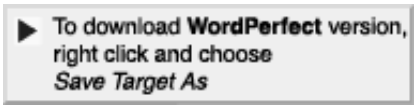
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.147 6. Form: Meeting and Action of Committees

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Section 5.6 Meeting and Action of Committees

The Board of Directors may adopt rules for any committee not inconsistent with the provisions of these Bylaws.

Comment: See Corp C §5211(d).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ F. Officers of the Corporation/§7.148 1. Form: Offices Held

F. Officers of the Corporation

§7.148 1. Form: Offices Held

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ARTICLE 6: OFFICERS

Section 6.1 Officers

The Corporation shall have the following Officers: President, Secretary, and Treasurer, and such other Officers as the Board may designate by resolution and appoint pursuant to Section 6.3. Officers need not be Directors. One person may hold two or more offices, except those of President and Secretary, and President and Treasurer.

Comment: See Corp C §5213(a). For discussion, see §§9.11-9.14.

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§7.149 2. Form: Election of Officers

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Section 6.2 Election of Officers

The Officers of the Corporation, except those appointed in accordance with the provisions of Section 6.3 of this Article, shall be chosen by the Board of Directors, and each shall serve at the pleasure of the Board, subject to the rights, if any, of any Officer under a contract of employment.

Comment: The articles or bylaws may provide for other methods for election of the officers. See Corp C §5213(b). If the articles or bylaws provide for the election of any officers by the members, the term of office of the elected officer will be 1 year unless the articles or bylaws provide for a different term that may not exceed 3 years. Corp C §5213(c).

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.150 3. Form: Subordinate Officers

§7.150 3. Form: Subordinate Officers

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Section 6.3 Subordinate Officers

The Board of Directors may appoint, and may authorize the President or any other Officer to appoint, any other Officers that the business of the Corporation may require, each of whom shall have the title, hold office for the period, have the authority, and perform the duties specified by the Bylaws or determined from time to time by the Board of Directors.

Comment: See Corp C §5213.

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§7.151 4. Form: Removal of Officers

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Section 6.4 Removal of Officers

Subject to rights, if any, under any contract of employment, any Officer may be removed, with or without cause, by the Board of Directors, at any regular or special meeting of the Board, or, except in the case of an Officer chosen by the Board of Directors, by an Officer on whom such power of removal has been conferred by the Board of Directors.

Comment: See Corp C §5213(b).

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§7.152 5. Form: Resignation of Officers

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Section 6.5 Resignation of Officers

Any Officer may resign at any time by giving written notice to the Board of Directors, the President, or the Secretary of the Corporation. Any resignation shall take effect at the date of receipt of that notice or at any later time specified in that notice. Unless otherwise specified in that notice, the acceptance of the resignation shall not be necessary to make it effective. Any resignation shall be without prejudice to the rights, if any, of the Corporation under any contract to which the Officer is a party.

Comment: See Corp C §5213(b).

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§7.153 6. Form: Vacancies in Office

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Section 6.6 Vacancies in Office

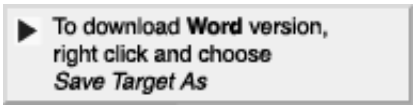
A vacancy in any Office because of death, resignation, removal, disqualification, or any other cause shall be filled only in the manner prescribed in these Bylaws for regular appointments to that Office.

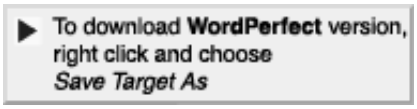
Comment: There are no statutes governing this issue.

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§7.154 7. Form: Responsibilities of Officers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.123-7.171.





Section 6.7 Responsibilities of Officers

(a) *President*. The President shall be the chief executive officer of the Corporation. He or she shall have such other powers and duties as may be prescribed by the Board of Directors or these Bylaws. The President shall be responsible to the Board of Directors, shall see that the Board is advised on all significant matters of the Corporation's business, and shall see that all orders and resolutions of the Board are carried into effect. The President shall be empowered to act, speak for, or otherwise represent the Corporation between meetings of the Board within the boundaries of policies and purposes established by the Board and as set forth in the Articles of Incorporation and these Bylaws. The President shall be responsible for keeping the Board informed at all times of staff performance as related to program objectives, and for implementing any personnel policies adopted by the Board.

(b) *Secretary*. The Secretary shall attend to the following:

(i) *Book of Minutes*. The Secretary shall keep or cause to be kept, at the principal executive office or such other place as the Board of Directors may direct, a book of minutes of all meetings and actions of Directors and committees of Directors, with the time and place of holding regular and special meetings, and if special, how authorized, the notice given, the names of those present at such meetings, and the proceedings of such meetings.

(ii) *Notices and Other Duties*. The Secretary shall give, or cause to be given, notice of all meetings of the Board of Directors required by the Bylaws to be given. The Secretary shall have such other powers and perform such other duties as may be prescribed by the Board of Directors or the Bylaws.

(c) *Treasurer*. The Treasurer shall be the chief financial officer of the Corporation and shall attend to the following:

(i) *Books of Account*. The Treasurer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and records of accounts of the properties and business transactions of the Corporation, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, and other matters customarily included in financial statements. The books of account shall be open to inspection by any Director at all reasonable times.

(ii) *Deposit and Disbursement of Money and Valuables*. The Treasurer shall deposit all money and other valuables in the name and to the credit of the Corporation with such depositors as may be designated by the Board of Directors; shall disburse funds of the Corporation as may be ordered by the Board of Directors; shall render to the President and Directors, whenever they request it, an account of all financial transactions and of the financial condition of the Corporation; and shall have other powers and perform such other duties as may be prescribed by the Board of Directors or the Bylaws.

(iii) *Bond*. If required by the Board of Directors, the Treasurer shall give the Corporation a bond in the amount and with the surety specified by the Board for the faithful performance of the duties of his or her office and for restoration to the Corporation of all its books, papers, vouchers, money, and other property of every kind in his or her possession or under his or her control on his or her death, resignation, retirement, or removal from office.

Comment: See Corp C §5160.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/ G. Records and Reports/§7.155 1. Form: Maintenance of Articles and Bylaws

G. Records and Reports

§7.155 1. Form: Maintenance of Articles and Bylaws

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ARTICLE 7: RECORDS AND REPORTS

Section 7.1 Maintenance of Articles and Bylaws

The Corporation shall keep at its principal executive office the original or a copy of its Articles and Bylaws as amended to date.

Comment: See Corp C §5160.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.156 2. Form: Maintenance of Other Corporate Records

§7.156 2. Form: Maintenance of Other Corporate Records

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Section 7.2 Maintenance of Other Corporate Records

The accounting books, records, and minutes of the proceedings of the Board of Directors and any committee(s) of the Board of Directors shall be kept at such place or places designated by the Board of Directors, or, in the absence of such designation, at the principal executive office of the Corporation. The minutes shall be kept in written or typed form, and the accounting books and records shall be kept in either written or typed form or in any other form capable of being converted into written, typed, or printed form.

Comment: See Corp C §6320.

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§7.157 3. Form: Inspection by Directors

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Section 7.3 Inspection by Directors

Every Director shall have the absolute right at any reasonable time to inspect all books, records, and documents of every kind and the physical properties of the Corporation and each of its subsidiary corporations. This inspection by a Director may be made in person or by an agent or attorney, and the right of inspection includes the right to copy and make extracts of documents.

Comment: See Corp C §§6311-6312, 6334.

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§7.158 4. Form: Annual Report

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Section 7.4 Annual Report

Within 120 days after the end of the Corporation's fiscal year, the President shall furnish or cause to be furnished a written report to all directors containing the following information:

(a) The assets and liabilities, including the trust funds, of the Corporation as of the end of the fiscal year;

(b) The principal changes in assets and liabilities, including trust funds, during the fiscal year;

(c) The revenue or receipts of the Corporation, both unrestricted and restricted for particular purposes, for the fiscal year;

(d) The expenses or disbursements of the Corporation, for both general and restricted purposes, during the fiscal year;

(e) Any transaction during the previous fiscal year involving more than $50,000 in which the Corporation (or its parent or subsidiaries, if any) was a party and in which any director or officer of the Corporation has a direct or indirect financial interest, or any of a number of such transactions in which the same person had a direct or indirect financial interest and which transactions in the aggregate involved more than $50,000; and

(f) The amount and circumstances of any indemnifications or advances aggregating more than $10,000 paid during the fiscal year to any director or officer of the Corporation pursuant to Article 8 of these Bylaws, unless such indemnification has already been approved pursuant to Section 8.1.

For each transaction, the report must disclose the names of the interested persons involved in such transaction and state such person's relationship to the corporation, the nature of such person's interest in the transaction and, where practicable, the value of such interest.

The report shall be accompanied by any report of independent accountants or, if there is no such report, by the certificate of an authorized officer of this Corporation that such statements were prepared without an audit from the books and records of this Corporation. Such report may be furnished to the directors by electronic transmission in accordance with Section 15.2 of these Bylaws.

Comment: See Corp C §6321(d)-(e). For discussion of reports to members and directors generally, see §§12.43-12.87.

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§7.159 5. Form: Financial Audit

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Section 7.5 Financial Audit

The Corporation shall obtain a financial audit for any tax year in which it receives or accrues gross revenue of $2 million or more, excluding grant or contract income from any governmental entity for which the governmental entity requires an accounting. Any audited financial statements obtained by the Corporation, whether or not required by law, shall be made available for inspection by the Attorney General and by the general public within 9 months after the close of the fiscal year to which the statements relate. For 3 years, such statements (a) shall be available at the Corporation's principal, regional, and district offices during regular business hours and (b) shall be made available either by mailing a copy to any person who so requests in person or in writing, or by posting them on the Corporation's website.

Comment: California law requires charities that have gross revenues in excess of $2 million to obtain an audit. Govt C §12586(e). Some states have a lower threshold. If the charity will operate or solicit in other states, counsel should check the applicable audit requirements.

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H. Indemnification of Directors and Officers

§7.160 1. Form: Right to Indemnification

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ARTICLE 8: INDEMNIFICATION OF DIRECTORS AND OFFICERS

Section 8.1 Right to Indemnification

This Corporation shall indemnify any person who was or is a party, or is threatened to be made a party, to any action or proceeding by reason of the fact that such person is or was an Officer, Director, or agent of this Corporation, or is or was serving at the request of this Corporation as a director, officer, employee, or agent of another foreign or domestic corporation, partnership, joint venture, or other enterprise, against expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred in connection with such proceeding, to the fullest extent permitted under the California Nonprofit Corporation Law.

In determining whether indemnification is available to the Director, Officer, or agent of this Corporation under California law, the determination as to whether the applicable standard of conduct set forth in Corporations Code §5238 has been met shall be made by a majority vote of a quorum of Directors who are not parties to the proceeding. If the number of Directors who are not parties to the proceeding is less than two-thirds of the total number of Directors seated at the time the determination is to be made, the determination as to whether the applicable standard of conduct has been met shall be made by the court in which the proceeding is or was pending.

The indemnification provided herein shall not be deemed exclusive of any other rights to which those indemnified may be entitled, and shall continue as to a person who has ceased to be an agent and shall inure to the benefit of the heirs, executors, and administrators of such a person.

Comment: See Corp C §5238. If the corporation will not have a continuing relationship with an attorney, the detailed indemnification requirements in that section should be set forth, rather than merely referred to, in the bylaws. See §§9.156-9.162. See also the indemnification provisions of Lab C §2802 that generally require indemnification of employees.

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§7.161 2. Form: Insurance

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Section 8.2 Insurance

This Corporation shall have the power and shall use its best efforts to purchase and maintain insurance on behalf of any Director, Officer, or agent of the Corporation, against any liability asserted against or incurred by the Director, Officer, or agent in any such capacity or arising out of the Director's, Officer's, or agent's status as such, whether or not the Corporation would have the power to indemnify the agent against such liability under Section 8.1 of these Bylaws; provided, however, that the Corporation shall have no power to purchase and maintain such insurance to indemnify any Director, Officer, or agent of the Corporation for any self-dealing transaction, as described in Corporations Code §5233.

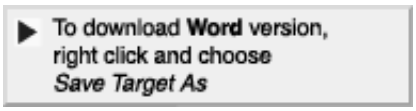
Comment: See Corp C §5238(i). For discussion, see §9.162. In certain circumstances involving nonprofit corporations, a volunteer director may be protected from personal liability for his or her negligence as a director or officer if, among other things, the board has made all reasonable efforts in good faith to obtain liability insurance. See §§9.151-9.155.

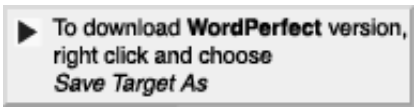
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I. Contracts and Loans With Directors and Officers

§7.162 1. Form: Contracts With Directors and Officers

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ARTICLE 9: CONTRACTS AND LOANS WITH DIRECTORS AND OFFICERS

Section 9.1 Contracts with Directors and Officers

(a) No Director or Officer of this Corporation, nor any other corporation, firm, association, or other entity in which one or more of this Corporation's Directors or Officers are directors or have a material financial interest, shall be interested, directly or indirectly, in any contract or other transaction with this Corporation, unless (i) the material facts regarding such Director's or Officer's financial interest in such contract or transaction and/or regarding such common directorship, officership, or financial interest are fully disclosed in good faith and are noted in the minutes, or are known to all members of the Board prior to consideration by the Board of such contract or transaction; (ii) such contract or transaction is authorized in good faith by a majority of the Board by a vote sufficient for that purpose without counting the vote or votes of such interested Director(s); (iii) prior to authorizing or approving the transaction, the Board considers and in good faith determines after reasonable investigation under the circumstances that the Corporation could not obtain a more advantageous arrangement with reasonable effort under the circumstances; and (iv) this Corporation enters into the transaction for its own benefit, and the transaction is fair and reasonable to this Corporation at the time the transaction is entered into.

(b) The provisions of this Section do not apply to a transaction which is part of an educational or charitable program of the Corporation if it: (i) is approved or authorized by the Corporation in good faith and without unjustified favoritism; and (ii) results in a benefit to one or more Directors or Officers or their families because they are in the class of persons intended to be benefited by the educational or charitable program of this Corporation.

Comment: See Corp C §5233. Note that this statute may not apply to a transaction between a nonprofit corporation and an entity in which a director has a material financial interest. It is a better practice, however, to retain the more restrictive language in this provision to establish a policy that will promote compliance with the private foundation prohibition on self-dealing under IRC §4941 and the public charity prohibition on excess benefit transactions under IRC §4958.

In addition, to promote compliance with Corp C §5234, this provision is drafted to require approval by a disinterested majority when a director sits on a board of another corporation that is a party to the transaction, even if the director does not have a material financial interest in the transaction. However, the provision does not address insider transactions involving all "disqualified persons," which are subject to substantial penalties under IRC §4941 (for private foundations) and IRC §4958 (for public charities and IRC §501(c)(4) and §501(c)(5) organizations). Counsel should strongly recommend a comprehensive conflict-of-interest policy to avoid exposing insiders to penalties. These policies generally should not be included in the bylaws. For discussion of transactions between nonprofit corporations and their directors, officers, and other "disqualified persons" generally, see §§9.131-9.150.

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§7.163 2. Form: Loans to Directors and Officers

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Section 9.2 Loans to Directors and Officers

The Corporation shall not make any loan of money or property to or guarantee the obligation of any Director or Officer, unless approved by the Attorney General of the State of California; provided, however, that the Corporation may advance money to a Director or Officer of the Corporation for expenses reasonably anticipated to be incurred in the performance of the duties of such Director or Officer, provided that in the absence of such advance such Director or Officer would be entitled to be reimbursed for such expenses by the Corporation.

Comment: See Corp C §5236. For discussion of loans and guaranties, see §§9.146-9.149. This provision tracks the statutory language of Corp C §5236(a), barring loans or guarantees unless approved by the Attorney General and permitting advancement of reasonably anticipated job expenses. Corporations Code §5236(b) and (c) expressly except the payment of life insurance premiums for officers and directors, and loans deemed necessary to provide financing to purchase an officer's residence, under specified conditions. The section may be amended accordingly.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.164 J. Form: Fiscal Year

§7.164 J. Form: Fiscal Year

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ARTICLE 10: FISCAL YEAR

The fiscal year of the Corporation shall end on _ _[*date*]_ _.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.165 K. Form: Amendments

§7.165 K. Form: Amendments

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ARTICLE 11: AMENDMENTS

These Bylaws may be adopted, amended, or repealed by a majority vote of the entire Board of Directors; provided, however, that amendment or repeal of Section 4.3, Section 4.5, _ _[*specify any others***]_ _ or this ARTICLE 11 shall require the unanimous approval of _ _[***the Board of Directors/or insert designator language, if appropriate***]_ _.**

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§7.166 L. Form: Members

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ARTICLE 12: MEMBERS

This Corporation shall not have voting members within the meaning of the California Nonprofit Corporation Law. The Board of Directors may admit nonvoting members of one or more classes having such rights and obligations as the Board shall deem appropriate from time to time.

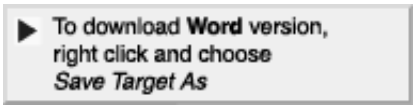
Comment: The corporation need not have members. Corp C §5310(a). If there is no provision for members in the articles or bylaws, the corporation is deemed to have no members. It is preferable, however, that the bylaws state that there are to be no members. For discussion of the effect of having no members, see §10.4.

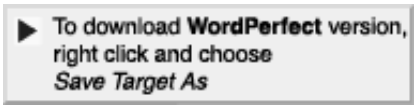
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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.167 M. Form: Private Foundation Restrictions

§7.167 M. Form: Private Foundation Restrictions

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ARTICLE 13: PRIVATE FOUNDATION RESTRICTIONS

In any period in which the Corporation is a private foundation, as defined in Internal Revenue Code §509, this Corporation shall make distributions at such time and in such manner as not to subject the Corporation to tax under Internal Revenue Code §4942, and the Corporation shall not (i) engage in any act of self-dealing, as defined in Internal Revenue Code §4941(d), (ii) retain any excess business holdings, as defined in Internal Revenue Code §4943(c), (iii) make any investments in such manner as to subject the Corporation to tax under Internal Revenue Code §4944, or (iv) make any taxable expenditures, as defined in Internal Revenue Code §4945(d).

Comment: See Corp C §§5260, 9260. This section is required for public benefit corporations and nonprofit religious corporations that are "private foundations" within the meaning of IRC §509(a). See §§4.23-4.55.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.168 N. Form: Supporting Organization Restrictions

§7.168 N. Form: Supporting Organization Restrictions

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ARTICLE 14: SUPPORTING ORGANIZATION RESTRICTIONS

This Corporation shall not accept any contribution from any "prohibited person." For purposes of this Section, a "prohibited person" is: (i) a person who controls, directly or indirectly, either alone or with persons listed described in (ii) and (iii) below, the governing body of this Corporation or any successor organization pursuant to Section _ _[*section number*]_ _ of these Bylaws; (ii) a member of the family of an individual listed in (i) above; or (iii) a corporation, partnership, trust, or estate more than 35 percent of which is actually or constructively controlled by persons described in (i) or (ii) above. For purposes of this Section, a member of an individual's family includes his or her spouse, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren, as well as the individual's brothers and sisters, by whole or half blood, and their spouses.

Comment: This provision should be used only if the corporation is organized as a supporting organization described in IRC §509(a)(3). See Treas Reg §1.509(a)-4(f)(2).

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§7.169 O. Form: Construction and Definitions

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ARTICLE 15: CONSTRUCTION AND DEFINITIONS

Section 15.1 Construction and Definitions

Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the California Nonprofit Corporation Law shall govern the construction of these Bylaws. Without limiting the generality of the above, the masculine gender includes the feminine and neuter, the singular number includes the plural, and the plural number includes the singular.

Section 15.2 Electronic Transmission

Subject to any guidelines and procedures that the Board of Directors may adopt from time to time, the terms "written", and "in writing" as used in these Bylaws include any form of recorded message in the English language capable of comprehension by ordinary visual means and may include electronic transmissions, such as facsimile or email, provided (i) for electronic transmissions *from* the Corporation, the Corporation has obtained an unrevoked written consent from the recipient to the use of such means of communication; (ii) for electronic transmissions *to* the Corporation, the Corporation has in effect reasonable measures to verify that the sender is the individual purporting to have sent such transmission; and (iii) the transmission creates a record that can be retained, retrieved, reviewed, and rendered into clearly legible tangible form.

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§7.170 P. Form: Certificate of Secretary

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CERTIFICATE OF SECRETARY

I, the undersigned, the duly elected Secretary of _ _[*name of corporation*]_ _, a California nonprofit public benefit corporation, do hereby certify:

That the foregoing Bylaws consisting of _ _[*number*]_ _ pages were adopted as the Bylaws of the Corporation by the Directors of the Corporation on _ _[*date*]_ _, and the same do now constitute the Bylaws of said Corporation.

IN WITNESS WHEREOF, I have hereunto subscribed my name this _ _[*date*]_ _.

__[*Signature*]__
_ _[*Typed name*]_ _
Secretary

Comment: This certificate is prima facie evidence of adoption of the bylaws. Corp C §5215.

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Source: Business Law/Advising California Nonprofit Corporations/7 Bylaws/§7.171 Q. Form: Exhibit A, Members of Board

§7.171 Q. Form: Exhibit A, Members of Board

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EXHIBIT A

MEMBERS OF THE BOARD OF DIRECTORS

Name	Term Expires Annual Meeting
_ _[*Name*]_ _	_ _[*year*]_ _
_ _[*Name*]_ _	_ _[*year*]_ _
_ _[*Name*]_ _	_ _[*year*]_ _
_ _[*Name*]_ _	_ _[*year*]_ _
_ _[*Name*]_ _	_ _[*year*]_ _

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8

Sales and Use Taxes

J. Patrick Whaley

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§8.1 I. SCOPE OF CHAPTER

Nonprofit corporations, although usually exempt from federal and California income and franchise taxes and often exempt from California property taxes, are normally not exempt from California sales and use taxes. Unlike many other states, California does not provide a blanket exemption from its sales and use taxes to charitable organizations. The sales tax is often a nonprofit corporation's greatest, and perhaps its only, tax obligation.

The purpose of this chapter is to provide a general overview of California sales and use tax laws and to identify particular provisions that might be of concern to nonprofit corporations. This chapter does not explain all the intricacies of the California sales and use tax laws.

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§8.2 II. INTRODUCTION TO SALES AND USE TAX

When tax imposed. A nonprofit organization should determine which of its purchases are subject to tax and when it should collect taxes on its sales. The sales tax is imposed on all sales of personal property that are not specifically exempted by provisions of the Revenue and Taxation Code. Although the seller is responsible for paying the tax, the seller may collect the tax from the buyer.

The use tax is complementary to the sales tax, and is never imposed in addition to the sales tax. It applies to retail purchases of taxable property outside California for use, storage, or consumption within California. Leases are usually treated as continuous sales subject to use tax.

Tax rates. The normal tax rates in local jurisdictions vary from 7.25 to 8.75 percent. The rate in the jurisdiction where the sale or use transaction takes place applies. The California State Board of Equalization (BOE) publishes sales tax rates in local jurisdictions in California City and County Sales and Use Tax Rates, BOE Publication No. 71, available at http://www.boe.ca.gov/pdf/pub71.pdf.

NOTE: In response to the state's fiscal crisis, the California Legislature temporarily increased the sales and use tax by 1 percent on sales made on and after April 1, 2009, and before July 1, 2012. Rev & T C §6051.7.

Transactions subject to tax. The tax applies not only to transactions that are obvious sales but also to less obvious transactions, such as the sale of items at a silent auction for the benefit of a charitable organization, premiums given to donors in consideration of their making charitable contributions, and meals served at fundraising events. There are a few limited exemptions from these taxes. See §§8.31-8.57.

These taxes are remitted to and administered by the BOE. The BOE website, at http://www.boe.ca.gov, provides information on sales and use tax laws, BOE regulations, memorandum opinions, and pamphlets including Tax Tips for Nonprofit Organizations, BOE Publication No. 18; Tax Tips for Hospitals, BOE Publication No. 45; and Sales and Use Taxes: Exemptions and Exclusions, BOE Publication No. 61. The website also lists dates and locations of free seminars that explain application of the sales and use tax laws to nonprofit organizations.

Research. A practitioner facing a sales or use tax problem should ordinarily begin research with a review of the sales and use tax provisions in the California Revenue and Taxation Code (Rev & T C §§6001-7176). The answer to most questions will be found in these statutes. Virtually all related regulations (see Title 18 of the California Code of Regulations), rulings of the State Board of Equalization Sales Tax Counsel, and court decisions are based on literal interpretations of one or more sections of the Revenue and Taxation Code. Only rarely does the BOE apply nonstatutory concepts. The application of the law in the sales and use tax area tends to be technical, formal, and rigid, and the BOE's disputes are often resolved based on the form of the transaction. *Navistar Int'l Transp. Corp. v State Bd. of Equalization* (1994) 8 C4th 868, 878 n5, 35 CR2d 651, quoting *Wallace Berrie & Co. v State Bd. of Equalization* (1985) 40 C3d 60, 70, 219 CR 142.

The BOE is the main source of publications on California sales and use taxes. An additional resource is the California State Tax Reporter, published by CCH, Inc., which contains statutory provisions, BOE regulations, selected Opinions of Sales Tax Counsel and judicial decisions, and some explanatory comments.

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III. THE SALES TAX

§8.3 A. Imposition of Sales Tax

The sales tax is imposed on retailers for the privilege of selling tangible personal property at retail in California. Rev & T C §6051. The tax may be passed on to purchasers and collected by the retailer from purchasers. See §§8.19-8.20. The sales tax is measured as a percentage of a retailer's gross receipts from the sale of tangible personal property at retail in the state. Rev & T C §6051. For substantive definitions of the statutory terms used to determine what transactions are subject to the sales tax, see generally Rev & T C §§6005-6017. See §§8.4-8.18.

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1. Definition of "Sale"

§8.4 a. Transfer of Title for Consideration

"Sale" includes any transfer of title or possession of tangible property for consideration. A transfer of possession, however, is treated as a sale only when the BOE finds it to be in lieu of a transfer of title. Rev & T C §6006(a). A sale will be deemed to have occurred even though the contract expressly provides that the "seller" retains title if possession is transferred and retention of title is a mere security interest. See *Northrop Corp. v State Bd. of Equalization* (1980) 110 CA3d 132, 167 CR 707.

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§8.5 b. Distinction Between Sales and Services

Sales tax applies only to the retail sale of tangible personal property and not to the performance of services. Rev & T C §§6006-6007. But in some instances, the performance of a service may be difficult to distinguish from a sale of tangible personal property. In many instances, a service transaction requires the transfer of tangible personal property incidental to the performance of the service.

Bundled transactions. For "bundled transactions" in which goods and services are inextricably intertwined in a single sale, the "true object" test is applied, and the entire transaction is generally taxed or not taxed as a whole. 18 Cal Code Regs §1501.

If the true object of the transaction is the service itself, tax will not be imposed on the transaction even though some tangible personal property is transferred. *MCI Airsignal, Inc. v State Bd. of Equalization* (1991) 1 CA4th 1527, 1530, 2 CR2d 746 (no tax on transfer of pagers by supplier of pager services; pagers merely incidental to true object of transaction). On the other hand, if the true object of the transaction is the tangible personal property itself, the transaction will be taxable. When, under the true object test, the transaction is deemed to be a service transaction, the person performing the service is considered to be the consumer of the property, and tax applies to the sale of such property to that person by the supplier. No tax is due on the incidental transfer of the tangible personal property to the service provider's customer. See 18 Cal Code Regs §1501. For example, in *Culligan Water Conditioning v State Bd. of Equalization* (1976) 17 C3d 86, 96, 130 CR 321, the court held that the true object of a water conditioning contract (in which water softening equipment is attached to a customer's home plumbing and periodically serviced) is to furnish the tangible equipment that softens the water.

Mixed transactions. If a transaction is a "mixed transaction" (*i.e.,* a sale of tangible personal property along with an optional purchase of a service contract or intangible personal property), only the sale of tangible property will be taxed, even if the invoice does not separate the price of the components. *Dell, Inc. v Superior Court* (2008) 159 CA4th 911, 71 CR3d 905 (when sales of computers were coupled with sales of computer service contracts, only purchase prices attributable to sale of computers were taxable).

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§8.6 c. Fabrication Taxable as Sale

The definition of a sale includes the "producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, processing, printing, or imprinting." Rev & T C §6006(b).

The purpose of this provision is to prevent avoidance of sales tax by restructuring a transaction into some form other than a sale.

EXAMPLE: If a tailor makes and sells a suit for $200, the transfer of the suit is a taxable sale for $200. The same result is reached if the transaction is structured so that the customer pays the tailor $100 for a quantity of cloth and also pays the tailor $100 to convert that cloth to a suit. The fabrication of the suit is, under Rev & T C §6006(b), a taxable sale.

This principle also applies to contractors, graphic artists, repair persons, and others.

Certain property is excluded from the definitions of "sale" and "purchase." See Rev & T C §§6010.3-6010.11; *Navistar Int'l Transp. Corp. v State Bd. of Equalization* (1994) 8 C4th 868, 35 CR2d 651 (computer program designed for company but subsequently sold not exempt from sales tax).

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§8.7 2. "Retail Sale" Versus Resale

A sale must be a retail sale for the sales tax to apply. A "retail sale" is defined as "a sale for any purpose other than resale in the regular course of the buyer's business in the form of tangible personal property." Rev & T C §6007. Courts will consider the primary intent of the purchaser in determining whether a sale is taxable as a retail sale or exempt as a sale for resale. *Kaiser Steel Corp. v State Bd. of Equalization* (1979) 24 C3d 188, 194, 154 CR 919 (main purpose of acquiring materials recovered from steel manufacturing process and resold was to aid in manufacturing, not to resell).

The burden of proving that a sale of tangible personal property is not a retail sale, and thus subject to tax, is on the seller unless the seller timely obtains a certificate from the purchaser establishing that the property was purchased for resale. Rev & T C §6091. See §8.60.

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§8.8 3. Definition of "Tangible Personal Property"

Only property that is tangible and personal is subject to tax. Rev & T C §6006(a). Tangible personal property is "personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses." Rev & T C §6016. For example, an antique vase sold at a silent auction would be tangible personal property, but airline tickets and use of a condominium would not be. See, *e.g., Dell, Inc. v Superior Court* (2008) 159 CA4th 911, 71 CR3d 905 (purchase of service contract in conjunction with purchase of new computer was not subject to California sales tax because contract was intangible property). See also *Navistar Int'l Transp. Corp. v State Bd. of Equalization* (1994) 8 C4th 868, 875, 35 CR2d 651 (sale of designs and manuals, although acquired primarily for intellectual content, held to be taxable as transfer of tangible property).

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§8.9 4. Definition of "Person"

"Person" is broadly defined to include any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, receiver, trustee, trustee in bankruptcy, the State of California, any political subdivision of the State of California, the United States, or any other group or combination acting as a unit. Rev & T C §6005.

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§8.10 5. Definition of "Retailer"

Because a sale is subject to sales tax under Rev & T C §6051 only if the sale is made by a "retailer" (see §8.3), the definition of this term is of critical importance. The Revenue and Taxation Code defines "retailer" to include every seller who makes a retail sale of any tangible personal property. Rev & T C §6015(a)(1). Persons making more than two retail sales of tangible personal property during any 12-month period are also defined as retailers. Rev & T C §6019. See §8.13.

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§8.11 a. "Sellers" as Retailers

A "seller" is any person engaged in the business of selling tangible personal property if the gross receipts from the retail sales would be included in the measure of sales tax "if sold at retail, whether or not the tangible personal property is ever sold at retail or is suitable for sale at retail." Rev & T C §6014.

NOTE: A person selling property suitable for retail sale is required to hold a seller's permit. Rev & T C §6066. Only "persons" may be retailers. Rev & T C §6015. See §8.58.

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§8.12 b. Auctioneers

Persons engaged in the business of making retail sales at auction are treated as retailers of tangible personal property owned by them or by others and auctioned by them and are thus required to hold seller's permits and pay sales taxes measured by the gross receipts from such sales. Rev & T C §6015(a)(1)-(2); 18 Cal Code Regs §1565.

NOTE: Under a special statutory rule, the measure of taxable sales of auctioneers includes sales to a successful bidder at an auction sale, even if the sale is made under an understanding at the time of sale that the property will not be delivered or that the amount paid will be refunded to the bidder. Rev & T C §6006.6. The purpose of the provision is to tax sham sales to shills in the audience. However, no tax applies when an owner of property bids on his or her own property at the auction. See 18 Cal Code Regs §1565.

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§8.13 c. Persons Making More Than Two Retail Sales

A person who makes more than two retail sales of tangible personal property in any 12-month period is treated as a retailer. Rev & T C §6019. A sale is a transaction, not an event. For example, a rummage sale at which 100 items are separately sold results in 100 sales. The purpose of Rev & T C §6019 is to expand the definition of retailers in Rev & T C §6015 (see §8.10) to include vendors not normally considered to be in the business of selling tangible personal property but who engage in enough sales transactions to be distinguished from a nonbusiness vendor.

A vendor is not a retailer under Rev & T C §6019 until the third sale is made in a 12-month period. At the time of the first and second sales, the vendor may not know whether the vendor will be a retailer by virtue of this provision. Nevertheless, sales tax is imposed on the gross receipts from all three sales. Such a vendor should consider providing in the first two sales contracts for sales tax reimbursement if a tax should ultimately be due on the sale. If this is not feasible, the vendor should attempt to delay the third sale until after the 12 months have passed.

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§8.14 6. Place of Sale

The place of sale or purchase of tangible personal property is the place "where the property is physically located at the time the act constituting the sale or purchase… takes place." Rev & T C §6010.5. The phrase "in this state" in Rev & T C §6051 is defined as "within the exterior limits of the State of California and includes all territory within these limits owned by or ceded to the United States." Rev & T C §6017. Federal law authorizes collection of sales and use taxes in federal areas. See 4 USC §§105-110.

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§8.15 7. Gross Receipts

"Gross receipts" means the total amount of the sales price, valued in money, whether received in money or otherwise. Rev & T C §6012(a). If the parties to a sale agree in an arm's-length transaction on the value of property sold, the agreed price determines the measure of the sales tax, rather than an appraised or market value. *Wallace Berrie & Co. v State Bd. of Equalization* (1985) 40 C3d 60, 70, 219 CR 142, citing *Hawley v Johnson* (1943) 58 CA2d 232, 136 P2d 638. Gross receipts include both cash payments and credits. Rev & T C §6012(b)(2); *Peterson Tractor Co. v State Bd. of Equalization* (1962) 199 CA2d 662, 18 CR 800.

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§8.16 a. Allocation of Purchase Price

A sales contract will often cover the sale of both taxable tangible personal property and exempt property or services (*e.g.,* installation or servicing of equipment by the vendor). In such a situation, it becomes necessary to allocate the consideration received between the property and the services sold. A bona fide arm's-length agreement by the parties will ordinarily be followed. See *Hawley v Johnson* (1943) 58 CA2d 232, 136 P2d 638. In the absence of a bona fide arm's-length allocation in the contract of sale, the taxpayer will be required to establish by convincing evidence, taking into account all the facts and circumstances, the amount to be allocated to nontaxable elements.

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§8.17 b. Services as Part of Sale

Gross receipts include any amounts charged for services that are part of the sale. Rev & T C §6012(b)(1).

EXAMPLE: If a lessor rents a tractor only on condition that the tractor be operated by a driver furnished by the lessor for $100 an hour, the measure of tax is the full $100 per hour. In contrast, if the lessor leases the same tractor without a driver for $80 per hour, the measure of tax does not include an additional $20 per hour charged for the services of a driver.

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§8.18 c. Exclusions From Gross Receipts; Worthless Accounts

There are a number of exclusions from the measure of taxable gross receipts. These are set forth in Rev & T C §6012(c). A deduction for worthless accounts is provided for in Rev & T C §6055.

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B. Responsibility for Tax Payments

§8.19 1. Retailer's Responsibility

The legal incidence of the sales tax is the responsibility of the retailer, and the purchaser has no statutory obligation to pay the sales tax. Unless the retailer requires reimbursement from the consumer, the retailer will have no recourse against the purchaser when a subsequent assessment is made against the retailer. *Occidental Life Ins. Co. v State Bd. of Equalization* (1982) 135 CA3d 845, 185 CR 779; *Pacific Coast Eng'g Co. v State* (1952) 111 CA2d 31, 244 P2d 21.

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§8.20 2. Reimbursement of Retailers by Purchaser

Although the legal incidence of the sales tax is on the retailer, retailers are authorized to collect reimbursement from purchasers if the parties contractually so agree. Civil Code §1656.1 establishes certain rebuttable presumptions as to whether the parties are deemed to have agreed to the addition of sales tax. It is presumed that the parties agreed to the addition of sales tax reimbursement to the sales price of tangible personal property if the agreement of sale expressly provides for the addition of sales tax, sales tax reimbursement is shown on the sales check, or the retailer posts a sign or includes in advertisements or other printed material a notice that sales tax will be added to the sales price. CC §1656.1(a).

Rather than add sales tax reimbursement to the sales price, retailers may include in the sales price of each item an amount representing sales tax reimbursement. It is presumed that property is sold at a price that includes tax reimbursement if the retailer posts a sign or includes on a price tag or advertisement a statement that prices include sales tax reimbursement "computed to the nearest mill." CC §1656.1(b).

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IV. THE USE TAX

§8.21 A. Imposition of Use Tax

Use tax is imposed on the storage, use, or other consumption in California of tangible personal property purchased from any retailer. Rev & T C §6201. The use tax is calculated as a percentage of the sales price of the property. See Rev & T C §6201. The principal purpose of the use tax is to prevent avoidance or evasion of the sales tax by the purchase of tangible personal property outside California.

NOTE: Use tax is never imposed as a duplicate tax along with California sales tax because any use of property in California is exempt from use tax if the gross receipts from the sale of the property are included in the measure of the sales tax. Rev & T C §6401.

Use tax is also imposed on rental payments received for the use of tangible personal property within California. See §8.29.

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§8.22 B. What Is Taxed?

The apparently straightforward provisions of Rev & T C §6201 imposing the use tax contain several terms of art. Use tax is imposed on (1) the storage, use, or other consumption; (2) in this state; (3) of tangible personal property; (4) purchased from a retailer; (5) for storage, use, or other consumption in this state; (6) measured by a percentage of the sales price. Rev & T C §6201.

The discussions of the sales tax terms, "tangible personal property" (see §8.8), "retailer" (see §8.10), and "in this state" (see §8.14) apply equally to the sales tax and the use tax. The definition of "sales price" for general tax purposes (see Rev & T C §6011), applicable to measuring the use tax, is similar to the definition of "gross receipts," the sales tax measure (see Rev & T C §6012, discussed in §8.15). Consequently, the only use tax concepts that must be separately analyzed are "storage, use, or other consumption" (see Rev & T C §§6008-6009, discussed in §8.23) and the purchase of property for storage, use, or other consumption in this state (see §§8.24-8.26).

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§8.23 1. Storage, Use, or Other Consumption

"Storage" is defined to include "any keeping or retention in [California] for any purpose except sale in the regular course of business or subsequent use solely outside [California] of tangible personal property purchased from a retailer." Rev & T C §6008. "Use" includes the "exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease." Rev & T C §6009. The sale of property in the regular course of business is excluded from the meaning of "use."

Neither "storage" nor "use" includes keeping or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside California for use solely outside the state, or for the purpose of being processed, fabricated, manufactured into, attached to, or incorporated into other tangible personal property to be transported outside the state and used solely outside the state. Rev & T C §6009.1.

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§8.24 2. Property Purchased for Use in California

Use tax is imposed only on property purchased outside the state for use in California. Several statutory presumptions assist the BOE in determining whether property is purchased for that use. It is presumed that property sold for delivery in California is sold for storage, use, or other consumption in this state unless the contrary is established. Rev & T C §6241. Tangible personal property brought into California by the purchaser is presumed to have been purchased from a retailer for storage, use, or other consumption in this state. Rev & T C §6246.

Property delivered outside of California to a purchaser known by the retailer to be a California resident is regarded as having been purchased for use in California unless a statement in writing, signed by the purchaser or the purchaser's authorized representative, that the property was purchased for use at a designated point or points outside California, is retained by the vendor. 18 Cal Code Regs §1620(b)(3). However, notwithstanding the retention of such a statement, property purchased outside of California that is brought into California is regarded as having been purchased for use in California if the first functional use of the property is in California. 18 Cal Code Regs §1620(b)(3). See §§8.25-8.26.

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§8.25 a. First Functional Use in California

Use tax will apply if the first functional use of the property (that is, use for the purpose(s) for which the property was designed) is made in California, no matter how fleeting the taxable moment of use may be. See 18 Cal Code Regs §1620(b)(3).

NOTE: The administrative practice as to what constitutes "functional use" depends on the facts and circumstances of each case.

Thus, if property is purchased outside California by a purchaser who brings the property into this state for installation, a taxable moment occurs when the journey into the state ends, even though the property is thereafter used solely in interstate commerce. *Southern Pac. Co. v Gallagher* (1939) 306 US 167, 83 L Ed 586, 59 S Ct 389.

NOTE: Whether the purchaser intended at the time of acquisition to use the property in California is not controlling. An indefinite intent to use the property wherever required after acquisition is tantamount to an intent to use property in California when the first use of the property for the purpose intended is made in this state. See *Chicago Bridge & Iron Co. v Johnson* (1941) 19 C2d 162, 119 P2d 945. See also *Western Contracting Corp. v State Bd. of Equalization* (1968) 265 CA2d 568, 71 CR 472 (use tax applied to dredge parts and materials absent taxpayer showing property purchased with affirmative intent to use it elsewhere).

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§8.26 b. First Functional Use Outside California

If the first functional (taxable) use of tangible personal property occurs outside California, the property will ordinarily be presumed to have been purchased for use in California and subject to tax if it is brought into California within 90 days after purchase unless the property is used, stored, or both used and stored, outside of California at least one-half of the time during the 6-month period immediately following the property's entry into California.

In general, prior out-of-state use not exceeding 90 days from the date of purchase to the date of entry into California is considered temporary and does not constitute proof of an intent that the property was purchased for use elsewhere. However, except in the case of motor vehicles, vessels, and aircraft, prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California. 18 Cal Code Regs §1620(b)(3). As to motor vehicles, vessels, and aircraft, the period is 12 months rather than 90 days. Rev & T C §6248.

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§8.27 C. Who Is Taxed?

Primary liability for the use tax is imposed on the purchaser of tangible personal property. Rev & T C §6202(a). The purchaser's liability is not extinguished until the tax is paid to the state, except when the purchaser can produce a receipt from a retailer engaged in business in California or from a retailer authorized by the BOE to collect use tax and the receipt shows that the tax has been paid. Rev & T C §6202(a); *Overhead Elec. Co. v State Bd. of Equalization* (1991) 227 CA3d 1230, 1238, 278 CR 112. See §8.28. In lease transactions that are taxed as sales under Rev & T C §§6006(g) and 6006.1, the use tax is imposed on the lessee and collected by the lessor. See §8.29.

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D. Collection of Tax

§8.28 1. Retailer Engaged in Business in California

Every retailer engaged in business in California and making sales of tangible personal property for taxable use in this state is required to collect the tax from the purchaser and give the purchaser a receipt in the manner prescribed by the Board of Equalization. Rev & T C §6203. The use tax should be collected at the time of sale, unless the use of the property is not taxable at that time, in which case the tax should be collected when the use becomes taxable. Rev & T C §6203.

When a retailer pays an amount to the state in satisfaction of use tax liability, the purchaser must reimburse the retailer for the amount paid. See *Brandtjen & Kluge, Inc. v Fincher* (1941) 44 CA2d Supp 939, 111 P2d 979.

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§8.29 2. Leases

Leases and rentals of tangible personal property for use within California are ordinarily treated and taxed as continuous sales. Rev & T C §6006(g). The principal tax is the use tax imposed on the lessee and collected by the lessor. However, sales tax is imposed on the lessor when the use tax is not due but may be passed on to the lessee. Rev & T C §§6203, 6390, 6401. The measure of the tax is the amount of the rental payments, including amounts paid by the lessee to cover property taxes. 18 Cal Code Regs §1660(c).

There are several situations set forth in Rev & T C §6006(g) when leases are not treated as sales subject to tax. These include when property is leased in substantially the same form in which it was acquired by the lessor and the lessor has paid sales or use tax measured by the purchase price. Rev & T C §6006(g)(5). If the lessor acquired the property in a transaction not subject to tax (*e.g.,* the occasional sale exemption; see §8.32), the lessor may elect to pay sales tax on the purchase price on the tax return for the period when the property was first leased. 18 Cal Code Regs §1660(c)(4).

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§8.30 E. Measure of Tax

Except for use tax imposed on rental payments (see §8.29), use tax is computed by multiplying the appropriate tax rate by the "sales price" (see Rev & T C §6201) of the tangible personal property charged to the taxpayer. The "sales price" is determined by applying a definition in Rev & T C §6011 that is similar to the definition of "gross receipts" in Rev & T C §6012, which is the basis of the sales tax measure (see §8.15).

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§8.31 V. EXEMPTIONS FROM TAX

Sections 8.32-8.57 discuss the occasional sale exemption as it applies to isolated or occasional sales, exemptions applicable to sales to the United States, exemptions for sales in certain activities of certain nonprofit organizations, and exemptions applicable to the sale of food products and medicine. Exemptions not discussed include those pertaining to transfers of property to a new corporation or partnership if the transferor receives no consideration (18 Cal Code Regs §1595(b)(4)); distributions in dissolution of a business; certain corporate reorganizations (see 18 Cal Code Regs §1595(b)); purchases of certain property to be used by a new business for manufacturing, construction, or research (Rev & T C §6377); and exemptions applicable to sales in interstate or foreign commerce (18 Cal Code Regs §1620).

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§8.32 A. Occasional Sale Exemption

"Occasional sale" defined. Occasional sales are exempt from both the sales and use tax. Rev & T C §6367. The phrase "occasional sale" is defined in part as follows (Rev & T C §6006.5(a)):

> A sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided that the sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state.

NOTE: It is important to keep in mind that a sale is a transaction, not an event. For example, a "garage sale" is an event at which many sales may take place.

Exemption applies to sales by vendors. A seller is a person engaged in the business of making retail sales of tangible personal property, the gross receipts from which are subject to the sales tax, and is required to hold a seller's permit. Rev & T C §§6014, 6066. Thus, the occasional sale exemption applies only to sales by vendors not engaged in such business activities (*e.g.,* the single sale of a used lawnmower by a homeowner) and to isolated or occasional sales by vendors engaged in business activities that do not regularly involve making retail sales subject to sales tax. See Rev & T C §§6006.5, 6007; 18 Cal Code Regs §1595.

EXAMPLE: An example of the latter type of isolated or occasional sale is the sale of a computer by a lawyer or an accountant. Another example would be the sale of a cash register by a meat market because retail sales of meat are not subject to sales tax.

When exemption may not apply. However, if such sales are of sufficient frequency and are substantial in amount, a vendor may nevertheless be required to obtain a seller's permit, and no occasional sale exemption will apply. See Rev & T C §6006.5(a). No hard and fast rule exists to guide a taxpayer in determining how many sales may be made before he or she will be considered a seller required to hold a seller's permit. The general rule expressed by the BOE is that a person who makes three or more sales of substantial amounts in a 12-month period is required to hold a seller's permit. The 12-month period can be 12 months before the sale, the 12 months after the sale, or any other 12-month period in which the sale occurs. Sales and Use Taxes: Exemptions and Exclusions, Part V, BOE Publication No. 61, available at http://www.boe.ca.gov/pdf/pub61.pdf.

A person may be engaged in an activity requiring a seller's permit and also be engaged in other business endeavors that do not, taken by themselves, require the holding of a seller's permit. Rev & T C §6006.5(a). If the assets of the business activities that do not require the holding of a seller's permit are sold, the question arises whether the fact that the seller is also engaged in other activities requiring a seller's permit makes the sale subject to tax. In *Ontario Community Founds., Inc. v State Bd. of Equalization* (1984) 35 C3d 811, 201 CR 165, the taxpayer operated a hospital containing a food service facility that sold meals to patients and nonpatients, a supply department that sold miscellaneous personal items, and a pharmacy. The taxpayer held a seller's permit for those activities. After the taxpayer sold the hospital and its equipment in a single transaction, the BOE asserted a sales tax deficiency measured by gross receipts from the sale of all hospital tangible personal property. The court held that the occasional sale exemption in Rev & T C §6006.5 was designed expressly to exempt from tax a one-time sale of property not held or used by a seller in the course of activities for which it is required to hold a seller's permit, and that the liquidation sale of the hospital was such a sale.

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§8.33 B. Sales to Government Agencies

A sales tax exemption applies to gross receipts from the sale of tangible personal property to the United States and to its unincorporated agencies and instrumentalities, to corporations wholly owned by the United States, and to the American National Red Cross. Rev & T C §6381. The exemption also applies to rentals under a lease of tangible personal property. 18 Cal Code Regs §1660(c)(1). However, no exemption applies to sales to the state of California or its political subdivisions, such as school districts.

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§8.34 C. Nonprofit Organizations

No general statutory provision exempts sales to or by nonprofit organizations. However, there is a series of narrow statutory exemptions that may be available in particular situations. See §§8.35-8.57. A seller will request an exempt certificate because it is relieved from liability for sales or use tax if the purchaser gives a timely exemption certificate to the seller that the property will be used in a manner or for a purpose entitling the seller to assume that the gross receipts from the sale are exempt. 18 Cal Code Regs §1667(b). See §8.62.

Some exemptions provide that an organization is exempt from tax with respect to certain of its sales. Even so, the organization must hold a seller's permit if it is a retailer.

Some other exemptions provide that an organization is deemed to be the consumer, which means that the organization will pay a sales tax on its purchases, but no tax will be due on its subsequent sales of exempted items (*e.g.,* flags sold by veterans' organizations; see §8.39) when presumably resold at a higher price. If an organization is deemed to be the consumer, it need not hold a seller's permit.

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§8.35 1. Donated Property

An exemption from the use tax is extended to property donated to charities described in IRC §170(b)(1)(A). Rev & T C §6403. If the donee is a museum, it must meet the free admission requirements of Rev & T C §6366.4(c) and use the property exclusively for display within the museum. Rev & T C §6403.

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§8.36 2. Children's Clothing

New children's clothing sold to nonprofit organizations for distribution to individuals under the age of 18 free of charge is exempt from sales and use tax. Rev & T C §6375.5(a). The term "nonprofit organization" here means an organization that is organized and operated for charitable purposes, is exempt from state franchise and income taxes under Rev & T C §23701d or §23701f, and furnishes new children's clothing as a matter of assistance to recipients in distressed financial conditions. Rev & T C §6375.5(b).

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§8.37 3. Meals Served by Religious Organizations

An exemption from sales and use tax covers gross receipts from the sale and use of meals and food products furnished or served by a religious organization at a gathering conducted under its auspices if the purpose in serving the food products is to obtain revenue for the functions and activities of the organization and the revenue is so used. Rev & T C §6363.5. A religious organization is defined as one whose property is exempt form taxation under Cal Const art XIII, §3(f). Rev & T C §6363.5. Hotels and restaurants providing meals and food for fundraising events that qualify for this exemption may accept a timely resale certificate from the religious organization if the religious organization itself is purchasing the meals or food from the hotel or restaurant and reselling them to the attendees of the fundraising event.

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Source: Business Law/Advising California Nonprofit Corporations/8 Sales and Use Taxes/§8.38 4. Meals Served to Patients and Inmates of Health Facilities

§8.38 4. Meals Served to Patients and Inmates of Health Facilities

Meals and food products for human consumption furnished and served to patients and residents of the following facilities are exempt from sales and use taxes (Rev & T C §6363.6):

- Health facilities defined in Health & S C §1250 and either licensed under Health & S C §1253 or exempt from licensing under Health & S C §1270(a);
- Health facilities operated by the United States;
- Houses or institutions supplying room and board for a flat monthly rate and serving as a principal residence exclusively for persons 62 years of age or older; and any housing that primarily serves older persons that is financed by state or federal programs;
- Certain community care facilities defined in Health & S C §1502;
- Alcoholism recovery facilities defined in Health & S C §11834.02 and licensed under Health & S C §11834.30;
- Drug abuse recovery or treatment facilities defined in Health & S C §11834.02 and licensed under Health & S C §11834.30; and
- Residential care facilities for the elderly as defined in Health & S C §1569.2 if they are (1) licensed under Health & S C 1569.10; (2) exempt from licensing under Health & S C §1569.145; or (3) run by the federal government.

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§8.39 5. Flags Sold by Nonprofit Veterans' Organizations

A nonprofit veterans' organization is treated as the consumer and not a retailer of United States flags that it sells if the profits are used exclusively to further the purposes of the organization. Rev & T C §6359.3.

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§8.40 6. Art Work

Gross receipts from the sale, storage, use, or other consumption of original works of art that become part of a permanent collection of certain museums, nonprofit corporations, or government entities (when displayed in public) are exempt from sales and use tax. Rev & T C §6365; 18 Cal Code Regs §1586.

Purchases of art by certain museums to replace art destroyed by fire, flood, earthquakes, or other calamity are exempt from tax. Rev & T C §6366.3.

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§8.41 7. Prisoner of War Bracelets and Veterans' Memorial Pins

A charitable organization exempt from property tax under the welfare exemption (Rev & T C §214) is considered to be the consumer and not the retailer of bracelets commemorating American prisoners of war that it distributes if the profits are used solely in furtherance of the purposes of such organization. Rev & T C §6360. There is also an exemption from tax for sales of impermanent lapel pins memorializing the death of United States veterans killed in foreign wars sold by certain veterans' organizations. Rev & T C §6360.1.

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§8.42 8. Medical Alert Tags

The sale, use, or other consumption of medical identification tags furnished by organizations exempt from tax under Rev & T C §23701 is exempt from sales and use taxes. Rev & T C §6371.

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§8.43 9. Friends of the Library, PTAs, and Museum Auxiliaries

Nonprofit associations commonly called "Friends of the Library" and equivalent organizations, chartered nonprofit parent-teacher associations and their equivalents performing similar services for public or private schools, and nonprofit parent cooperative nursery schools are considered consumers rather than retailers of tangible personal property that they sell. Rev & T C §6370. There is a similar provision for rummage sales conducted by nonprofit associations and equivalent organizations performing auxiliary services to any city or county museum in California that have conducted annual rummage sales for the preceding 5 years. Rev & T C 6370.5.

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§8.44 10. Sales by Youth Organizations

Qualified nonprofit youth sportsmanship and citizenship organizations and youth groups sponsored by or affiliated with qualified educational institutions that do not discriminate on the basis of race, sex, nationality, or religion are treated as consumers, not retailers, of food products, nonalcoholic beverages, and other tangible personal property made or produced by organization members, if the goods are sold only on an irregular or intermittent basis and the profits are used to further organization purposes. Rev & T C §6361.

The following organizations are exempt under these provisions:

- Nondiscriminatory nonprofit organizations that qualify for tax-exempt status under IRC §501(c) whose primary purpose is to provide supervised competitive sports for youth or to promote good citizenship in youth (Rev & T C §6361(b)(1));
- Youth groups sponsored by or affiliated with a qualified educational institution, including student activity clubs, athletic groups, and musical groups (Rev & T C §6361(b)(2)); the term "qualified educational institution" includes certain schools and colleges operated by state and local governments and certain private nonprofit schools and colleges that do not discriminate (Rev & T C §6361(b)(2)(B)); and
- Little League, Bobby Sox, Boy Scouts, Cub Scouts, Girl Scouts, Campfire, Inc., Young Men's Christian Association, Young Women's Christian Association, Future Farmers of America, Future Homemakers of America, 4-H Clubs, Distributive Education Clubs of America, Future Business Leaders of America, Vocational Industrial Clubs of America, Collegiate Young Farmers, Boys' Clubs and Girls' Clubs, Special Olympics, Inc., American Youth Soccer Association, California Youth Soccer Organization (North), California Youth Soccer Association (South), and Pop Warner football (Rev & T C §6361(b)(3)).

"Irregular or intermittent" means associated directly with a particular event, such as fairs, galas, parades, scout-a-ramas, games, and similar activities. Rev & T C §6361(c). That term includes refreshment stands or booths used at scheduled events of organized leagues, but does not include store fronts or mobile retail outlets, which ordinarily require local business licenses. Rev & T C §6361(c).

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§8.45 11. Sales by Charitable Organizations Engaged in Relief of Poverty or Distress

A very narrow exemption from sales and use taxes is provided by Rev & T C §6375 for sales by certain charitable organizations. To be exempt, four conditions must be met:

- The selling organization must qualify for the welfare exemption from property taxation (see Rev & T C §214);
- The organization must be engaged in the relief of poverty and distress (18 Cal Code Regs §1570(a)(2));
- The organization's sales or donations must be made to assist purchasers and donees in distressed financial condition (18 Cal Code Regs §1570(a)(3)); and
- The property sold or donated must have been made, prepared, assembled, or manufactured by the organization (Rev & T C §6375; 18 Cal Code Regs §1570(a)(4)).

The second and third conditions are met if the principal purpose of the charitable organization is to relieve poverty and aid purchasers by selling or donating property at reduced prices so as to give real assistance to the purchasers. Incidental sales to persons other than indigents will not eliminate the exemption. 18 Cal Code Regs §1570(a)(4)(C).

The fourth condition is met if the property is picked up at various locations and assembled at one or more places for purposes of sale, even though nothing further need be done to put the property in a salable condition. Property is prepared when it is made ready for sale by processes such as cleaning, repairing, or reconditioning. See 18 Cal Code Regs §1570(a)(4)(D).

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§8.46 12. Auctions to Raise Funds to Shelter the Homeless

Revenue and Taxation Code §6363.2 exempts from sales and use taxes the sale of tangible personal property that is sold at an auction conducted by, or affiliated with, a nonprofit organization exempt from franchise and income taxes under Rev & T C §23701d to raise money to shelter the homeless. The money raised must actually be used to shelter the homeless. Such an auction cannot be conducted more than once during any 12-month period. Rev & T C §6363.2.

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§8.47 13. Property Loaned to Educational Institutions; School Yearbooks

Any retailer's loan of tangible personal property to a school district or educational program of a school district is exempt from use tax. Also exempt is a retailer's loan of a motor vehicle to a California State University, the University of California, an accredited secondary school, or a veterans' hospital, for use in an approved driver education class. Rev & T C §6404. Any public or private school, school district, county office of education, or student organization is a consumer and not a retailer of yearbooks and catalogs prepared for or by it and distributed to students. Rev & T C §6361.5.

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Source: Business Law/Advising California Nonprofit Corporations/8 Sales and Use Taxes/§8.48 14. Organizations Serving Developmentally Disabled Individuals or Emotionally Handicapped Children

§8.48 14. Organizations Serving Developmentally Disabled Individuals or Emotionally Handicapped Children

Organizations selling handcrafted items or art designed, created, or made by developmentally disabled individuals or emotionally handicapped children who are either members of the organization or receive services from it are exempt from sales taxes on such items provided that (Rev & T C §6361.1):

- Sales are on an irregular or intermittent basis;
- The price of each item sold does not exceed $20;
- The profits from sales are used exclusively to further the purpose of the organization;
- The organization is tax-exempt under IRC §501(c)(3); and
- The organization does not discriminate on the basis of race, sex, nationality, or religion.

The organization is treated as the consumer and not the seller of such items.

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§8.49 15. Newspapers Published or Distributed by Nonprofit Organizations

Revenue and Taxation Code §6362.8 exempts from sales and use tax the sale of any personal property (such as newsprint and ink) becoming an ingredient or part of any newspaper or periodical issued at least every 3 months provided that the newspaper or periodical is:

- Published or purchased by an organization that qualifies for tax exemption under IRC §501(c)(3) and distributed to the members of the organization in consideration of payment of the organization's membership fee or to the organization's contributors;
- Published by an organization exempt under IRC §501(c)(3) that does not receive revenue from, or accept, any commercial advertising; or
- Distributed by a nonprofit organization and there is both distribution to any member of the organization in consideration, in whole or in part, of payment of the organization's membership fee and the amount paid or incurred by the organization for the cost of printing is less than 10 percent of the membership fee attributable to the period for which the newspaper or periodical is distributed.

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§8.50 16. School Meals

Sales and use taxes do not apply to meals and food products furnished or served to students by public or private schools, school districts, student organizations, parent-teacher associations, and blind persons operating a restaurant or vending stand in an educational institution. Rev & T C §6363. This exemption does not apply when the meals or food products are sold for compensation within a place that is subject to an admission charge, except national and state parks and monuments. Rev & T C §6363.

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Source: Business Law/Advising California Nonprofit Corporations/8 Sales and Use Taxes/§8.51 17. Meals Delivered to Homebound Elderly and Disabled

§8.51 17. Meals Delivered to Homebound Elderly and Disabled

Sales and use taxes do not apply to meals delivered to homebound elderly or disabled persons by a nonprofit volunteer home delivery provider. Rev & T C §6363.7.

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§8.52 18. Meals for Low-Income Elderly

Sales and use taxes do not apply to meals and food products furnished to low-income elderly persons at or below cost by a nonprofit organization or by a program funded by the federal or state government. Rev & T C §6374.

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§8.53 19. Animals and Plant Species

Sales and use taxes do not apply to sales of endangered animals or plant species as defined in Rev & T C §6010.50 if both the seller and the purchaser are nonprofit zoological societies as defined in Rev & T C §6010.5(c). Rev & T C §6366.5.

Tax does not apply to pet adoptions by individuals from a pet shelter operated by a governmental entity or nonprofit organization formed and operated for the primary purpose of prevention of abuse, neglect, or exploitation of animals that qualifies for exemption from franchise and income tax under Rev & T C §23701d. Also excluded are charges by the shelter in connection with the transfer of the animals, including, but not limited to, the spaying or neutering or future spaying or neutering of the animal, or any vaccination, future vaccination, or similar service. Rev & T C §6010.40.

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§8.54 20. Meals Served by Veterans' Organizations

Sales and use taxes do not apply to meals and food products furnished or served by any nonprofit veterans' organization at a social or other gathering conducted by it or under its auspices to obtain revenue for the functions and activities of the organization. Rev & T C §6363.8.

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§8.55 21. Thrift Stores

Sales and use taxes do not apply to sales of used clothing, household items, or other retail items sold by a thrift store operated by a nonprofit organization to obtain revenue for medical, hospice, or social services to chronologically ill individuals, when at least 75 percent of the net income is expended for these purposes. Rev & T C §6363.3(a). Here, a "nonprofit organization" means an organization that provides such services to individuals with chronic, life-threatening illness as defined in Health & S C §1568.01 and is exempt from franchise and income tax under Rev & T C §23701d. Rev & T C §6363.3(b). This exemption expires on January 1, 2012. Rev & T C §6363.3(c).

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§8.56 22. Medical Health Information Literature

The use tax is not applicable to medical health information literature purchased by a charitable organization that qualifies for the welfare exemption under Rev & T C §214 and is engaged in the dissemination of such literature, provided that it is purchased from a national office, or another branch of that national office, of the same organization. 18 Cal Code Regs §1570(e).

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§8.57 23. Food, Food Products, and Prescription Medicines

The sale and the use of food products and prescription medicines are exempt from tax. Rev & T C §§6359, 6369. "Food products" are defined in Rev & T C §6359. There is, however, no general exemption for prepared foods.

Food products sold through vending machines are subject to special rules with regard to the sales and use tax. See Rev & T C §6459.2(c)-(e) (certain percentages of food products sold through vending machines), §6459.4 (certain vending machine operators).

There is an exemption for wheelchairs, crutches, quad canes and white canes sold to the legally blind, walkers, and replacement parts for these devices, sold to individuals for use as directed by a physician. Rev & T C §6369.2.

Anyone purchasing or selling food products or medicines should be aware of 18 Cal Code Regs §1591 (medicines and medical devices), §1591.2 (wheelchairs, crutches, canes, and walkers), §1592 (eyeglasses and ophthalmic materials), §1602 (food products), and §1603 (taxable sales of food products).

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§8.57A 24. Sales to Members

Effective October 11, 2009, an organization exempt from federal income tax under IRC §501(c)(3) is a consumer and not a retailer of tangible personal property sold to its members (as defined in Corp C §5056) if the following requirements are met (Rev & T C §6018.9(a)):

- The item bears the logo or other identifying mark of the organization and is a promotional item or other item commonly associated with use by a member;
- The cost to the member is not more than the cost to the organization;
- No member is allowed to acquire more than 30 identical items or to resell the property; and
- The property is not distributed for purposes of political campaigning or issue advocacy.

This provision expires on December 31, 2014. Rev & T C §6018.9(b).

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VI. DOING BUSINESS AS RETAILER

A. Obtaining Permit

§8.58 1. Seller's Permit

Application for permit. Every person desiring to engage in business in California as a retailer of tangible personal property subject to sales tax must file an application with the BOE for a seller's permit. The application may be completed online at http://www.boe.ca.gov/pdf/boe400spa.pdf, printed, and submitted in person at a BOE office or mailed. There is no fee for the permit. See Your California Seller's Permit, BOE Publication No. 73, available on the BOE website at http://www.boe.ca.gov/pdf/pub73.pdf.

Penalties for operating without valid permit. Anyone who engages in a business in California without a permit (or permits, if the person has more than one place of business) or after the permit is suspended or revoked, is guilty of a misdemeanor. Rev & T C §6071. Each officer of a corporation operating without a valid permit is also guilty of a misdemeanor. Rev & T C §6071. A wholesaler that encourages a retailer to sell at retail, knowing that the retailer lacks a valid permit, may be charged with aiding and abetting. 62 Ops Cal Atty Gen 336 (1979).

Required for each place of business. A permit is required for each place of business. Rev & T C §6066(a). No additional permit is needed at warehouses and other places where sales are not ordinarily made, and if two or more activities (*e.g.*, a restaurant and a service station) are conducted by the same person on the same premises, only one permit is required for both activities. 18 Cal Code Regs §1699(a). Permits are required, however, for warehouses where merchandise is stored and sales of the merchandise are negotiated out of state but the merchandise is delivered or the orders filled at the warehouse. 18 Cal Code Regs §1699(a).

Agents with no fixed place of business. If agents make sales on behalf of a principal and do not have a fixed place of business but travel from place to place, each agent need not obtain a seller's permit if the principal obtains a permit for each place of business in California. If the principal does not do so, each agent must obtain a permit. 18 Cal Code Regs §1699(e).

Changes in location. Holders of a seller's permit must notify the BOE of any changes in location or any new locations. Rev & T C §6068. The Board allows reregistration by mail and telephone.

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§8.59 2. Use Tax Registration

Retailers doing business in California and making sales of tangible personal property, the storage, use, or other consumption of which is subject to use tax, must register with the BOE. Rev & T C §6226. A retailer receiving rentals from a lease of tangible personal property located in California is deemed to be a retailer engaged in business in California and must collect tax when the rentals are paid by the lessee. 18 Cal Code Regs §1684(a).

Retailers who are not doing business in California may apply to the BOE for a "Certificate of Registration—Use Tax." Holders of such certificates must collect tax from purchasers, give them receipts, and pay the tax to the BOE in the same manner as retailers doing business in California. 18 Cal Code Regs §1684(c).

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§8.60 3. Security

The State Board of Equalization may in its discretion require security for the payment of any tax due or to be due. Rev & T C §6701.

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B. Resale and Other Exemption Certificates

§8.61 1. Resale Certificate

The burden of proving that a sale of tangible personal property is not a retail sale, and thus not subject to tax, is on the seller unless the seller timely obtains a certificate from the purchaser establishing that the property was purchased for resale. Rev & T C §6091.

A certificate will be considered timely obtained if it is received at any time before the seller bills the purchaser for the property, within the seller's usual billing and payment cycle, or at or before the property is delivered to the purchaser. 18 Cal Code Regs §1668(a)(1). If the seller takes the certificate in good faith from someone who is engaged in selling tangible personal property and who at the time of the purchase is the holder of a seller's permit, the certificate relieves the seller from liability for the sales tax and the duty of collecting use tax. See Rev & T C §6092; 18 Cal Code Regs §1668(a);

A person who gives a resale certificate for property that he or she knows at the time of purchase is not to be resold by him or her in the regular course of business is liable to the state for the amount of tax that would otherwise have been due. Rev & T C §6094.5(b). Penalties may be imposed on any person, including an officer or employee of a corporation, who, for the purpose of avoiding tax, gives a resale certificate if the purchaser knows at the time of purchase that the property is not to be resold in the regular course of business. Rev & T C §6094.5. A seller is presumed to have taken a resale certificate in good faith in the absence of evidence to the contrary. 18 Cal Code Regs §1668(c).

A resale certificate should be substantially in the form prescribed by the BOE in 18 Cal Code Regs §1668(b). It should contain a description of the property to be purchased and a statement that it is being purchased for resale; be dated and signed by the purchaser or the purchaser's representative; bear the purchaser's name, address, and number of the purchaser's seller's permit, or, if the purchaser does not have a seller's permit because the purchaser only sells property of a kind the retail sales of which are not taxable, an appropriate notation to that effect; and indicate the general character of the property sold by the purchaser in the regular course of business. Rev & T C §6093; 18 Cal Code Regs §1668(b)(1).

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§8.62 2. Exemption Certificate

Sellers may take exemption certificates from purchasers, thereby rebutting the presumption that all gross receipts are taxable. Rev & T C §6091; 18 Cal Code Regs §1667(a). A seller will not be liable for the sales tax if the purchaser timely certifies in writing to the seller that the property will be used in a manner or for a purpose that exempts the sale from the measure of taxable sales. 18 Cal Code Regs §1667(b)(1). A certificate is timely given at any time before the seller bills the purchaser, within the seller's normal billing and payment cycle, or at or prior to delivery of the property to the purchaser. 18 Cal Code Regs §1667(b)(1).

If no specific form of exemption certificate is prescribed in the Revenue and Taxation Code or in the regulations, a written certificate will suffice if it is dated and bears the signature of the purchaser or the purchaser's agent or employee, the name and address of the purchaser, the number of the purchaser's seller's permit (or, if the purchaser is not required to hold a seller's permit, a notation to that effect and the reason), a description of the property purchased under the certificate, and a statement of how the property will be used so as to make the sales or use tax inapplicable. 18 Cal Code Regs §1667(c)(1). A few special exemption forms are provided in the regulations. See, *e.g.,* 18 Cal Code Regs §1603, App A (taxable sales of food products).

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§8.63 C. Tax Returns and Payment

Unless the BOE specifies otherwise, returns and payments for sales and use taxes must be submitted on or before the last day of the month following each quarterly period. Rev & T C §§6451-6452, 6455. Sellers are instructed at the time of registration as a seller whether to file returns on a monthly, quarterly, or annual basis. Taxpayers reporting monthly or annually must file and pay within one month following the close of the period. At the close of each reporting period, sellers are sent appropriate forms on which to make a return. Failure to receive the form does not excuse a failure to file a timely return as required by Rev & T C §§6452 and 6455.

Any person whose estimated measure of sales and use tax liability averages $50,000 or more per month is required to make prepayments and file reports. Rev & T C §§6471-6472.

If estimated tax liability averages $20,000 or more per month, payments must be made by electronic funds transfers. See Rev & T C §§6479.3-6479.5.

Various penalties and interest apply for failure to timely file and pay taxes. See Rev & T C §§6452(c), 6455(c), 7153.

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§8.64 D. Records

Every seller, retailer, or person storing, using, or otherwise consuming in California tangible personal property purchased from a retailer, and every lessor and lessee of tangible personal property for use in California, must maintain adequate records. Rev & T C §7053. The records must show gross receipts from sales or rental payments made in California, all deductions claimed in a return, and the total purchase price of all tangible personal property purchased for sale, consumption, or lease in California. See 18 Cal Code Regs §1698.

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9

Directors and Officers

Gary L. Wollberg

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§9.1 I. SCOPE OF CHAPTER

This chapter discusses the corporate governance rules applicable to nonprofit corporations, including the role of the board of directors (see §§9.2-9.10), the composition of the board (see §§9.15-9.64), the execution of board actions (see §§9.65-9.102), the relevant standard of conduct and director liability (see §§9.103-9.130), statutory liability protections (see §§9.151-9.155), and inspection rights (see §§9.163-9.164). The chapter also addresses transactions between directors and corporations, including the rules governing self-dealing transactions. See §§9.131-9.150. In addition, it discusses governance requirements applicable to corporate officers (see §§9.11-9.14) and indemnification for directors, officers, and agents (see §§9.156-9.162).

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II. ROLE OF BOARD OF DIRECTORS

§9.2 A. Authority of Board

Board exercises corporate powers. The activities and affairs of a nonprofit corporation and all of its corporate powers are exercised by or under the direction of a board of directors. Corp C §§5210, 7210, 9210(a). Every nonprofit corporation, other than a religious corporation, must have a board of directors. Corp C §§5210, 7210. The articles or bylaws of a religious corporation may eliminate the requirement for a board of directors, or change the scope of authority of a board of directors. Corp C §9210(a).

Limitations on authority. The authority of the board of directors is subject to general principles of fiduciary duty (Corp C §§5231, 7231, 9241) and to the Attorney General's power to regulate public benefit corporations and mutual benefit corporations that hold assets in charitable trust (Corp C §§5250, 6511, 7240, 8511).

NOTE: The Attorney General's oversight of religious corporations is limited to enforcing statutes requiring certain periodic filings, matters concerning the liquidation of the corporation, and prosecutions under the criminal laws, among other limited powers. The Attorney General may also seek to enforce the provisions of any charitable trust on assets acquired by general solicitation for a charitable purpose other than the general support of the corporation. Corp C §9230. This limited authority reflects a sensitivity to the rights of religious corporations under the First Amendment to avoid the state adjudicating ecclesiastical disputes unless genuine civil or property rights are involved.

The directors' authority can also be limited by a requirement for member approval imposed by law, the articles, or the bylaws. See Corp C §§5210, 7210, 9210. For a list of corporate actions that are reserved by law for member approval, see §10.35. Other than as provided by law, the articles, or the bylaws, the members have no role in the management of the corporation except to exercise their franchise to elect or remove directors or to approve self-dealing transactions by the directors. See §§9.26, 9.131-9.143. Indeed, a nonprofit corporation is not even required to have members. Corp C §§5310(a), 7310(a), 9310(a). See §10.4. In a corporation without members, the directors are subject only to their general fiduciary duties and the oversight of the Attorney General, and they are elected by their fellow directors. See §9.29.

Deliberative body. The decisions of a board of directors, and of the committees of a board, are made collectively by deliberation. All actions of a board of directors must be consistent with the directors' fiduciary duties, in essence the duty of loyalty and the duty of care. See §§9.109-9.114. For further discussion, see ABA Section of Business Law, Nonprofit Governance and Management (2002); ABA Section of Business Law, Guidebook for Directors of Nonprofit Corporations (2d ed 2002); ABA Section of Business Law, Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (2005).

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§9.3 1. Significant Matters Typically Requiring Board Action or Approval

The following actions customarily require board action or ratification to be effective:

- Adopting, amending, or repealing bylaws (Corp C §§5150(a), 7150(a), 9150(b));
- Amending articles of incorporation (Corp C §§5812, 7812, 9620(a));
- Electing directors in some nonmember corporations (see Corp C §§5310(c), 7310(c), 9310(c));
- Filling vacancies on the board and removing directors in some instances (Corp C §§5221, 5224, 7221, 7224, 9221, 9224; see §§9.45-9.47);
- Electing officers (Corp C §§5213(b), 7213(b), 9213(b));
- Employing an executive director, if applicable;
- Appointing and assigning duties to committees of the board (Corp C §§5212(a), 7212(a), 9212(a); see Corp C §§5210, 7210, 9210(b); see also §§9.5-9.10);
- Adopting the annual budget;
- Planning the year's activities;
- Adopting corporate policies and long-term plans;
- Investing corporate funds;
- Complying with governmental reporting requirements and taxation laws (see chap 12);
- Issuing reports and financial statements to members and acting on members' requests for inspection of records (see §§10.108-10.120);
- Calling and fixing special membership meetings (Corp C §§5510(e), 5511(c), 7510(e), 7511(c), 9411(b)-(c));
- Deciding to seek member approval by written ballot and preparing, distributing, tabulating, and reporting the ballot results (Corp C §§5515, 7515, 9414);
- Bringing or defending legal actions on behalf of the corporation;
- Designating the corporate depositary and authorized signatories;
- Approving corporate borrowing or loans (see Corp C §§5236, 7235 on loans to directors; see also §§9.146-9.149);
- Approving indemnification of corporate directors, officers, and other agents (Corp C §§5238(e), 7237(e), 9246(e); see §§9.156-9.162);
- Approving the mortgage or other hypothecation of corporate property to secure payment or performance of contracts or obligations (Corp C §§5910, 7910, 9630);
- Approving the sale, lease, conveyance, exchange, transfer, or other disposition of corporate assets (Corp C §§5911, 7911, 9631; see chap 20);
- Approving mergers, reorganizations, and dissolutions (Corp C §§6011, 6610-6721, 8011, 8610-8724, 9640(c), 9680; see chap 20).

For actions ordinarily requiring member approval, see §10.35.

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§9.4 2. Delegation by Board

The board may delegate management functions and corporate powers to officers, committees, or other persons provided that the board retains the ultimate power to oversee, or change, the actions of the persons delegated. Corp C §§5210, 7210, 9210(b). However, certain actions may not be delegated at all, even to an executive committee of a board. See §9.8.

It is worth emphasizing that corporate powers can be exercised *under* the direction of the board, as well as directly by the board. Because a board is composed of several individuals who have different busy schedules, it is unreasonable to expect that they will be able as a group to apply the time necessary to actually conduct the corporation's affairs and exercise its powers. Therefore, to be effective, boards delegate their powers to committees (see §§9.5-9.10) and officers (see §§9.11-9.14).

NOTE: Subject to any limitations in the Code, articles, or bylaws, delegation is an inherent power. Because a corporation has "all of the powers of a natural person" (Corp C §§5140, 7140, 9140), the corporation has the same rights and powers as a natural person to delegate the conduct of its business affairs.

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B. Executive Committee and Other Board Committees

§9.5 1. Committees Possessing Board's Authority

Committees that are given the authority of the board ("committees of the board") may be authorized in the bylaws (Corp C §§5151(c)(4), 7151(c)(4), 9151(c)(4)), or established by resolution of the board. Membership in a committee of the board is limited to two or more voting directors. Corp C §§5212(a), 7212(a), 9212(a). See also Corp C §§5210, 7210, 9210(b).

CAUTION: Persons who are not directors are barred from serving on a committee that exercises the authority of the board. Corp C §§5212(b), 7212(b), 9212(b). To permit nondirectors to serve would give them the powers of directors because committees of the board act without first obtaining the approval of the full board (unless a limitation is imposed by the bylaws or the resolution establishing the committee).

Executive committee. The executive committee is the most common among committees of the board. An executive committee is customarily composed of the corporation's chief volunteer officers (*i.e.,* the president or chair of the board, the vice president or vice chair, and the chief financial officer) and other influential members of the board of directors. The committee serves at the pleasure of the board. Corp C §§5212(a), 7212(a), 9212(a).

PRACTICE TIP: An executive committee is advisable for corporations with a great number of directors as it often provides the only effective means for the corporation to respond to rapidly developing situations occurring between regular board meetings or when a quorum is otherwise unavailable.

Other customary standing committees include committees for recruitment and nomination of candidates for election as directors, finance, audit, marketing, fundraising, and program activities.

Establishment of committee. Unless the articles or bylaws require approval by a majority of the number of directors authorized by the articles or bylaws, a majority of directors then in office (provided that a quorum is present) may establish one or more committees of the board and appoint the committee's members and alternate members to substitute for any absent member at a committee meeting. Corp C §§5212(a), 7212(a), 9212(a). For a bylaw provision establishing an executive committee, see §7.84.

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2. Other Committees Appointed by Board

§9.6 a. Advisory Committees

Committees that do not exercise the authority of the board, often called advisory committees, may also be established through the bylaws or by resolution of the board. The members of advisory committees may include persons who are not voting directors. Corp C §§5212(b), 7212(b), 9212(b). Advisory committees can serve in an advisory capacity to the board of directors and are subject at all times to the ultimate direction of the board. Corp C §§5212(c), 7212(c), 9212(c).

NOTE: A board has the power to "delegate the management of the activities of the corporation to any… committee *however composed*" (emphasis added). Corp C §5210, 7210, 9210(b). This power of delegation is sufficiently broad to include advisory committees. The Code thus draws a distinction between committees of the board having the authority to act without any prior consultation with the board as a whole, and delegated powers which presume some initial deliberation by the board in fixing the delegation and perhaps including in the resolution effecting the delegation some limitation on the exercise of the delegated power. However, certain actions may not be undertaken by either a committee of the board or an advisory committee wielding delegated powers (see §9.8). See Corp C §§5212(c), 7212(c), 9219(c).

Bylaw or resolution should define committee's scope. The bylaw provision or board resolution establishing an advisory committee should clearly define the committee's advisory role, the scope of its activities, the number of committee members, and the qualifications, if any, for service. The bylaws may also describe the actions that cannot be delegated by the board to any committee. See §9.8. Clear subordination of the committee's authority to that of the board may also help ensure that the organization's directors' and officers' liability insurance will cover claims arising from, or relating to, the acts or omissions of the committee. See §9.160. For bylaw provisions establishing various board committees, see §§7.81-7.86.

Advantages of committees. Advisory committees can be used to augment the personnel resources available to a nonprofit corporation. The amount of time that volunteer directors may apply to the corporation's business will necessarily be limited, and many nonprofits will not have the funds to hire a large staff. An advisory committee can be used to staff efforts that might otherwise suffer from lack of attention.

Advisory committees are also a means for developing future directors. While introducing members of the general community to the work of the corporation, an advisory committee allows the corporation to assess the committee members' fitness for service as a director and their commitment to active participation. A nomination committee is often formed as an advisory committee because its non-director members expand outreach into the general community to identify persons with specialized skills or resources.

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§9.7 b. Audit Committees

Nonprofit corporations organized for charitable purposes (generally nonprofit public benefit corporations other than religious corporations, educational institutions, and hospitals and health care service plans) that receive or accrue in any fiscal year gross revenue of $2 million or more (exclusive of grants from, and contracts for services with, governmental entities for which the governmental entity requires an accounting of the funds received) must have an audit committee. Govt C §§12583, 12586(e)(2). The audit committee may include persons other than directors, but it may not include any officers or other members of the organization's staff. If the organization has a finance committee, the chair of the audit committee may not be a member of the finance committee, and members of the finance committee must constitute less than half of the members of the audit committee. Audit committee members may not be compensated specifically for service on the committee, and may not have a material financial interest in any entity doing business with the corporation. The duties of the audit committee include recommending to the board the retention or termination of auditors, negotiating the compensation for audit services, conferring with the auditor to satisfy its members that the financial affairs of the corporation are in order, reviewing and determining whether to accept an audit, and approving nonaudit services provided by the auditor. Govt C §12586(e)(2). For further discussion, see §21.11.

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§9.8 3. Powers Not Delegable to Board Committees

Any of the board's powers may be delegated to committees of the board, except the following powers:

- Approving any action required by law to be approved by the members or a majority of all members, regardless of whether the corporation has members. Corp C §§5212(a)(1), 7212(a)(1), 9212(a)(1).

NOTE: The limitation that a committee cannot approve any action that under law requires approval of the members or approval of a majority of all members (Corp C §§5212(a)(1), 7212(a)(1), 9212(a)(1); see Corp C §§5033-5034) is usually interpreted to also apply to nonprofit corporations without members. In such instances, the board must act.

- Filling vacancies on the board or on a committee of the board. Corp C §§5212(a)(2), 7212(a)(2), 9212(a)(2).
- Fixing the compensation of board and committee members. Corp C §§5212(a)(3), 7212(a)(3), 9212(a)(3).
- Adopting, amending, or repealing bylaws. Corp C §§5212(a)(4), 7212(a)(4), 9212(a)(4).
- Amending or repealing any board resolution that by its express terms cannot be amended or repealed by a committee. Corp C §§5212(a)(5), 7212(a)(5), 9212(a)(5).
- Appointing committees of the board or members of board committees. Corp C §§5212(a)(6), 7212(a)(6), 9212(a)(6).
- For public benefit and mutual benefit corporations, expending corporate funds to support a nominee in an election for director if more people have been nominated than can be elected. Corp C §§5212(a)(7), 7212(a)(7).
- For public benefit corporations and mutual benefit corporations holding assets in charitable trust, approving self-dealing transactions (except in certain emergency situations, and then only if the committee's approval is ratified by the full board; see §9.131). Corp C §§5212(a)(8), 7212(a)(8).

NOTE: Board committees of corporations with members are without power to approve an amendment to the articles (Corp C §§5812, 7812, 9620), the sale of substantially all assets not in the usual course of business (Corp C §§5911, 7911, 9630), a merger (Corp C §§6011, 8011, 9640), or a dissolution (except in limited circumstances such as bankruptcy and inactivity for over 5 years) (Corp C §§6610, 8610, 9680), as these actions also require approval by the members. See Corp C §5212(a)(1).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.9 4. Term of Office, Committee Appointments, and Recordkeeping Requirements

§9.9 4. Term of Office, Committee Appointments, and Recordkeeping Requirements

Committee members, whether serving on a committee of the board exercising the board's authority (see §9.5) or an advisory board (see §9.6), serve at the board's pleasure. Similarly, the committees themselves exist at the board's pleasure unless the bylaws provide otherwise. Corp C §§5212(a), 7212(a), 9212(a). Bylaws that create board committees may also fix the length of the terms of committee members. See Corp C §§5151(c)(4), 7151(c)(4), 9151(c)(4).

The meetings and minutes of board committees are governed by the same procedural rules governing the meetings and minutes of the board (see §§9.76-9.95). Corp C §§5211(d), 7211(d), 9211(d). However, advisory committees are not required to maintain formal minutes or follow any particular procedures. See Corp C §§6320(a)(2), 8320(a)(2), 9510(a)(2).

PRACTICE TIP: Because the Corporation Code's procedural rules for board meetings do not automatically apply to an advisory committee, counsel drafting an enabling resolution for an advisory committee should advise the client to consider what procedural rules, if any, should apply. Although the reports and recommendations of advisory committees are not binding on the corporation, formal procedural rules may help direct the work of these committees and avoid disputes among committee members over protocol.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.10 5. Appointing Staff as Ex Officio Committee Members

§9.10 5. Appointing Staff as Ex Officio Committee Members

Committees addressing program and personnel issues often involve staff employees in deliberations. However, it is inadvisable to include staff employees as members of advisory committees because it may give the impression that directors serving on these committees are involving themselves in day-to-day operations rather than exercising their oversight and policy responsibilities.

PRACTICE TIP: The better practice is to invite staff employees to join meetings on an ad hoc basis, and note in the minutes that these employees were invited to join the meeting. Alternatively, the bylaws can provide that certain persons, such as staff, be nonvoting members of advisory committees. Care should be taken to not designate staff employees as ex officio members of advisory committees because an ex officio designation implies full rights to participate and vote in all meetings of the committee. See Corp C §5047.

For analogous concerns when appointing the chief executive officer to serve as a board member, see §9.20.

NOTE: If the committee exercises board powers, staff members cannot legally serve in any capacity other than as advisory and nonvoting unless they are also duly elected or appointed board members. See §§9.5-9.6.

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C. Corporate Officers

§9.11 1. Required and Discretionary Officers

Nonprofit corporations must have a chair of the board or a president (and may have both), a secretary, and a chief financial officer or treasurer (and may have both). Corporations may have other officers, with the titles and duties as stated in the bylaws or established by the board, as may be necessary to enable the corporation to execute documents. The president or, if none, the chair of the board, is the general manager and chief executive officer of the corporation unless the articles or bylaws designate another person. Unless the articles or bylaws provide otherwise, if there is no chief financial officer, the treasurer is the chief financial officer. Corp C §§5213(a), 7213(a), 9213(a).

Holding concurrent offices. The same person may hold concurrently any number of officer positions unless the articles or bylaws provide otherwise. Corp C §§5213(a), 7213(a), 9213(a). However, the president or chair of the board of a public benefit or religious corporation may not serve concurrently as the secretary or chief financial officer. Corp C §§5213(a), 9213(a).

Scope of officer positions. Nonprofit corporations frequently differ from their business counterparts in the treatment of officer positions. The president of a business corporation is ordinarily charged with the duties and responsibilities associated with the chief executive officer. Nonprofit corporations might use different titles for officer positions, divide the responsibilities customarily associated with a single office among more than one office, or divide responsibilities between volunteer directors and paid staff. Each of these practices present challenges for counsel.

PRACTICE TIP: The president is sometimes referred to as the Chief Executive Officer, Executive Director, or Managing Director; the chief financial officer is often referred to as the Treasurer. When used, these naming conventions should be reflected in the bylaws. The better practice is for the sections of the bylaws pertaining to required officers of the corporation to begin with a reference to the officer by the title used in the Code, followed by the phrase, *e.g.,* "who shall be referred to as the treasurer." In addition, according to the Code, the title of "chair" replaces "chairperson," "chairman," or "chairwoman." Corp C §5039.5. See also Corp C §12228.5 (same for consumer cooperative corporations).

Delegation to paid staff. Nonprofit institutions with paid staff often delegate to staff the day-to-day management of the corporation. The senior employee may typically hold a title such as General Manager or Executive Director, while volunteers serving on the board might hold the positions required by the Code (*e.g.,* President or Chief Financial Officer). In these arrangements, board members might be holding officer titles primarily to satisfy statutory requirements, rather than from an expectation that the officers will exercise the full range of authority normally associated with their positions. Any restriction on the officers' powers or discretion, or variation in reporting obligations, should be clearly stated in the bylaws or in a board resolution. To do otherwise would leave the persons holding the statutory positions to appear derelict in the execution of their statutory duties.

Co-leadership issues. Some nonprofit institutions divide the principal leadership of the organization between an employee in charge of programs and another employee in charge of finances and personnel. The Code does not provide for co-presidents. In this situation, the corporation should determine as a policy matter which person is ultimately in charge, and provide the other with a different office, such as chief operating officer, taking care in the bylaws to describe the duties and reporting obligations of that office.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.12 2. Selection and Resignation of Officers

§9.12 2. Selection and Resignation of Officers

Corporate officers are chosen by the board and serve at the board's pleasure unless the articles or bylaws provide otherwise, and subject to any contractual rights the officer may have as an employee. An officer may resign at any time, subject to the corporation's rights under contract. Corp C §§5213(b), 7213(b), 9213(b).

Public benefit corporations. A public benefit corporation may provide in its articles or bylaws for the election of officers by the members. However, the term of office for any officer position filled by election by the members is 1 year unless the articles or bylaws set a longer term not to exceed 3 years. Corp C §5213(c).

Mutual benefit and religious corporations. The Corporations Code places no restriction on the term of service of an officer of a mutual benefit or religious corporation, whether appointed by the directors or elected by the members.

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§9.13 3. Statutory Authority of Officers

Binding acts. The authority of corporate officers is derived from several sources, including articles, bylaws, statutes, and board resolutions. Principles of agency law may also confer on officers implied, ostensible, or apparent authority vis-à-vis persons with whom they deal in an official capacity. See generally 1 Ballantine & Sterling, California Corporation Laws §89 (4th rev ed 1962). Accordingly, any contract or conveyance made in the name of a corporation is enforceable by and against the corporation whether the contract has been completed or is wholly or partially executory, unless otherwise limited by law, if it is (Corp C §§5141(b), 7141(b), 9141(b)):

- Authorized or ratified by the board, or
- Done within the scope of actual or apparent authority conferred by the board or within the agency power of the officer executing it.

Enforceability. If the corporation's articles or bylaws expressly or impliedly limit the activities, purposes, or powers of the corporation or its members, officers, or directors, or if limitations are imposed by statute because the corporation is in the process of dissolving and winding up its affairs, the persons with standing to challenge a corporate action or to prevent its execution because the action is beyond the scope of those limitations are strictly limited. Corp C §§5214, 7214, 9214. This is subject to the limitations expressed in Corp C §§5141(a), 5142, 7141(a), 7142, 9141(a), and 9142, as discussed in §§9.125-9.128.

Conclusive presumption that officers were authorized. Any note, mortgage, evidence of indebtedness, contract, conveyance, or other instrument in writing that is executed or entered into between a public benefit, mutual benefit, or religious corporation and any other person, when signed by (a) the chair of the board, or the president, or any vice-president, and (b) the secretary, or assistant secretary, or chief financial officer, or assistant treasurer of the corporation, is not invalid because the signing officers lacked authority unless the other party had actual knowledge of the signing officer's lack of authority. Corp C §§5214, 7214, 9214. These statutes provides a conclusive, rather than rebuttable, presumption that the signing officers had the requisite authority to sign the document. In *Snukal v Flightways Mfg., Inc.* (2000) 23 C4th 754, 98 CR2d 1, the court held that a parallel provision of the General Corporation Law (Corp C §313) did not require that the signing officers be separate individuals, or that the signing officers specify the office or offices they hold. It is sufficient that the instrument is executed by one individual who in fact holds two of the specified corporate offices (one in each category). In *Snukal,* the signing officer was both the president and the chief financial officer, but the notation following his name indicated only that he was the president.

NOTE: *Snukal* would likely have limited application to nonprofit corporations because the president or chair of the board of a public benefit or religious corporation may not serve concurrently as the secretary or chief financial officer. Corp C §§5213(a), 9213(a).

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§9.14 4. Compensation of Officers

Fixed by bylaws or board resolution. The bylaws may address the compensation, if any, of officers. If the bylaws are silent, compensation may be fixed by board resolution. Corp C §§5151(c)(5), 7151(c)(5), 9151(c)(5).

Public benefit corporations. The board of a public benefit corporation may fix the compensation of a director in his or her capacity as an officer. Corp C §5235. No obligation on the part of the corporation to pay compensation that is otherwise valid and enforceable is voidable merely because the persons receiving compensation participated in the vote to approve the compensation arrangement, unless the compensation was not just and reasonable as to the corporation at the time the compensation was approved or ratified. Corp C §5235(a). If compensation of a public benefit corporation director or officer, in his or her capacity as such, is found to be excessive, the director or officer can be held liable for repayment of the excess amount, plus interest from the date of payment. Corp C §5235(b) (no similar provision for mutual benefit or religious corporations).

Mutual benefit corporations. A director of a mutual benefit corporation who has a material financial interest in a transaction with the corporation may still be counted for purposes of determining the presence of a quorum at a meeting at which the board authorizes or ratifies the contract creating the interest. Corp C §7234.

PRACTICE TIP: When an officer of a mutual benefit corporation is also a director, any board action to approve the officer's compensation should consider the rules on self-dealing transactions (Corp C §9243; see §§9.129-9.141) and on transactions in which a director has a material financial interest (Corp C §7233(a); see §9.142).

Review requirements. When a president or CEO or a treasurer or CFO is hired, the board of directors, or an authorized committee of the board, of a nonprofit corporation that is required to register as a charitable corporation under the Supervision of Trustees and Fundraisers for Charitable Purposes Act (see Govt C §12580-12599.7) must review and approve the officer's compensation and benefits to ensure that they are just and reasonable. This review is also required when the officer's employment is renewed or extended and whenever the compensation is modified. Govt C §12586(g). For a bylaw provision establishing a compensation committee, see §7.83.

NOTE: Intermediate sanctions under the Internal Revenue Code impose a penalty of up to 200 percent on the recipient of excess compensation and a penalty of up to 10 percent on a manager who approves the payment. IRC §4958. See §3.27. These sanctions apply to nonprofit organizations that have obtained federal tax exemption, most often public benefit and religious corporations. On establishing a rebuttable presumption that a compensation arrangement is not an excess benefit transaction, see Treas Reg §53.4958-6, discussed in §§3.19-3.23.

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III. COMPOSITION OF BOARD

A. Size and Qualifications

§9.15 1. Number of Directors

A nonprofit corporation may have one or more directors; no statutory maximum applies. The articles or bylaws may establish the number of directors, state the method of determining the number of directors, or state a minimum and a maximum number and provide for the board or the members to set the exact number within those limits. Corp C §§5151(a), 7151(a), 9151(a).

NOTE: Most charities operate with three or more directors; the California Attorney General strongly recommends at least three directors. See California Attorney General's *Guide for Charities*, chap 6 (2005).

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§9.16 2. Optimum Board Size

Dependent on organization's nature. The optimum size of a nonprofit corporate board depends on the nature and mission of the organization. Large boards help ensure a diversity of representation and diminish the risk of factional domination of board policy. However, large boards can be unwieldy unless the corporation makes effective use of executive and other committees. Conversely, small boards can be effective decision-makers, but risk being dominated by a single individual or faction within the organization. Once this situation occurs, it is difficult to effectively address problems associated with power entrenchment and the resulting atrophy, particularly if the corporation has no voting membership or if the members are largely uninvolved in corporate operations.

Bylaws or exemption requirements. A corporation's bylaws or its tax-exempt status may require that the board reflect a particular composition representing the public constituency served by the organization. For example, the bylaws of a charitable foundation formed to operate food services and a bookstore on a college campus that applies its revenues to fund educational activities may require that one position on the board be reserved for a student representative.

Quorum considerations. A final consideration in board size is the ease with which the board will be able to satisfy quorum requirements. The quorum for the transaction of business is generally a majority of the authorized number of directors. Corp C §§5211(a)(7), 7211(a)(7), 9211(a)(7). The articles or bylaws of public benefit and mutual benefit corporations can alter this rule, but they cannot provide for a quorum that is less than one-fifth of the total number of authorized directors or two directors, whichever is larger, unless the corporation has a one-person board (in which case the quorum is one). Corp C §§5211(a)(7), 7211(a)(7). The articles or bylaws of a religious corporation can alter the statutory rules on quorum requirements, except that a majority vote of all directors present at a meeting is required for the board to act. Corp C §9211(a)(8).

PRACTICE TIP: If the number of directors is to be fixed between a stated minimum and maximum (subject to the rules discussed above), the bylaw's quorum provision should clearly state that the quorum is determined not by reference to the total authorized directors, but rather by reference to the total number of directors initially fixed in the bylaws or subsequently fixed by resolution, or the number then in office. This is because the Corporations Code does not define what constitutes the "authorized directors."

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§9.17 3. Becoming a Board Member

Public benefit and mutual benefit corporations. Individuals can become directors of public benefit and mutual benefit corporations in the following ways (Corp C §§5220(d), 7220(d)):

- If the corporation has voting members, the directors are typically elected to office by vote of the members.
- If the corporation is organized without members who possess voting rights (see Corp C §5056), the directors are typically chosen by individuals currently serving on the board.
- All or any portion of the directors authorized in the articles or bylaws may hold office by virtue of designation or selection by a third party as provided in the articles or bylaws (*e.g.,* the corporation's bylaws may state that one seat on the board shall be filled by a person designated by the board of an affiliated corporation).
- The articles or bylaws may designate that a natural person is a director or a member of the governing body by reason of occupying a specified position within or outside the corporation. On appointment, that person is a director for all purposes, having the same rights and obligations, including voting rights, as the other directors. Corp C §5047.
- If a public benefit or mutual benefit corporation has not issued memberships and all of the corporation's directors resign, die, or become incompetent, or the corporation's initial directors have not been named in the articles of incorporation and all incorporators resign, die, or become incompetent before initial directors are elected, the superior court in any county may appoint the corporation's initial directors on application by any party in interest. Corp C §7220(e).

Religious corporations. The articles or bylaws of religious corporations may provide for the tenure, election, selection, designation, removal, and resignation of directors. Corp C §9220. If a religious corporation has not issued memberships and all directors resign, die, or become incompetent, or the corporation's initial directors are not named in the articles and all incorporators resign, die, or become incompetent before initial directors are elected, the superior court in any county may appoint the corporation's directors on application of any party in interest. Corp C §9220(d).

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§9.18 4. Qualifications and Composition of Board

Natural persons. Only a natural person may serve as a director. Corp C §5047. The Code places no other restriction on the qualification of an individual to serve as a director, save for the "interested director" limitation for public benefit corporations provided in Corp C §5227. See §9.25.

Qualifications in articles or bylaws. A nonprofit that desires to have qualification requirements for election or appointment as a director should place them in the articles or bylaws. See Corp C §§5151(c)(3), 7151(c)(3), 9151(c)(3). The board of a mutual benefit corporation is almost always composed exclusively of members of the corporation. Religious corporations may impose special requirements, *e.g.,* that directors be ordained ministers or members of a particular religious entity. Often the nature of the organization determines some of the directors' qualifications. For example, a hospital or a research organization may want physicians or scientists as directors. The government may mandate the composition of the boards of public benefit corporations as a condition to receipt of state or federal funding.

Size considerations. Some public benefit corporations have large boards whose members are selected primarily for their ability to provide financial support or professional services to the organization or to persuade others to do so. Other corporations function with small boards consisting exclusively or primarily of the corporation's officers.

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§9.19 a. Board Composition

A challenge faced by all boards is to determine who should be asked to serve as a director. Initially, a nonprofit board may be composed of the persons who were principally responsible for the corporation's founding or who are active in the daily work of the corporation. As a nonprofit corporation matures, persons may be asked to serve on a board because of their interest in the work of the corporation, their connections to the community at large, their special occupational or management skills, or their generosity.

Governance issues. Boards of directors at each stage in the life of a corporation encounter different governance issues. A corporation at the earliest stage will have to be especially mindful to avoid conflicts of interest and feather-bedding by the volunteer directors who are actually paid to do the work of the corporation. A well-established corporation, with volunteer directors, will have to establish clear reporting requirements and effective accounting controls to manage the paid executives.

Initial composition. Whether or not a nonprofit corporation adopts formal qualification requirements in its articles or bylaws, the composition of the board is frequently a critical issue in the development of the organization. When nonprofit corporations are first organized, their boards are often populated by individuals who are keenly interested in the mission of the organization and are active in its day-to-day operations.

Composition as corporation matures. As a nonprofit corporation matures, it often expands the board's composition to include individuals with varying backgrounds, abilities, and access to resources that will benefit the corporation's mission (particularly for charitable organizations). Many charitable boards are populated with community leaders from various backgrounds, such as banking, accounting, business, real estate, construction, science, the arts, the media, politics, and the law. Although still ultimately responsible for managing the corporation, such a board may meet infrequently and delegate day-to-day decisions to a compensated general manager or executive director, or to a few of its members acting as an executive committee of the board. See §§9.5-9.10. The board may also reflect representation from various groups that are part of the charity's support or program base.

Transitional issues. Effecting a smooth transition from a board dominated by founders and individuals who are actively involved in the corporation's program activities to a board composed primarily of community leaders can be challenging. One technique to use in moving a board in that direction is to expand its size or adopt a bylaw imposing term limits for service as a director. Alternatively, the bylaws could authorize a nonvoting community advisory board with the intention of eventually adopting a subsequent bylaw amendment to combine the two boards (voting and advisory) into one board with full voting power.

PRACTICE TIP: If the corporation's articles or bylaws call for a large board, the corporation should establish a well-developed committee structure to keep the directors involved in issues complementary to their personal skills, individual experience, and personal or business resources. A strong committee structure can aid in identifying and developing new executive leadership and maximizing the benefit to the organization of having diverse resources and skills represented on the board.

NOTE: Although counsel may on occasion be asked to draft bylaws that provide for the election or appointment of alternates for some or all of the directors, counsel should advise against this practice. The Code makes no provision for alternate directors for public benefit, mutual benefit, or religious corporations. In fact, the Code provides that a person who does not have authority to act as a member of the governing body of the corporation, including through voting rights as a member of the governing body, is not a director for purposes of the Code. Corp C §5047. A director alternate who, by definition, would not have the right always to act as a member of the governing body could not be considered a director. This is in contrast to the Code's express permission for boards to appoint directors as alternates to serve on committees of the board (Corp C §§5212(a), 7212(a), 9212(a)) and the specific provision for alternate directors for consumer cooperative corporations. Corp C §§12233, 12331(a). Thus, it follows that the absence of alternate directors for public benefit, mutual benefit, and religious corporations was not a legislative oversight.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.20 b. Chief Executive Officer as Ex Officio Director

§9.20 b. Chief Executive Officer as Ex Officio Director

Dual service not advised. Chief executive officers of many business corporations customarily serve also as directors. Dual service as a director and corporate executive may result from the CEO's voting power as a shareholder, because of the force of the CEO's personality, or because the corporation's bylaws provide for that service on an ex officio basis, among other reasons. Many volunteer directors of nonprofit corporations readily embrace the notion that the organization's general manager, executive director, or other compensated chief executive officer should also hold a seat on the board. However, there are several reasons to advise that a CEO not serve on the board of a nonprofit corporation.

Negative effect on oversight. Absent an active and involved membership with voting powers, a principal function of the board of a nonprofit corporation (particularly a charity) is to provide oversight to ensure that the corporation's mission is properly implemented and that assets held in trust are properly applied. See generally California Attorney General's *Guide for Charities*, chap 6 (2005), available on the Attorney General's website at http://www.ag.ca.gov/charities/publications.php. By combining the officers' and directors' roles, a key element is missing in the conventional structure of corporate internal checks and balances among the board, members, and management. Allocating a board position to the CEO, particularly a position with full voting rights, may harm the beneficial separation of the persons responsible for managerial oversight and for establishing corporate policy from the person who is principally responsible for implementing those policies in concrete programs.

Negative impact on CEO's effectiveness. A CEO with equal voting rights as a director may find that serving as a director actually diminishes his or her effectiveness as the chief executive of the corporation. Wearing the chief executive's hat, the CEO presents agendas and proposals for the board's consideration and possibly for action, but wearing the director's hat, the CEO is only one of several voting on those proposals. A CEO who holds a seat on the board has the same rights as other directors to participate in board deliberations and to have access to all corporate records, including communications between the board and its legal counsel. Exercising these rights could create problems if the board is faced with issues involving the performance or conduct of senior management. Although there are no limitations on a director's right to inspect corporate books and records (Corp C §§6334, 8334, 9513; see §9.163), access to certain records can be denied to a director if constitutional privacy rights are involved. *Chantiles v Lake Forest II Master Homeowners Ass'n* (1995) 37 CA4th 914, 45 CR2d 1.

NOTE: Despite these many reasons for the CEO not to hold a seat on the board as a voting director, the CEO should at least be invited to attend the meetings of the board. This approach may be helpful because it is typical for CEOs to be responsible for arranging board and committee meetings and producing the minutes of those meetings.

PRACTICE TIP: Sometimes a CEO is appointed as a director ex officio on the assumption that an ex officio position lacks voting power. This is not true. Corp C §5047. See §9.17. Thus, the appointment of a CEO to the board ex officio will provide the CEO full voting rights. If this is not the intent, the better practice is to use some different designation to show that the board position carries no voting rights, such as "honorary director," with a clear statement in the bylaws that the appointment carries no voting rights.

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§9.21 5. Compensation of Directors

Compensation permitted. Directors may be compensated for their services, although directors often serve without compensation other than reimbursement of reasonable expenses incurred in the performance of their duties. The governing documents may provide that expenses will be reimbursed only if approved before the expenses are incurred. If directors are compensated, the terms of their compensation should be addressed in the bylaws or (if the bylaws do not prohibit compensation) by board resolution. See Corp C §§5151(c)(3), 7151(c)(3), 9151(c)(3).

NOTE: The Better Business Bureau Wise Giving Alliance, a private watchdog organization that establishes uniform standards to assist contributors in making informed decisions about charitable giving, recommends that not more than one director, or 10 percent of the directors, receive any direct or indirect compensation other than reasonable expense reimbursement. Further, compensated members should not serve as board chair or treasurer. Better Business Bureau Wise Giving Alliance, *Standards for Charity Accountability* (2003), available at http://www.us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=4dd040fd-08af-4dd2-aaa0-dcd66c1a17fc.

Public benefit corporations. If the board of a public benefit corporation establishes compensation of directors and the obligation is otherwise valid, the compensation agreement is not voidable as to any particular director merely because the compensated director participated in the decision to pay it, unless the amount of compensation was not just and reasonable as to the corporation at the time it was authorized, ratified, or approved. Corp C §5235(a). Liability for excessive compensation established by board action for any public benefit corporate director is limited to the amount by which the compensation exceeded what was just and reasonable, plus interest from the date of payment, in the absence of fraud. Corp C §5235(b). If fraud is established, additional damages, including exemplary damages, may be available.

NOTE: The statute does not specify who is liable for the repayment, but by implication the liability is that of the director receiving the excessive compensation. Public benefit corporations are subject to continuous monitoring by the Attorney General to ascertain the condition of a corporation's affairs and whether the corporation has failed to comply with trusts or has departed from its stated purposes. The Attorney General may institute a proceeding to correct the noncompliance or departure. See Corp C §5250.

For discussion of intermediate sanctions imposed as a result of excessive compensation, see §3.27.

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§9.22 a. Private Inurement Issues

Like other nonprofit corporations, public benefit corporations exempt from tax as charitable organizations are not prohibited from compensating their directors, officers, and employees as long as such compensation is reasonable. See Rev Rul 73-126, 1973-1 Cum Bull 220; Treas Reg §§1.162-7(b)(3), 53.4958-6. The IRS tests reasonableness by examining compensation paid to employees of comparable organizations with a similar public or charitable purpose. See GCM 39670 (Oct. 14, 1987).

Excessive compensation may result in a finding of impermissible private inurement, which would jeopardize the charity's tax-exempt status. See Treas Reg §1.501(c)(3)-1(d)(1)(ii). The IRS does not recognize any de minimis rule; even one dollar of excessive compensation may cause the charity to lose its tax-exempt status.

NOTE: Excise taxes on directors, officers, trustees, and others having similar powers and responsibilities who realize an unfair advantage from their positions with organizations exempt under IRC §501(c)(3) or §501(c)(4) (IRC §4958) were designed to provide an intermediate sanction short of loss of exemption. See §§3.27, 9.14.

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§9.23 b. Potential Adverse Effect of Compensation on Statutory Liability Protections

Several statutes limit the liability of directors of nonprofit corporations as long as the director is serving as an uncompensated volunteer. See, *e.g.,* Corp C §§5047.5, 5239, 7231.5, 9247; CC §1365.7. See also §§9.149-9.153. Accordingly, payment of compensation beyond a per diem or reimbursement of out-of-pocket expenses could preclude the director from enjoying these statutory liability protections.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.24 c. Potential Adverse Impact on Funding Opportunities

§9.24 c. Potential Adverse Impact on Funding Opportunities

Certain types of funding may be jeopardized if excessive expenditures are made for the board and its activities. The organization's principal objective should always be to advance its nonprofit purposes. Funds spent on board activities cannot otherwise be used to advance the nonprofit purposes. Thus, each expenditure for board activities should be justified in light of the corporation's specified purposes, and the board should consider whether a particular application of funds may give the appearance of impropriety.

NOTE: The Better Business Bureau Wise Giving Alliance issues reports on national charitable organizations and evaluates their operations according to basic standards in the areas of governance, solicitation practices, expenses, policy, program, and fiscal fundamentals. Quarterly, the Bureau publishes a Wise Giving Guide, which summarizes the results of its investigations and reports. See http://www.us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=518b8c5d-e1ba-4b6b-9d6c-28a412cab5a4.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.25 6. 'Interested Person' Rule--Public Benefit Corporations

§9.25 6. "Interested Person" Rule—Public Benefit Corporations

"Interested person" defined. In a public benefit corporation, no more than 49 percent of the directors may be interested persons. The term "interested persons" includes (Corp C §5227):

- Any person compensated for services rendered to the corporation (other than as a director) during the previous 12 months; and
- Brothers, sisters, spouses, parents, descendants, and in-laws of interested persons.

Any compensation for services, whether received as a full-time or part-time employee, officer, independent contractor, or otherwise (excluding compensation for director services), regardless of the amount, causes a person to be "interested" for purposes of determining eligibility for service on a public benefit corporation board. (Compare this definition of "interested person" to that of "interested director" in a self-dealing transaction (Corp C §5233(a), discussed in §9.129), which requires a material financial interest.)

Purpose of limitation. This limitation relieves directors from having to choose between using funds to compensate themselves appropriately as employees or consultants or using the funds to further the corporation's charitable or public purposes in another manner, reduces the number of opportunities for public benefit corporations to become involved in self-dealing transactions with directors, and provides the means for a disinterested review of transactions that might otherwise come within the definition of a self-dealing transaction. See Basile, *Directors' Liability Under the New California Nonprofit Corporation Law*, 13 USF L Rev 891, 902 (1979).

NOTE: Similar IRS rules apply to private foundations desiring to qualify as exempt operating foundations, requiring that such foundations have no more than 25 percent "disqualified individuals" serving as directors and no such individuals serving as officers. See IRC §4940(d)(2), (3)(B)-(E).

Effect of violation. Violation of the 49-percent limit does not affect the validity or enforceability of transactions entered into by a public benefit corporation. Corp C §5227(d). The corporation, its members, officers, and directors, and the Attorney General all have standing to enforce this requirement. If someone other than the Attorney General initiates the action, notice must be given to the Attorney General, who then has the right to intervene in the action. Corp C §5225(c). The court can order any equitable remedy, including ordering a change in the board's size or composition. Corp C §5227(c).

Avoiding violating limitation. To avoid violating the 49-percent limit, public benefit corporations with large boards should require each director to complete an annual questionnaire before the date of board elections, specifying the following:

- Any compensated services that the director or a close relative has rendered to the corporation in the past year;
- Any such services contemplated for the coming year; and
- Any such services rendered or contemplated by a firm or business with which the director (or a close relative) is associated.

Other public benefit and charitable corporations might use a more broadly worded conflict disclosure statement designed to identify both persons meeting the definition of an "interested person" and other relationships or transactions that could create an appearance of impropriety damaging to the mission of the organization or jeopardize its tax-exempt status. However, broad conflict of interest disclosure statements could appear unduly invasive and thereby alienate attractive director candidates.

Review of disclosure statement. The board or other corporate management personnel should review all disclosure statements to ensure that they are accurate and complete. If there is any question about whether a director is an "interested person," counsel should evaluate the facts.

PRACTICE TIP: If the board is nearing the 49-percent limit, the corporation should not let a director who is *not* an interested person become one by some new transaction, which may deprive the corporation of the required

disinterested majority.

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B. Method of Selecting Directors

§9.26 1. Election by Members or Delegates

Public benefit and mutual benefit corporations. If the corporation has statutory members (see §10.2), the members ordinarily elect the directors, because doing so is usually the members' most significant voting right (see §10.34). Even when a corporation has members, some directors may be designated. See §9.28. The articles of a mutual benefit corporation may also grant certain creditors the right to vote for directors. Corp C §7132(a)(2).

Religious corporations. There are no specific restrictions on the manner in which directors of religious corporations are selected or elected. The articles or bylaws provide for directors' tenure, election, selection, designation, removal, and resignation. Corp C §9220(a).

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§9.27 2. Cumulative Voting

Members have no right to cumulate votes in elections of directors unless the articles or bylaws authorize cumulative voting. Corp C §§5616(a), 7615(a), 9415(a). For further discussion, see §10.52.

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§9.28 3. Designation of Directors by Specified Persons

Public benefit and mutual benefit corporations. A public benefit or mutual benefit corporation may provide in its articles or bylaws that any or all of the directors be designated or selected by specified designators other than the members. Corp C §§5220(d), 7220(d). See form in §7.55. These designation provisions cease if the specified designator dies or if the office or status that created the right has ceased to exist. Corp C §§5220(d)(1)-(2), 7220(d)(1)-(2).

Customary designation or selection bylaws may include provisions that:

- Reserve appointment of directors to a head organization;
- Reserve a seat on the board for the charity's chief executive officer (see §9.20); and
- Reserve a seat on the board for an individual who comes from or represents a particular segment of the public served by the charity.

Religious corporations. Directors of religious corporations may be chosen by designation or selection. No restrictions limit the number of designated directors or the manner of designation in religious corporations. See Corp C §9220(a).

NOTE: Bylaw provisions that establish eligibility requirements for directors also apply to designated directors unless the eligibility requirements specifically exclude designated directors. Corp C §§5151(c)(3), 7131(c)(3), 9151(c)(3).

Same rights and duties. A designated director has all the rights, duties, and liabilities of any other director. Although a designated director may present the views and interests of the person or entity making the designation, the designated director's ultimate duty is to act in the corporation's best interests.

Special requirements. The bylaws of some nonprofit corporations attach special rights or requirements applicable to the designated directors, such as the following:

- The presence of the designated director is required for a quorum of a meeting of the board;
- The vote of the designated director is required to approve all, or certain types of, board actions;
- The designated director designates his or her successor;
- The designated director may call meetings of the board or the members, if any; or
- The designated director sits on selected committees ex officio.

Termination of designation right. Unless the articles or bylaws provide otherwise, the power to designate ceases (1) if the designator dies or, if not a natural person, ceases to exist, and (2) if the power to designate is in the capacity of an officer, trustee, or other status, and the office, trust, or status ceases to exist. Corp C §§5220(d), 9220(d).

PRACTICE TIP: Care must be exercised in drafting article or bylaw provisions for the designation of directors. The bylaws should provide for the method to communicate the designation. Provision should be made for the selection of a successor designator should the initial designator die or cease to exist, and for a change in a non-natural designator by way of merger or reincorporation. Provision should also be made for the situation when the term of a designated director expires but the designator fails or refuses to appoint a successor, the designator can no longer be found or, if an individual, the designator no longer has the capacity to act because of a disability or because he or she is subject to a conservatorship.

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§9.29 4. Election by Directors

Directors may elect their successors if the corporation has no statutory members or the only members are persons serving as directors. Corp C §§5310(c), 7310(c), 9310(c); see §§10.3-10.4. See also Corp C §§5310(b), 7310(b)(1), 9310(b)(1). For corporations without members whose bylaws provide for a board with a number of directors that can vary within a stated maximum and minimum, it may be desirable to provide for flexible nomination and election procedures so that qualified candidates can be recruited and installed at any time during the year when a seat becomes open.

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§9.30 5. Court Appointment of Provisional Director

Public benefit and mutual benefit corporations. If a nonprofit public benefit or mutual benefit corporation has an even number of directors who are equally divided and cannot agree on the management of its affairs, so that its activities can no longer be conducted to advantage or there is risk that the corporation's property, activities, or business may be impaired or lost, the superior court of the county where the corporation's principal office is located may appoint a provisional director to break the deadlock. The court's jurisdiction exists regardless of whether an action is pending for involuntary dissolution and winding up of the corporation and regardless of contrary provisions in the articles or bylaws. Any director, members holding at least one third of the voting power of the corporation, and the Attorney General have standing to bring an action to appoint a provisional director. Corp C §§5225(a), (d), 7225(a), (d). If a director or the requisite percentage of members initiates the action, notice must be given to the Attorney General, who has the right to intervene in the action. Corp C §§5225(c), 7225(c).

If the members of a public benefit or mutual benefit corporation are deadlocked so that they cannot elect directors to office when vacancies exist on the board, members holding at least 50 percent of the voting power may petition the superior court to appoint a provisional director or directors or to order other appropriate equitable relief. Corp C §§5225(b), 7225(b).

Anyone appointed as a provisional director must be an impartial person who is neither a member nor a creditor of the corporation. Provisional directors may not have any relationship by consanguinity or affinity within the third degree, according to the common law, to any directors of the corporation or the judge hearing the matter. Corp C §§5225(e), 7225(e).

A provisional director has all the rights and powers of a director until the deadlock is broken or until the provisional director is removed by court order or by approval of a majority of all members. The court sets the compensation for service as a provisional director unless otherwise agreed by the provisional director and the corporation. Corp C §5225(e).

Religious corporations. No similar right to seek the appointment of a provisional director exists for religious corporations, probably out of concern for the involvement of the government, through the courts, in the internal affairs of religious organizations. See Runquist, *The Government's Role in the "Purification" of Religious Organizations*, 7 Pepperdine L Rev 355, 369 (1980).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/ C. Statutory Nomination and Election Procedures--Public Benefit and Mutual Benefit Corporations/§9.31 1. Reasonable Nomination and Election Procedures--Safe Harbor Rule

C. Statutory Nomination and Election Procedures—Public Benefit and Mutual Benefit Corporations

§9.31 1. Reasonable Nomination and Election Procedures—Safe Harbor Rule

Public benefit and mutual benefit corporations. The articles and bylaws of public benefit and mutual benefit corporations need not specify nomination and election procedures, although the members must be accorded procedures that are reasonable "given the nature, size and operations of the corporation" if the directors are elected by the members. Corp C §§5520, 7520.

Public benefit and mutual benefit corporations with 500 or more members may comply with Corp C §§5521-5524 or §§7521-7524 (see §§9.31-9.35) to enjoy a safe harbor that results in the corporation's nomination and election procedures being deemed reasonable. As to these larger corporations, these statutes do not prescribe the *exclusive* means of making available to the members reasonable procedures for nomination and election of directors. These corporations can make other reasonable nomination and election procedures available to its members. Corp C §§5520(b), 7520(b).

NOTE: If challenged, the corporation will have the burden of establishing that the alternative procedures were reasonable.

If more persons are nominated than can be elected, the corporation may not expend corporate funds to support any nominee's candidacy without board authorization. Corp C §§5526, 7526.

Religious corporations provide for the selection and election of their directors in the articles or bylaws. Corp C §9220(a). The Code does not require reasonable procedures for religious corporations.

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§9.32 a. Mailing Election Materials

Mailing requested materials. A public benefit or mutual benefit corporation with 500 or more members may provide that, on written request by any nominee for election to the board and payment of the reasonable costs of mailing (including postage), the corporation, within 10 business days after the request and tender of payment, will mail to all members, or that portion of the membership as the nominee may reasonably specify, any materials that the nominee has provided and that are reasonably related to the election. Corp C §§5524, 7524.

Alternative inspection rights. Alternatively, the corporation may choose to permit the nominee either to inspect and copy the corporation's roster of member names and addresses or to obtain from the corporate secretary, on tender of a reasonable charge, an alphabetized list of the names, addresses, and voting rights of the members entitled to vote in the election. If the corporation decides to provide access to the membership roster or a list of the members' names and addresses, that option must be exercised within 5 business days after the corporation receives the nominee's request that election materials be mailed. Corp C §§5524, 7524; see Corp C §§6330(a), 8330(a).

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§9.33 b. Publication of Materials Soliciting Votes; Nominee's Rights

A corporation with 500 or more members that publishes any material soliciting a vote for any nominee for director in any publication owned or controlled by the corporation may make available to all other nominees, in the same issue of the publication, an equal amount of space, with equal prominence, to be used by the nominee. The nominee must use the space for a purpose reasonably related to the election. Corp C §§5523, 7523.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.34 c. Nomination Procedures

§9.34 c. Nomination Procedures

Corporations with 500 or more members may provide that, except for directors elected by delegates, or by members or delegates voting as a unit or group (Corp C §§5152-5153, 7152-7153), anyone who is qualified to serve as a director may be nominated as follows (Corp C §§5521, 7521):

- By any method authorized in the bylaws;
- By any method authorized by the board of directors, if the bylaws are silent;
- By petition delivered to a corporate officer and signed within the 11 months preceding the election by (1) 2 percent of the voting power of the members if the corporation has fewer than 5000 members or (2) 1/20 of 1 percent of the voting power (but at least 100 members) if the corporation has 5000 or more members; or
- By a member present, in person or by proxy, at a meeting called for the election of directors.

Exception. The member petition procedure for nominating directors does not apply to mutual benefit corporations with one million or more members engaged primarily in retail merchandising of consumer goods. For these corporations, a petition must be signed, within the 11 months preceding the election date, by a reasonable number of members as is stated in the bylaws or, if the bylaws are silent, then by the reasonable number of members as the board determines. Corp C §7521(c).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.35 d. Close of Nominations; When Election Not Required

§9.35 d. Close of Nominations; When Election Not Required

A corporation with 5000 or more members may provide for the following in any election of a director or directors, other than an election in which directors are elected by delegates or by members or delegates voting by unit or group (Corp C §§5522, 7522):

- The articles or bylaws must set a date for the close of nominations for the board, not less than 50 or more than 120 days before the election.
- No nominations for the board can be made after the date set for the close of nominations.
- If more people are nominated for the board than can be elected, the election must include a procedure that gives all nominees a reasonable opportunity to solicit votes and for all members to choose among the nominees.
- Nominees must have a reasonable opportunity to communicate to the members their qualifications and the reasons for their candidacy.
- If after the close of nominations the number of people nominated for the board is no more than the number of directors to be elected, the corporation may declare that those nominated and qualified to be elected have been elected without further action.

NOTE: Although no statute provides for a similar practice in electing directors in smaller nonprofit organizations, the risk of electoral conflict is reduced if the bylaws provide clear procedures for opening and closing nominations.

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§9.36 e. Protecting Corporation and Corporate Agents From Liability for Content of Nominee-Generated Election Materials

Content not subject to approval. Nonprofit corporations may not condition the dissemination of a candidate's election materials on the corporation's approval of the content of the materials. See *KQED v Hall* (1982) 135 CA3d 951, 185 CR 630. However, it remains an open question whether a nonprofit corporation can create rules of general application prescribing the content of candidates' statements. But see *Clark v Burleigh* (1992) 4 C4th 474, 14 CR2d 455 (upholding Elec C §10012.1 to prohibit references to other candidates running for office in any candidate's statement submitted for inclusion in voter information pamphlet).

COMMENT: Although constitutional issues are not involved in the regulations of private organizations, in the author's opinion, *Clark* supports the reasonableness of content regulations when adopted by nonprofit organizations.

Public benefit and mutual benefit corporations. No public benefit or mutual benefit corporation (or its agents, officers, directors, or employees) can be held criminally liable, or liable for negligence (active or passive) or otherwise, for damages to any person because of any material that a nominee for director supplies and that the corporation mails or publishes under reasonable nomination or election procedures. Corp C §§5523-5524, 7523-7524. The nominee remains liable and must indemnify and hold harmless the corporation, its agents, officers, directors, and employees for all demands, costs (including reasonable legal fees), expenses, claims, damages, and causes of action arising from such material or its distribution. Corp C §§5525(b), 7525(b).

PRACTICE TIP: A public benefit or mutual benefit corporation (or its officers, directors, agents, or employees) may seek a court order that the corporation need not mail or publish material tendered by or on behalf of a nominee on the ground that the material will expose the corporation to liability. Corp C §§5525(c), 7525(c).

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§9.37 2. Typical Nomination and Election Procedures

Bylaws should specify the minimum nomination and election procedures that must be observed. For corporations with a voting membership, the procedures typically call for the appointment of a nominating committee comprising three or more members who may or may not be directors. It is recommended that this committee be required to recruit qualified candidates and recommend a slate of nominees 60 to 90 days before the election.

PRACTICE TIP: If a corporation with 500 or more members wants the benefit of the safe harbor rules (see §§9.31-9.36), the rules should be reflected in the bylaw nomination procedures and in any special requirements for the nomination of candidates by delegates or by classes of members or for the designation of certain director positions by persons possessing designation authority. See Corp C §§5220(d), 7220(d).

Large corporations. The bylaws of many large nonprofit corporations state that the corporation will conduct one mailing of all candidates' statements, within a reasonable time before the election, to give them an economical means of communicating with members. Typically, these bylaws limit candidates' statements to two pages so that they can be photocopied on two sides of a single sheet of paper.

PRACTICE TIP: Because no specific nominating and electing procedures are prescribed for directors of religious corporations, it is particularly important for their articles or bylaws to clearly state the manner in which persons can be selected or elected to serve as directors. For bylaw provisions for nomination and election of directors, see §§7.56-7.63.

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§9.38 3. Judicially Imposed Procedural Fairness

Courts may review fairness and legality. The safe harbor rules (see §§9.31-9.36) essentially codify *Braude v Automobile Club* (1978) 78 CA3d 178, 144 CR 169. The plaintiff in *Braude* sought a judicial decision that an election of directors in a nonprofit corporation as large as the Automobile Club could not be conducted fairly if management could use proxies to solicit votes. The court ruled that the authority for courts to determine the validity of elections (former Corp C §2236; now Corp C §§5617, 7616) cannot be construed to permit a court to prohibit the use of proxies entirely. However, the court affirmed its right to review the fairness and legality of proxy solicitation systems or other nomination and election procedures specified in the corporate bylaws and to order corporations to revise their bylaws to provide a fair method of electing directors despite the use of proxies. 78 CA3d at 187.

Judicial discretion. The court's discretion in fashioning relief must be consistent with law and with the corporation's articles and bylaws "to the extent feasible." Corp C §§5617(d), 7616(d). For an expanded discussion of the legislative response to *Braude* and other issues concerning the election of directors of nonprofit corporations, see Andrews, *Procedures for Electing Directors of Nonprofit Corporations Pursuant to the New Nonprofit Corporation Law*, 13 USF L Rev 857 (1979). On member proxy rights and their limitation or elimination, see §§10.56-10.65.

NOTE: Members of nonprofit mutual benefit corporations have proxy voting privileges unless such privileges are limited or withdrawn by the articles or bylaws. Corp C §§5613, 7613. Arguably, a court can exercise its discretion under Corp C §5617(d) or §7616(d) to prohibit the use of proxies if the court finds it necessary to completely eliminate proxy voting to ensure reasonable nomination and election procedures, given the nature and size of the corporation.

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§9.39 4. Election Inspectors—Public Benefit and Mutual Benefit Corporations

One or three inspectors. The boards of public benefit and mutual benefit corporations may appoint either one or three election inspectors "[i]n advance of any meeting of members" to elect directors. If the board does not appoint inspectors, or if any inspector does not appear at the meeting, the chair of the meeting may—and on the request of any member or a member's proxy must—appoint inspectors of election or replacement inspectors for any who do not appear. When inspectors are appointed at the meeting, the majority of members represented in person or by proxy must determine whether there will be one or three inspectors. Inspectors may similarly be appointed by the board or at the meeting to act with respect to any action by written ballot. Corp C §§5615(a), 7614(a).

Inspectors' duties. The particular duties of inspectors are described by statute. Corp C §§5615(b), 7614(b). These duties must be performed impartially, in good faith, and to the best of the inspector's ability, and as expeditiously as practicable. If a corporation has three inspectors, the decision, act, or certificate of a majority is effective in all respects as if all agreed. Corp C §§5615(c), 7614(c).

PRACTICE TIP: If the board anticipates that a disagreement is likely to arise over the conduct of an election or the validity of proxies or written ballots, the board should appoint election inspectors to provide a degree of certainty or finality to the decisions made by the inspector or inspectors in connection with a potentially contentious election or recall. Any report or certificate made by the inspectors is prima facie evidence of the facts stated in the document. Corp C §§5615(c), 7614(c). Thus, appointing a fair and impartial inspector can diminish the risk of entanglement in a costly and divisive election challenge.

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§9.40 5. Request for Election Results

If a written request is received from any member of a nonprofit public benefit or mutual benefit corporation within 60 days after the conclusion of a membership meeting at which directors are elected seeking information on election results, the corporation must report the number of memberships, or votes if voted cumulatively, cast for each nominee for director. If more than one class or series of membership voted in the election, the report must also state the appropriate numbers of votes by class and series of memberships. See Corp C §§6325, 8325.

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§9.41 6. Judicial Challenge of Director Elections

Remedies. Any director, member, or person who had the right to vote in the election may challenge the electoral outcome or the appointment of any director by filing an action in the superior court of the county in which the corporation's principal office is located. The superior court may order that a new election be held or an appointment be made. The superior court may also determine the validity of the issuance of memberships and the right of persons to vote. Corp C §§5617, 7616, 9418. When a complaint is filed, the court must enter an order fixing a date for the hearing within 5 days after the filing unless good cause is shown for setting the hearing at a later time. Corp C §§5617(c), 7616(c), 9418(b).

PRACTICE TIP: Anyone bringing this type of action against a public benefit corporation or mutual benefit corporation holding assets in charitable trust must give notice of the action to the Attorney General, who may intervene in the proceeding. Corp C §§5617(b), 7616(b).

Notice and service. The court's initial order must also require that notice of the date for the hearing be given and that a copy of the complaint be served on the corporation, the person whose purported election or appointment is being questioned, and anyone (other than the plaintiff) whom the plaintiff alleges to have been elected or appointed. These documents must be served in the manner in which a summons is served or, if the court so directs, by registered mail. The court may also impose further requirements on the notice as appear proper in the circumstances (such as posting a copy of the court filings at a conspicuous place within the corporation's principal office). Corp C §§5617(c), 7616(c), 9418(b). (For this purpose, registered mail includes certified mail. Corp C §5009.)

Public benefit and mutual benefit corporations. An action challenging the validity of any election, appointment, or removal of a director of a public benefit or mutual benefit corporation must be begun within 9 months after the election, appointment, or removal. If no such action is begun, any election, appointment, or removal of a director is conclusively presumed valid on expiration of the 9-month period absent fraud. Corp C §§5527, 7527. Fraud actions must be commenced within 3 years after the date the plaintiff knew or should have known of the facts constituting the fraud. CCP §338(d).

Religious corporations. In the absence of fraud, any election, appointment, or removal of a director of a religious corporation is conclusively presumed to be valid 9 months thereafter if the only defect in the election, appointment, or removal is failure to give notice as provided in the law, the articles, or the bylaws. Corp C §9419. Apparently, other reasons for challenging an election (other than claims based on allegations of fraud) would be governed by either the 4-year statute of limitations applicable to actions on a written contract or the 4-year statute of limitations applicable to actions not otherwise specified in the Code of Civil Procedure. CCP §343. But see Brockman, *Business Torts: The (Correct) Statute of Limitations for Breach of Fiduciary Duty Under California Law*, 16 Bus L News 9 (Winter 1994) (applicable statute of limitations is 2 years (see CCP §339(1)) in actions alleging that director breached fiduciary duties).

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D. Term of Office

§9.42 1. Term of Office Generally

Term limits. Elected directors generally serve 1-year terms unless the articles or bylaws call for longer or staggered terms of office. Corp C §§5220(a), 7220(a), 9220(b). The maximum term is 4 years for public benefit corporations and mutual benefit corporations with statutory members, and 6 years for public benefit and mutual benefit corporations that have no statutory members. Corp C §§5220(a), 7220(a). The articles or bylaws of a religious corporation may provide a maximum term of any length for the directors. Corp C §9220(a).

PRACTICE TIP: A nonprofit corporation dependent on the active involvement of a small group of dedicated individuals may prefer longer terms. Note that term limitations do not preclude an individual from being reelected to consecutive terms unless the articles or bylaws provide to the contrary. See §9.44.

Unless the articles or bylaws provide otherwise, each elected director holds office until expiration of the term for which he or she was elected and until a successor has been elected and qualified, unless the director has been removed from office. Corp C §§5220(b), 7220(b), 9220(c).

Designated directors. The designated directors of public benefit or mutual benefit corporations serve for the term stated in the article or bylaw creating the designated director position; if no term is stated, the designated director (subject to removal procedures; see §§9.47-9.63) serves until the governing provision of the articles or bylaws is amended to specify a term or is repealed. Corp C §§5220(d), 7220(d). Designated directors of religious corporations serve for 1 year and until their successor is designated unless the articles or bylaws state otherwise. Corp C §9220(a)-(c). For further discussion, see §9.28.

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§9.43 2. Public Benefit and Mutual Benefit Corporations

The articles or bylaws may provide for staggered terms by dividing the total number of directors into groups of one or more directors. The terms of office of the several groups of directors, and the number of directors in each group, need not be uniform. Corp C §§5220(a), 7220(a).

No amendment of the articles or bylaws may extend the term of a director beyond that for which the director was elected. Further, no bylaw increasing the terms of directors may be adopted without the approval of the members. Corp C §§5220(a), 7220(a).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.44 3. Consecutive Terms of Office

§9.44 3. Consecutive Terms of Office

The number of times a director may be reelected is not limited by statute. However, the bylaws may limit the permitted number of consecutive terms of office to ensure an influx of new ideas and to minimize the opportunity for undesirable or difficult individuals becoming entrenched on the board, particularly if the board is self-appointed. Corporations adopting term limitations may also want directors to serve for staggered terms (see §9.42) to ensure continuity in management and to preserve institutional memory.

PRACTICE TIP: Some term limitation provisions state that any service in an appointed position of fewer than a specified number of months does not count as a term for purposes of applying the limitation provision. A bylaw limiting consecutive terms should clearly state whether service as an appointee to fill an unexpired term counts as a term, or whether the limitation applies only to elected terms of office.

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§9.45 E. Vacancies

Public benefit and mutual benefit corporations. A majority of the directors then in office (even though less than a quorum) or a sole remaining director may fill any board vacancies resulting from any cause except removal unless the articles or bylaws provide to the contrary. Corp C §§5224(a), 7224(a). The board of a corporation with members can fill vacancies caused by removal only if the articles or a bylaw approved by the members explicitly authorizes the board to do so; otherwise, these vacancies may only be filled by approval of the members. Corp C §§5224(a), 7224(a). See also Corp C §§5222(e), 7222(e). On selecting successors to designated directors who have been removed, see §9.45.

PRACTICE TIP: Articles or bylaws authorizing the board to fill a vacancy after the removal of a director commonly limit that authority to circumstances in which a director has been removed for cause by action of the board, rather than extending the board's authority to situations involving removal by member action.

Religious corporations. A majority of the directors then in office (even though less than a quorum) or a sole remaining director may fill any board vacancies resulting from any cause except removal by members unless the articles or bylaws provide otherwise. Corp C §9224(a).

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§9.46 F. Resignation

Resignation authorized; restrictions. A director may usually resign from the board at any time by submitting written notice of resignation to the board, the chair of the board, the president, or the secretary of the corporation. Corp C §§5224(c), 7224(c), 9224(c). However, if a director's resignation would leave a public benefit corporation without any duly elected directors in charge of its affairs, the director may not resign without first giving notice to the Attorney General. Corp C §5226. The last remaining director of a religious corporation is not permitted to resign at all. Corp C §9226. (No similar restriction applies to mutual benefit corporations; presumably it is expected that the members, having an interest in the corporation, will elect new directors, thus ensuring that the corporation continues to function).

Effective date. The director's resignation is effective on receipt of the written notice of resignation unless the notice specifies a later time for the resignation to be effective. The corporation need not wait until the resignation is effective to initiate action to fill the vacancy; a successor can be appointed or elected to take office on the effective date. Corp C §§5224(c), 7224(c), 9224(c). This rule permits a resigning director to participate in the vote to elect his or her successor, a technique that can assist incumbent directors in maintaining their leadership of the organization when a resigning director is aligned with his or her colleagues but must resign for reasons unrelated to service on the board.

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§9.47 G. Removal of Directors

Board may remove for cause. If a corporation has members, directors may be removed only by action of the members, unless "cause" for removal can be demonstrated, in which event a director can be removed from office by action of the other directors. Corp C §§5221, 7221, 9221. The required affirmative vote for removal of directors by action of the members depends on the size of the corporation's membership. See §9.49.

Breach of fiduciary duty not "for cause." Because alleged breaches of fiduciary duty always involve material questions of fact, the Corporations Code does not include such malfeasance in office on the list of actions constituting "cause" and thus entitling the board, on the vote of a majority of a quorum, to remove a director from office. If a director is to be removed from office because of a breach of a fiduciary duty to the corporation, the action must be initiated by the members (see Corp C §§5222, 7222, 9222 (removal without cause)), by election of another person to office on expiration of the director's term, or by suit filed in the superior court of the county in which the principal office of the association is located (see Corp C §§5223, 7223, 9223).

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1. Authority to Remove Directors

§9.48 a. Removal of Board-Elected Directors

With or without cause. In nonprofit corporations without members, a majority of the directors then in office may remove any board-elected director without cause, except that the articles or bylaws of a religious corporation may expand or reduce the board's authority to remove a director without cause. Corp C §§5222, 7222, 9222. In strictly limited circumstances, the board may remove a director for cause. Corp C §§5221, 7221, 9221. For both removals without cause and removals for cause, the board may, depending on the particular circumstances, consider giving the director notice and an opportunity to respond, although neither is required by statute.

Cause for removal. The Corporations Code defines the following as cause for the removal of a director by board action (Corp C §§5221, 7221, 9221):

- When the director has been declared of unsound mind by a final court order;
- When the director has been convicted of a felony;
- When the director has failed to attend a specified number of board meetings, if the bylaws in effect when the director was elected to office provided that a director could be removed if he or she missed the specified number of meetings.

PRACTICE TIP: A bylaw stating that failure to attend meetings is cause for removal is often phrased in terms of a stated number of consecutive regular board meetings, or a stated number of regular board meetings in any 12-month period, because special meetings may be called on relatively short notice and cannot be anticipated by directors.

If the articles or bylaws prescribe qualifications for service as a director (see Corp C §§5151(c)(3), 7151(c)(3), 9151(c)(3)), a majority vote of directors who meet the stated qualifications may declare vacant the office of any director who fails or ceases to meet any qualification that was in effect when the director's current term began.
For public benefit corporations and mutual benefit corporations holding assets in charitable trust, a director can also be removed for cause if found, by a final court order, to have breached a statutory duty or obligation imposed on directors under Corp C §§5230-5239 or §7238. Corp C §§5221(a), 7221(a).

Felony convictions. The implication of the removal statutes is that a felony conviction serves as statutory cause for removal only if it occurs during the director's term of office. But see *Remillard Brick Co. v Remillard-Dandini Co.* (1952) 109 CA2d 405, 424, 241 P2d 66. Therefore, if a corporation desires to preclude persons from serving as directors who have been convicted of a felony in the past (*i.e.,* before nomination or election), the corporation ought to adopt uniform eligibility requirements for service as a director that prohibit convicted felons from serving as directors.

PRACTICE TIP: If the bylaws provide that all directors serve only 1-year terms, with no limit on how many terms they may serve, the likelihood of having to remove any director during his or her term is reduced.

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§9.49 b. Removal of Member-Elected Directors

Membership approval. Removal of a member-elected director without cause requires membership approval. Generally, approval by a majority of the members voting (at a meeting or by written ballot for which the minimum quorum has been established) is sufficient. However, for public benefit and mutual benefit corporations that have fewer than 50 members, a majority of all members must approve the removal. Corp C §§5222(a), 7222(a), 9222(a).

PRACTICE TIP: The rule for corporations with 50 or more members can make incumbent directors quite vulnerable if the bylaws provide for low quorum requirements. Accordingly, counsel should consider providing for a higher quorum percentage when the meeting is called to vote on removal of a director.

Class and cumulative voting. If a director being removed without cause was elected by a class of members, approval by an appropriate vote of that class is required. Corp C §§5222(b)(2), 7222(b)(2), 9222(b). Similarly, unless all directors are removed, directors of public benefit and mutual benefit corporations who were elected by cumulative voting may not be removed if the number of votes cast against removal, plus the number not consenting to removal, would be sufficient to elect the director under cumulative voting. Corp C §§5222(b)(1), 7222(b)(1); see 10 Cal Code Regs §2792.19(b)(2).

PRACTICE TIP: It is virtually impossible to remove a director when cumulative voting rights exist if there is any significant opposition to the proposal or significant member apathy. Because voter turnout at recall elections is typically lower than at regular elections, even a small but well-organized minority can muster sufficient votes to defeat the recall. If the corporation considers it desirable to reduce the political clout of minority factions and ensure greater director responsiveness to the will of the members as a whole, cumulative voting should be eliminated.

Status of removed directors after board recall. The Corporations Code does not address the status or authority of individuals removed as directors by a membership vote when the entire board is recalled but no provision is made for the immediate election of new directors to fill the vacancies. However, the Corporations Code states that "unless the articles or bylaws otherwise provide, each director… shall hold office until the expiration of the term for which elected and until a successor has been elected and qualified, unless the director has been removed from office." Corp C §§5220(b), 7220(b), 9220(b).

Community associations. Twenty percent of the directors of a community association must be elected by members other than the developer as long as a two-class voting structure is in effect. 10 Cal Code Regs §2792.19(c)(1). A director elected solely by the votes of the memberships held by owners other than the developer may be removed only by action of those members. 10 Cal Code Regs §2792.19. See also Corp C §7222(b)(2).

On ballot procedures for removal of directors, see §§9.54-9.62.

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§9.50 c. Removal of Designated Directors

Public benefit and mutual benefit corporations. Designated directors may be removed without cause by the designator unless the articles or bylaws provide otherwise. However, a designated director may not be removed without cause by procedures applicable to other directors except with the written consent of the designator. Corp C §§5222(f), 7222(f). Designated directors may also be removed for cause in the same manner as other directors. See §9.50. Once a designated director is removed, a successor may be designated only if the article or bylaw that authorized the original designation so provides. If silent on this point, the governing provision in the articles or bylaws is deemed repealed. Corp C §§5222(e), 7222(e). The designator's right to remove the designated director expires (1) if the designator dies or, if not a natural person, ceases to exist, and (2) if the designator possesses the power to designate in the capacity of an officer, trustee, or other status, and the office, trust, or status ceases to exist. Corp C §§5222(f)(3), 7222(f)(3).

Religious corporations. Although religious corporations may choose directors by designation, the Code leaves the manner of removal of designated directors to the articles or bylaws. Corp C §9220(a).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.51 d. Removal by Court Action

§9.51 d. Removal by Court Action

Superior court. Under certain circumstances constituting cause (see §9.51), the superior court of the county in which the corporation maintains its principal office may remove a director from office. Corp C §§5223, 7223, 9223. To remove a director, the superior court must find the director guilty of fraudulent or dishonest acts or of gross abuse of authority or discretion with reference to the corporation. Corp C §§5223(a), 7223(a), 9223(a).

Attorney General. For public benefit corporations or mutual benefit corporations holding assets in charitable trust, the Attorney General may initiate a court action or intervene in an action initiated by another party (who must give the Attorney General notice of the action). Corp C §§5223(b), 7223(c).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.52 (1) Grounds for Initiating Court Action--Removal for Cause

§9.52 (1) Grounds for Initiating Court Action—Removal for Cause

Directors may be removed by the superior court for specified acts of misconduct. Corp C §§5223, 7223, 9223. The court may bar any director removed by court action from reelection for a period prescribed by the court. Corp C §§5223(a), 7223(a), 9223(a).

Public benefit and mutual benefit corporations. Directors may be removed by the court for the following (Corp C §§5223(a), 7223(a)):

- Fraudulent or dishonest acts;
- Gross abuse of authority or discretion with reference to the corporation; or
- Breach of a director's duty under Corp C §§5230-5239 or §7238.

Religious corporations. Directors may be removed by the court for "fraudulent acts" only. Corp C §9223(a).

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§9.53 (2) Persons Empowered to Initiate Action

Directors, members, and Attorney General. A court action to remove a director for cause may be brought by any director, a specified portion of the membership, or (for public benefit and religious corporations, and for mutual benefit corporations holding assets in charitable trust) the Attorney General. Corp C §§5223, 7223, 9223. The corporation must be named as a party. Corp C §§5223(a), 7223(a), 9223(a). If the Attorney General could have brought suit but the action was initiated by another authorized person, the Attorney General must be given notice of the suit and may intervene. Corp C §§5223(b), 7223(c), 9223(b).

Member requirements. The specified portion of the members required to initiate an action varies, based on the size and type of corporation.

Public benefit corporation. Suit may be brought by the lesser of 20 members or twice the authorized number of members (generally 10 percent of the voting power of the corporation; for a definition of "authorized number of members," see §10.37). Corp C §§5036, 5223(a).

Mutual benefit corporations. The number of members necessary to institute a court action to remove a director is twice the authorized number of members. The minimum number of members required to join in the action is 20 if a mutual benefit corporation has fewer than 5000 members and 100 members if the corporation has more than 5000 members. Corp C §7223(b).

Religious corporations. The number of members necessary to institute a court action to remove a director is twice the authorized number of members. Corp C §9223(a).

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2. Ballot Procedure for Removal of Directors—Corporations With Members

§9.54 a. Inspectors of Election in Director Recall Elections

Although not required by law, the use of inspectors of election assists in defusing what can otherwise be an unstable and acrimonious political environment. One or more inspectors of election may be appointed by the board (Corp C §§5615, 7614 (no similar provision for religious corporations)) to decide the validity of signatures on the recall petition, tabulate votes, and determine challenges to the election process as they are presented. On inspectors of election generally, see §9.39.

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§9.55 b. Procedural Issues Not Addressed in Code

Recall proceedings. Statutory law provides no particular procedures for conducting recall proceedings initiated by member action. It follows that, absent special procedures provided in the articles or bylaws, recalls will follow the procedures set forth for calling, noticing, and holding special meetings of members or for taking action by written ballot distributed to the members. See §§10.66-10.71. Generally, a recall petition will take the form of a call for a special meeting of members because the statutes do not provide a mechanism for the members to otherwise force the board to distribute written ballots pursuant to Corp C §§5513, 7513 and 9413. See §10.71. In addition, a written ballot may not be feasible if the proponents of the recall wish to combine the recall with the nomination and election of replacement directors immediately following. If the corporation's articles or bylaws permit cumulative voting for directors, directors cannot be elected by written ballot. Corp C §§5513(e), 7513(e), 9413(e).

Role of bylaws. Whether the bylaws should expressly state special ground rules on recall elections to avoid disputes and disagreements in the recall effort will be a function of the nature and activities of the corporation as anticipated by its organizers. The Corporations Code provides considerable flexibility in the rules governing the nomination and election of directors according to the nature, size, and operations of the corporation. Corp C §§5520-5527, 7520-7527, 9220(a). By implication, the corporation should enjoy similar discretion to fashion reasonable recall procedures. Although not required, the principles of fair procedure that apply to the discipline of members of nonprofit public benefit and mutual benefit corporations (see §10.127) can be a model for providing targeted directors with reasonable notice and an opportunity to respond.

NOTE: The suggestions in §§9.56-9.63 describe bylaw provisions that would be typical of those designed to retard recall efforts.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.56 (1) Form and Content of Recall Petitions

§9.56 (1) Form and Content of Recall Petitions

If believed appropriate to provide targeted directors with a reasonable ability to respond to a recall effort or to discourage frivolous petitions, the bylaws may require that

- Any member petition by way of call for special meeting or request for distribution of written ballots contain a brief statement of the reasons the recall effort has been initiated;
- Each member personally sign the recall petition; and
- The principal sponsors of the recall identify themselves by name rather than by a pseudonym, such as "Members for Better Management."

NOTE: Cause of any kind is not a prerequisite to the members' right to initiate a recall. However, if recall procedures require petition proponents to state their reasons and none are given, the absence of any stated ground would likely influence the members solicited to vote on the proposed recall.

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§9.57 (2) Communications to Members

Bylaw recall procedures may state that, after a petition has been validated and before the recall election, the corporation will mail or personally deliver to all members, at the corporation's expense, statements of a specified length in support of and in opposition to the recall. The proponent's statement should be written by one or more of the named recall proponents and limited to the issues identified as justifications for the recall effort.

NOTE: Some corporations may consider it undesirable to mandate that the corporation underwrite any aspect of the efforts of recall proponents. However, if both sides are given a reasonable opportunity to air their positions, the resulting recall election will, as a practical matter, appear fairer and be less subject to successful challenge in court.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.58 (3) Statements by Directors

§9.58 (3) Statements by Directors

If individual directors hold strong opinions, pro or con, about the recall, the corporation should seriously consider distributing their statements to the members. If a director believes that a recall effort is being fueled by improper motives or that the proponents' success would be damaging to the corporation, it might be irresponsible for the director to remain detached and uninvolved. Otherwise, nontargeted directors may prefer to remain neutral.

CAUTION: If the board is aware of clear falsehoods in a petition, the proponents' statement, or the targeted director's defense statement, the board may have a fiduciary obligation to advise the members of the facts.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.59 (4) Targeted Directors Participating in Fashioning Board Responses

§9.59 (4) Targeted Directors Participating in Fashioning Board Responses

When a valid call for a special meeting to recall one or more directors is received, the board must set a date for the vote. Because an interested director is defined as one with a material financial interest in a transaction involving the corporation (Corp C §§5233, 7233(a), 9243), being the target of a recall does not make a director "interested" and therefore should not be a ground for excluding the director from board deliberations or actions on the petition or the subsequent recall procedures or vote.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.60 (5) Right to Terminate Recall Once Called

§9.60 (5) Right to Terminate Recall Once Called

After the board has received a valid call for a special meeting to recall one or more directors, the effort may lose momentum if the board initiates reforms that motivate the proponents to abandon the recall effort. A premature termination of the recall process would also be appropriate if the targeted director voluntarily resigns from office before the recall vote. However, statutory law provides no mechanism for terminating a recall drive after a call for a special meeting has been duly submitted by the required number of members.

PRACTICE TIP: The bylaws may provide that the board shall not notice the meeting or distribute written ballots if it receives a sufficient number of requests to terminate the recall (from members who originally signed the recall petition) to reduce the total number of members still requesting the recall to below 5 percent of the total voting power. See Corp C §§5510(f), 7510(e), 9411(b).

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§9.61 (6) Role of Legal Counsel

The initiation of a recall often generates an unhealthy environment of conflict and high emotions within the membership, which can put the corporation's employees, legal counsel, and nontargeted directors in awkward and delicate positions. They have a shared obligation to continue to conduct corporate business with a view to serving the best interests of the corporation and its members as a whole. These continuing fiduciary obligations may or may not be compatible with the views and agenda of the proponents of the recall (who may be a small minority of members) and the balance of the membership who initially expressed no position on the issue. The situation becomes further complicated if recall proponents or opponents hire separate counsel because that lawyer will communicate demands through the corporation's counsel. In these circumstances, corporate counsel should clearly state to the board that the client remains the corporation and that counsel will continue to provide advice that he or she believes to be in the corporation's best interests. Notwithstanding such precautions, it often seems inevitable that one side or the other (or both) will perceive counsel as biased toward their opponents, and counsel should be prepared to face lingering animosity following the recall election.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.62 (7) Separate or Combined Recall Vote If More Than One Director Targeted

§9.62 (7) Separate or Combined Recall Vote If More Than One Director Targeted

Directors hold their offices as individuals, and each director who is the target of a recall should have the right to be considered separately. Thus, the recall ballot should permit separate votes on the recall of each targeted director. A combined vote is proper only if the proposition is to vote on a complete change of leadership by recalling the entire board.

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§9.63 (8) Combining Vote to Elect New Candidates to Office With Recall

Occasionally, proponents of a recall have a slate of candidates they wish to elect to vacant positions on the board. If not inconsistent with the articles or bylaws, a call for a special meeting of members to recall one or more directors could also call for the nomination and election of replacement directors at the same meeting. See Corp C §§5224(b), 7224(b), 9224(b).

Combining the recall and the new election at one meeting might provide proponents of the recall with an advantage in the following situations:

- If the combined vote and presentation of a slate of alternative director prospects would impair the ability of a targeted director to focus the members' attention on the merits of his or her service; or
- If the general membership would be prejudiced by being presented with a slate of candidates selected by the recall proponents.

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§9.64 3. Effect of Reduction in Number of Directors

Neither a reduction in the authorized number of directors nor an amendment of the articles or bylaws reducing the number of classes of directors has the effect of removing an incumbent director before expiration of the director's term of office, unless the reduction or amendment also provides for the removal of specified directors. Corp C §§5222(c), 7222(c), 9222(c).

NOTE: If the bylaws provide for staggered director terms (see §9.42), the desire to reduce the number of authorized directors may require advice of counsel on the best way to preserve the concept of staggering. For example, a bylaw amendment might provide that at the next election following the reduction, all directors could stand for election, with those receiving the highest votes getting the longest terms. Another option is to specify in the proposed amendment which existing seats will be eliminated if the proposal is approved.

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IV. EXECUTION OF BOARD ACTIONS

A. Board Meetings

§9.65 1. Types and Frequency of Meetings

Board meetings are either regular (see §§9.66-9.67) or special (see §9.68). Except for nonprofit community associations (which must meet at least every quarter (see CC §1365.5)) and federally qualified health center boards (which must meet once a month), there is no rule on how often a board should meet. The frequency depends on the board's size, its role in the corporate structure, the nature of the corporation, and its funding sources. Meetings may be called by the chair, by any two directors, or by the corporation's president, secretary, or vice president. Corp C §§5211(a)(1), 7211(a)(1), 9211(a)(1). For written call of a board meeting, see the form in §9.72.

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§9.66 a. Annual Organizational Meeting

Corporations with members. In a nonprofit corporation with statutory members, the board generally holds an annual organizational meeting immediately after the annual meeting of the members. At this meeting, the board typically takes the following actions:

- Elects officers for the coming year;
- Appoints committees and committee members for the coming year;
- Ratifies specific actions taken during the past year by various persons and committees;
- Reviews the corporation's financial statements and assesses its current status;
- Reviews reports that must be filed with governmental authorities;
- If necessary, appoints a certified public accountant to perform the annual audit; and
- Conducts other current business before the board.

Corporations without members. For nonprofit corporations without statutory members, including corporations whose only members are its directors, the board should hold an annual organizational meeting to elect directors for the coming year, if appropriate, and to handle the other matters set forth earlier in this section, even though no annual membership meeting is required by statute.

Notice. When the time and place of the board's annual meeting are stated in the bylaws or established from time to time by board resolution, the meetings may be held without notice. Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2). For notice requirements when necessary, see §§9.70-9.77.

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§9.67 b. Other Regular Meetings

Factors. The frequency of other regular board meetings varies with the nature of the corporation and the size and type of its board. The board meets as often as necessary to manage the corporation's affairs and otherwise fulfill its fiduciary duties. The board of a public benefit corporation that is primarily a funding organization may meet only quarterly, with the executive committee, other standing committees, and the corporation's officers operating the corporation in the interim. The board of a more active public benefit corporation, such as a hospital, research organization, or theater, may hold monthly or bimonthly board meetings. The boards of mutual benefit corporations tend to meet frequently, often monthly.

Notice. When the time and place of regular board meetings are stated in the bylaws or established by board resolution, the meetings may be held without notice. For notice requirements when necessary, see §§9.70-9.77.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.68 c. Special Meetings

§9.68 c. Special Meetings

Purposes. Special board meetings are appropriate whenever board action is needed before the next regular meeting and the action cannot be taken by written consent or by an executive committee. On board action by unanimous written consent, see §§9.98-9.102. Typical matters that justify special meetings include:

- Signing material corporate contracts or incurring significant obligations for which prior board approval is desired;
- Removing or replacing officers;
- Filling vacancies on the board or its committees or among the officers; and
- Deliberating on significant corporate issues, such as personnel and litigation matters.

Who may call meeting. A special meeting may be called by the chair of the board, by any two directors, or by the corporation's president, secretary, or vice president. Corp C §§5211(a)(1), 7211(a)(1), 9211(a)(1). Although the call need not be in writing, a written call of the meeting provides a useful record that can be filed in the minute book. Notice of the meeting must be given to all directors but may be waived. See §§9.70-9.74.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.69 d. Conduct of Board Meetings--Community Associations

§9.69 d. Conduct of Board Meetings—Community Associations

Meeting requirements. The Common Interest Development Open Meeting Act (CC §1363.05) regulates the manner in which nonprofit community association boards of directors must conduct their meetings. See CC §1363.05(a). The Act imposes the following requirements on covered associations:

- The members must have the right to attend most board meetings (for this purpose a board meeting is broadly defined);
- The minutes must generally describe executive session actions;
- The members must have the right to receive minutes;
- The members must be sent periodic notification of their right to receive copies of the minutes;
- The members must have the right to receive notice of board meetings;
- The board must have the authority to call emergency meetings (free of normal member notification); and
- The members must have the right to address the board.

See Advising California Common Interest Communities, chap 2 (Cal CEB 2003).

Telephone meetings, written consent questionable. The Act makes the continued legality of community association boards conducting business by conference telephone (see §9.78) or taking action by written consent (see §§9.98-9.102) questionable, although these methods of conducting board business are not specifically prohibited by statute. In the author's opinion, to completely eliminate the directors' right to take action outside a formal meeting is ill-advised, given the volunteer nature of director service and the fact that some common interest developments may be managed by boards whose directors do not live in close proximity to each other (*e.g.,* associations in vacation developments).

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§9.70 2. Notice Requirements Applicable to Board Meetings

Annual and regular board meetings may be held without notice if the time and place of the meeting are fixed by the bylaws or by board resolution. Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2). Otherwise, annual and regular board meetings are held on such notice as may be required in the articles or bylaws. Corp C §§5132(c)(5), 5151(c)(2), 7132(c)(6), 7151(c)(2), 9132(c)(5), 9151(c)(2). Notice of special meetings must be given 4 days in advance by first-class mail or 48 hours in advance personally or by telephone, including a voice messaging system or electronic transmission. Neither the articles nor the bylaws can dispense with notice of a special meeting. Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2). Any required notice may be waived in writing by individual directors. Corp C §§5211(a)(3), 7211(a)(3), 9211(a)(3); see §§9.74-9.76. For a form of notice of meeting, see §9.71. For the definition of electronic transmission, see Corp C §20, discussed in §10.42.

NOTE: The same requirements apply to meetings of board committees but can be modified or waived for other committees. See §§9.5-9.10.

Delivery of notice. Oral notice is deemed to have been communicated when delivered in person or by telephone (whether a land line or wireless), including a voice messaging system or other system or technology designed to record and communicate messages, such as the voice mail recording system associated with the recipient's telephone or cell phone. Oral notice may also be given to a person at the office of the recipient who the person giving the notice has reason to believe will promptly communicate it to the recipient.

Written notice can be in any form capable of comprehension by ordinary visual means (Corp C §8) and is deemed delivered when personally received by the recipient, deposited in the United States mail, transmitted by fax or telegram actually delivered to a common carrier, or sent via e-mail actually transmitted to the recipient. Corp C §§20, 5015, 5211, 7211, 9211.

CAUTION: Corporations should proceed carefully in delivering notices via text messages to cell phones or in instant messages to computers, cell phones, and PDAs; although the Code aspires to flexibility in accommodating future advances in communication technologies, that very flexibility provides an opening for courts to determine whether a particular technology satisfactorily records and communicates messages. Presumably, a sufficiently clear provision in the bylaws that allows the use of new or emerging technologies should be enforceable. See Corp C §§5151(c)(2), 7151(c)(2), 9151(c)(2). Certain technologies, such as short message service (SMS), social networking, and micro-blogging services, may never be suitable because they cannot accommodate communication of all of the information required in a meeting notice.

Contents. The notice must state the date, time, and place of the meeting unless these matters are designated in the bylaws or in a board resolution. Corp C §§5211(a)(5), 7211(a)(5), 9211(a)(5). The notice need not state the purpose of the meeting (Corp C §§5211(a)(2), 7211(a)(2), 9211(a)(2)).

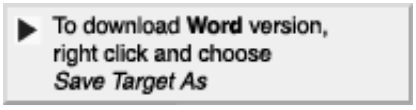
PRACTICE TIP: It is generally good practice to include an agenda, either in the notice itself or as a separate enclosed document. See §9.73. It is also helpful for directors to receive copies of written reports (especially financial reports) before the meeting.

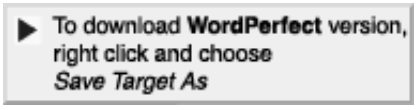
Call of a meeting. In addition to formal notice, some corporations use a call of the meeting which may be made orally (such as at the conclusion of a prior meeting), in writing, or by electronic transmission. For a form of written call of a meeting, see §9.72.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.71 a. Form: Notice of Meeting

§9.71 a. Form: Notice of Meeting





_ _[*NAME OF CORPORATION*]_ _ **NOTICE OF** _ _[*BOARD/COMMITTEE*]_ _ **MEETING**

To the members of the _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors of** _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious*]_ _ **corporation: A** _ _[*regular/special*]_ _ **meeting of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors will be held at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

_ _[*The following business, and any other business that may properly come before the* _ _[*board/committee*]_ _*, will be considered and acted on:* _ _[*List topics*]_ _.]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
Secretary of _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _ **corporation**

Comment: The notice may also state a time for ending the meeting.

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§9.72 b. Form: Call of Meeting

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_ _[*NAME OF CORPORATION*]_ _ **CALL OF** _ _[*BOARD/COMMITTEE*]_ _ **MEETING**

The undersigned calls a _ _[*regular/special*]_ _ **meeting of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors of** _ _[*name of corporation*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _**corporation, to be held at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

_ _[*The following business, and any other business that may properly come before the* _ _[*board/committee*]_ _*, will be considered and acted on:* _ _[*List topics*]_ _.]_ _

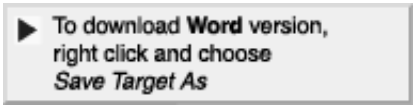
Date: _ _ _ _ _ _ __[*Signature*]__

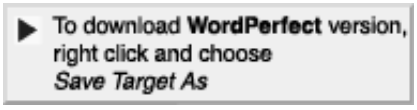
Secretary of
_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _ **corporation**

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.73 c. Form: Agenda of Meeting

§9.73 c. Form: Agenda of Meeting





_ _[*NAME OF CORPORATION*]_ _ **AGENDA FOR** _ _[*REGULAR/SPECIAL*]_ _ **MEETING OF THE** _ _[_ _[*SPECIFY*]_ _ *COMMITTEE OF THE*]_ _ **BOARD OF DIRECTORS, TO BE HELD ON** _ _[*DATE*]_ _

1. Call meeting to order.

2. Take attendance and determine existence of quorum.

3. Consider and approve or revise draft minutes of last meeting.

4. Act on old business: _ _[*specify*]_ _**.**

5. Hear reports of _ _[*specify*]_ _ **committees.**

6. Elect officers.

7. Act on new business: _ _[*specify*]_ _**.**

8. Consider _ _[*other/specify*]_ _ **business.**

9. Adjourn.

Comment: The agenda may be included with the written notice or call of the meeting, especially if the topics to be considered are not listed on the face of the notice or call (see the forms in §§9.71-9.73), mailed separately, or handed out at the beginning of the meeting.

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§9.74 d. Waiver of Notice

Directors may waive any required notice of a board or committee meeting by signing a written waiver of notice, a written consent to holding the meeting, or an approval of the minutes of the meeting; or by attending the meeting and not protesting the lack of notice before or at the start of the meeting. Corp C §§5211(a)(3), 7211(a)(3), 9211(a)(3). Written waiver or consent forms (see the forms in §§9.75-9.76) are sometimes used as an alternative to formal notice of board meetings, especially if the board is not large. Waivers, consents, and approvals of the minutes should be made a part of the minutes of the meeting or otherwise filed with the corporate records. Corp C §§5211(a)(3), 7211(a)(3), 9211(a)(3).

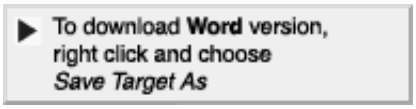
PRACTICE TIP: Although the only manner in which directors can take valid action without meeting is by unanimous written consent (see §9.98), if one or more directors fails to receive proper notice of a meeting, or fails to attend for other reasons, that absent director may execute a written consent to the actions taken by other directors attending the meeting.

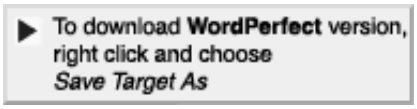
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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.75 (1) Form: Waiver of Notice

§9.75 (1) Form: Waiver of Notice

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.75-9.84.





_ _[*NAME OF CORPORATION*]_ _ **WAIVER OF NOTICE AND CONSENT TO HOLDING A MEETING OF THE** _ _[_ _[*SPECIFY*]_ _ *COMMITTEE OF THE*]_ _ **BOARD OF DIRECTORS**

The undersigned, a director of _ _[*name of corporation*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _ **corporation, waives notice and consents to the holding of a** _ _[*regular/special*]_ _ **meeting of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature of director*]__
Name: _ _[*Typed name*]_ _

Comment: This form is used to clean up an improper notice. The substance of this form and the signature line may alternatively be appended to the end of the minutes of the meeting. If the corporation knows in advance that some directors will be absent, the form in §9.76 is more appropriate.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.76 (2) Form: Waiver and Consent in Lieu of Notice

§9.76 (2) Form: Waiver and Consent in Lieu of Notice

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_ _[*NAME OF CORPORATION*]_ _ **WAIVER OF NOTICE AND CONSENT TO HOLDING A** _ _[*REGULAR/SPECIAL*]_ _ **MEETING OF THE** _ _[_ _[*SPECIFY*]_ _ *COMMITTEE OF THE*]_ _ **BOARD OF DIRECTORS**

The undersigned _ _[*, constituting all the*]_ _ **members of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors of** _ _[*name of corporation*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _ **corporation, waive notice and consent to holding a** _ _[*regular/special*]_ _ **meeting of** _ _[*that committee/the board*]_ _ **at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**, and agree that any business transacted at that meeting shall be as valid and have the same force and effect as though that meeting were held after notice duly given.**

Date: _ _ _ _ _ _ __[*Signature of director*]__

Name: _ _[*Typed name*]_ _

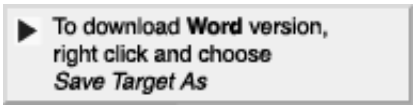
Comment: A signature line should be added for each director who needs to sign this form. The signatures need not all be on a single sheet; multiple copies of the form can be prepared and sent to the directors for signing, either before or after the meeting.

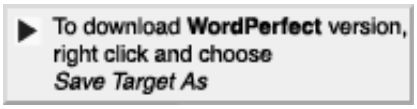
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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.77 (3) Form: Approval of Minutes of Meeting

§9.77 (3) Form: Approval of Minutes of Meeting

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_ _[*NAME OF CORPORATION*]_ _ **APPROVAL OF MINUTES OF MEETING OF THE** _ _[_ _[*SPECIFY*]_ _ *COMMITTEE OF THE*]_ _ **BOARD OF DIRECTORS**

The undersigned, a director of _ _[*name of corporation*]_ _**, a California nonprofit** [*public benefit/mutual benefit/religious*] **corporation, approves the minutes of the meeting of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors held on** _ _[*date*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature of director*]__
Name: _ _[*Typed name*]_ _

Comment: As an alternative to this form, an approval of minutes can be combined with the minutes of the meeting. See §§9.85-9.97.

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3. Meeting Procedure

§9.78 a. Manner of Attending Meetings

Methods. Typically, board meetings are conducted in a conventional setting at which directors are physically present at a specific time and place. Directors may also participate in meetings through conference calls or video screen communication (provided all persons participating in the meeting are able to hear one another) or by electronic transmission by and to the corporation. Corp C §§5211(a)(6), 7211(a)(6), 9211(a)(6). On electronic transmission, see §10.42.

Participation constitutes presence. If the statutory conditions for conducting board meetings are satisfied, participation in the meeting constitutes presence in person at the meeting (with its concomitant responsibilities). Corp C §§20-21, 5211(a)(6), 7211(a)(6), 9211(a)(6). Participation in a board meeting through use of electronic video screen communication or communications equipment other than conference telephone constitutes presence in person at the meeting if the following requirements are met (Corp C §§5211(a)(6), 7211(a)(6), 9211(a)(6)):

- Each director participating in the meeting can communicate with all of the other participants concurrently.
- Each director is provided the means of participating in all matters before the board, including, without limitation, the capacity to propose or to interpose an objection to a specific action to be taken by the corporation.

PRACTICE TIP: When any director participates by some form of electronic transmission, all directors should state their names for the record at the beginning of the meeting, and should state at the beginning that they are able to communicate with each other concurrently.

No right to designate. Unlike members, directors have no right to designate another person (whether or not a fellow director) to act as a proxy to participate in a board meeting or vote on behalf of an absent director.

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§9.79 b. Quorum Requirements

Quorum requirements. A majority of the number of directors authorized by the articles or bylaws ordinarily constitutes a quorum, but the articles or bylaws may provide otherwise. See Corp C §§5211(a)(7), 7211(a)(7), 9211(a)(7). If the articles or bylaws of the corporation provide that the number of directors is not less than a stated minimum or greater than a stated maximum, the authorized number of directors at any time is the number that has been fixed by approval of the board or the members acting pursuant to the articles or bylaws. See §9.15. The articles or bylaws may also require the presence of one or more specified directors to achieve a quorum provided that the corporation is not prevented from transacting business in the normal course of events due to the death of that director or the death or nonexistence of the person or persons otherwise authorized to appoint or designate that director. Corp C §§5211(a)(7), 7211(a)(7), 9211(a)(7). However, the bylaws of public benefit and mutual benefit corporations cannot establish a quorum that is either less than one-fifth of the number of directors authorized by the articles or bylaws or fewer than two directors, whichever is larger, unless there is only one authorized director (in which event one director is a quorum). Corp C §§5211(a)(7), 7211(a)(7).

NOTE: An exception to the quorum requirement applies where a board of a public benefit or mutual benefit corporation has the authority to elect to wind up and dissolve without a member vote, yet the number of directors remaining in office is less than a quorum. Corp C §§6610(c), 8610(c), 9680(b)(3). See §20.86

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§9.80 c. Conducting Board Meetings

Presiding officer. The chair of the board or the president ordinarily presides at board meetings. If neither is available, the highest-ranking available vice president usually presides. The presiding officer often relies on the corporation's attorney for help and guidance in matters such as preparing the agenda, deciding how to conduct the meeting, and determining required numbers for quorum and voting purposes.

PRACTICE TIP: The use of formal rules of parliamentary procedure is not required, and many small corporations find these rules too rigid, or too arcane, for ordinary use. If the board is acting on a matter that might later be subject to examination, it may be good practice to follow formal parliamentary rules. The rules customarily used are Robert's Rules of Order, which if desired may be adopted by board resolution for a particular meeting. It is not advisable to adopt Robert's Rules of Order in the bylaws because, in addition to being difficult for lay persons to understand, they can in certain circumstances conflict with California law.

Community associations. Members of a community association must receive prior notification of board meetings and the meetings, other than permitted executive session meetings, must be open to attendance by the members. CC §1363.05(i).

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§9.81 d. Voting by Directors at Meetings

Board action. Any action taken by a majority of the directors present at a meeting duly held at which a quorum is present ordinarily constitutes an act of the board. Neither the articles nor the bylaws may provide that less than a majority vote of all the directors present at a meeting is the act of the board. Corp C §§5211(a)(8), 7211(a)(8), 9211(a)(8). Each director present and voting at a meeting shall have one vote on each matter presented to the board of directors for action at that meeting. Corp C §§5211(c), 7211(c), 9211(c).

No proxy voting. No director may vote at any meeting by proxy. Corp C §§5211(c), 7211(c), 9211(c).

Voting following withdrawal of directors from meeting. A meeting at which a quorum of directors is initially present may continue to transact business despite the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for the meeting or by a greater number of directors than required under law, the articles, or the bylaws. Corp C §§5211(a)(8), 7211(a)(8), 9211(a)(8).

CAUTION: If the articles or bylaws require a specific or designated director be present in order to provide a quorum for the meeting, the withdrawal of that director will prevent the transaction of any business other than adjournment. See Corp C §§5211(a)(4), (a)(7); 7211(a)(4), (a)(7); 9211(a)(4), (a)(7). See §§9.82.

Supermajority or unanimous voting. A corporation's articles or bylaws may require a supermajority or unanimous vote of the board on any or all matters. Such a requirement cannot be altered, amended, or repealed except by the stated greater vote unless the bylaws provide otherwise. Corp C §§5151(e), 7151(e), 9151(e).

NOTE: Occasionally lay boards become confused over the voting rights of "honorary directors," "directors emeritus," "advisory directors," and others that have titles suggesting that they are directors, when in fact they have not been elected or designated in the manner required by the articles or bylaws for service on the board. To avoid confusion, it is best that any bylaw authorizing these positions states clearly that the recipients of these titles have no voting rights and do not count towards the authorized number of directors or a quorum. See Corp C §5047.

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§9.82 e. Adjournment of Meetings

A majority of the directors present may adjourn any board meeting to another time and place. Quorum and supermajority vote requirements are inapplicable for this purpose. Corp C §§5211(a)(4), 7211(a)(4), 9211(a)(4).

For public benefit and mutual benefit corporations, if a meeting is adjourned for more than 24 hours, notice of the time and place must be given to any directors who were absent when the meeting was adjourned. Corp C §§5211(a)(4), 7211(a)(4).

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4. Minutes of Meetings

§9.83 a. Use and Preparation

Written record required. A nonprofit corporation must keep a written record of the proceedings of its board and committees of the board. Corp C §§6320, 8320, 9510. The original or a certified copy of the minutes is prima facie evidence that the meeting was held and that the matters stated in the minutes are true. Corp C §§5215, 7215, 9215.

Counsel preparing minutes. Often the corporation's attorney attends board and committee meetings, serves as secretary of the meeting (as opposed to serving as corporate secretary generally), and prepares the minutes. When counsel does not personally attend the meeting, he or she may draft minutes based on the corporate secretary's notes. A detailed agenda (see the form in §9.73), a checklist (see §9.84) prepared before the meeting, or a tape recording of the meeting may help in preparing the minutes.

PRACTICE TIP: It may be advisable for the corporation to adopt a written policy that tape recordings be destroyed once the written minutes are approved, because only the written record is required by law.

Sufficiency of minutes. Although minutes should not be a verbatim transcript of every word said at a board meeting, they must present an accurate record of what was done. The minutes should contain sufficient information, either in the report of the discussion or as recitals in the formal resolutions adopted, to make a clear written record for future reference to ascertain the nature of the action, the time and circumstances under which it was taken, and the basis for it. This method is especially helpful for actions that might affect members' rights, the corporation's tax status, or the corporate structure, and for transactions between the corporation and any of its directors.

PRACTICE TIP: Opinions differ among attorneys about the amount of material to include in minutes. Some attorneys prefer to state only that discussion was held and omit recitals from the resolutions. Other attorneys prefer to summarize the deliberations leading to the board's formal action to justify the final action by placing it in context. Others favor recitals ("whereas" clauses) to precede resolutions. The better practice is to avoid ironclad rules and evaluate each occasion on its merits. For example, summarizing deliberations is particularly advisable when the decision concerns a conflict of interest or a controversial issue on which the board or membership was divided.

Supporting documentation. Written reports (including financial statements) on which the board or committee takes action should be attached to or kept with the minutes or, if they are otherwise a part of the corporation's permanent records, specifically referred to. If the materials are to be attached to or kept with the minutes, the chair should order that action and the order should be recorded in the minutes. When action is taken by written consent (see §9.98), that consent is the official record of the action taken and should be filed with the minutes. Corp C §§5211(b), 7211(b), 9211(b).

Minutes of executive sessions. Minutes recording actions taken in executive session present particular challenges to the drafter. The purpose of executive session is to encourage frank and open discussion by assuring the directors that sensitive comments, or materials that could harm the corporation's position if leaked, are kept confidential. However, any specific resolutions that are adopted and the reasons for those actions must be stated in minutes if those matters are to have the force of prima facie evidence. Care must be taken to create an accurate record without violating the confidential nature of the discussion.

WARNING: Minutes are open to inspection by members. See §10.108. This fact should be considered when the minutes are being prepared, particularly if personnel or other sensitive matters are on the agenda for discussion or action.

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§9.84 b. Checklist: Preparation of Minutes

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MINUTES PREPARATION CHECKLIST

Board of Directors or Committee Meeting

1. Name of corporation:_____
2. Date and time of meeting:_____
3. Place of meeting:_____
4. Type of meeting: __ Regular __ Special
5. Meeting held pursuant to: __ Notice (attach notice) __ Waiver
6. Number of directors required for quorum: __
7. Directors present: __ In person __ By telephone

   (List names)_____
8. Directors absent: (List names)_____
9. Others present: (List names and titles)_____

_____

10. Person presiding: (Name and title)_____
11. Minutes of previous meeting approved? __ Yes __ No
12. Financial report presented: __ Yes __ No

    __ Oral __ Written (attach copy)

    Date of report: _____ Presented by:_____

    Action taken:_____
13. Other reports presented: (List and summarize; if written, attach copy)

_____

14. Election of officers: __ Yes __ No

    Chair of the Board:_____

    President [or Chief Executive Officer]:_____

    Vice President(s):_____

    Secretary:_____

    Treasurer [or Chief Financial Officer]:_____

    Other:_____
15. Designation of depositary:_____

    Authorized signatories:_____
16. Amendments to Articles of Incorporation

    Article number: ____ Change: _____
17. Amendments to bylaws

    Article and paragraph number: _____ Change: _____

18. Other business:_____

19. Meeting adjourned at _____ a.m./p.m.

To be reconvened? (If yes, state time and place)_____

20. Notes taken by:_____

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/ c. Minutes of Board or Committee Meeting/§9.85 (1) Form: Introductory Statement

c. Minutes of Board or Committee Meeting

§9.85 (1) Form: Introductory Statement

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_ _[*NAME OF CORPORATION*]_ _ **MINUTES OF A** _ _[*REGULAR/SPECIAL*]_ _ **MEETING OF THE** _ _[_ _[*SPECIFY*]_ _ *COMMITTEE OF THE*]_ _ **BOARD OF DIRECTORS**

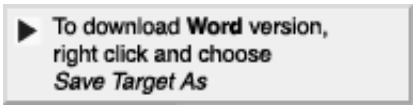
A _ _[*regular/special*]_ _ **meeting of the** _ _[_ _[*specify*]_ _ *committee of the*]_ _ **board of directors of** _ _[*name of corporation*]_ _**, a California nonprofit** _[*public benefit/mutual benefit/religious*]_ _**corporation, was held at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

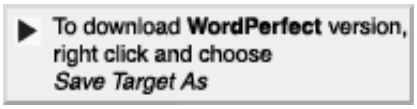
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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.86 (2) Form: Attendance and Quorum

§9.86 (2) Form: Attendance and Quorum

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[*Add one of the following alternatives*]

[*Alternative 1: All directors present]*

All directors were present, constituting a quorum for the meeting.

[*Alternative 2: Identifying all directors present by name]*

The following directors were present, constituting all of the directors and a quorum for the meeting: _ _[*List names*]**_ _.**

[*Alternative 3: Identifying directors present and absent]*

The following directors were present, constituting a quorum for the meeting: _ _[*List names*]**_ _. The following directors were absent: _ _**[*List names*]**_ _.**

[*Continue*]

[*If applicable, add one or more of the following options*]

[*Option 1: Participation by conference telephone]*

The following directors participated in the meeting by conference telephone through which all persons participating in the meeting could hear and speak to one another: _ _[*List names*]**_ _.**

[*Option 2: Additional persons present]*

The following individuals were also present at the invitation of the directors: _ _[*List names and titles*]**_ _.**

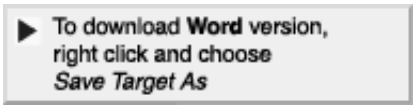
Comment: These forms of minutes should be modified if necessary to include a fuller summary of discussions or reasons for actions taken. See §9.83.

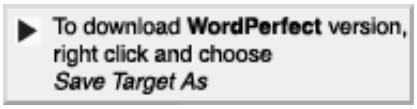
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§9.87 (3) Form: Chair and Secretary

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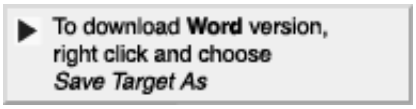
_ _[*Name*]**_ _ served as chair of the meeting and _ _**[*name*]**_ _ served as secretary of the meeting and kept the minutes for it.**

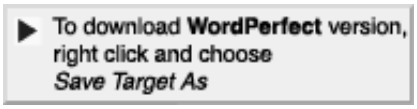
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§9.88 (4) Form: Notice

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[*Add one of the following alternatives*]

[*Alternative 1: Meeting held pursuant to written notice]*

The chair called the meeting to order and announced that the meeting was held pursuant to written notice duly delivered not less than _ _[*4 days by mail/48 hours telephonically*]**_ _ to all directors of the corporation. The chair ordered that a copy of this notice be inserted in the minute book immediately preceding the minutes of this meeting.**

[*Alternative 2: Notice waived]*

The chair called the meeting to order and announced that the meeting was held pursuant to written waiver of notice and consent to the holding of the meeting. The waiver and consent was presented to the meeting, made a part of the corporate records, and the chair ordered that the same be inserted in the minute book immediately preceding the minutes of this meeting.

[*Alternative 3: Notice not required]*

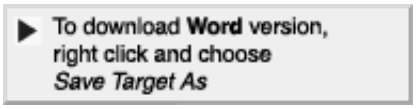
The chair called the meeting to order and noted that notice of the meeting is not required, because it is a regular meeting, and the time and place had been established previously by _ _[*board resolution/the bylaws*]**_ _.**

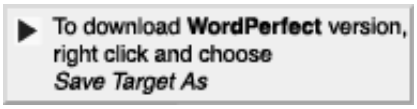
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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.89 (5) Form: Minutes of Last Meeting

§9.89 (5) Form: Minutes of Last Meeting

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[*Add one of the following alternatives*]

[*Alternative 1: Minutes of last meeting approved without modification or with minor modifications]*

The minutes of the last meeting, which were _ _[*mailed/delivered/presented*]_ _ **to the members of the** _ _[*board/committee*]_ _**, were approved as** _ _[*presented/corrected at the meeting*]_ _**.**

[*Alternative 2: Minutes approved with major or important correction]*

The minutes of the last meeting, which were _ _[*mailed/delivered/presented*]_ _ **to the members of the** _ _[*board/committee*]_ _**, were approved** _ _[*subject to the following correction*: _ _[*Set forth portion to be changed and corrected version*]_ _]_ _**.**

Comment: The draft minutes of the previous meeting are seldom read aloud. Instead, copies are mailed to the directors prior to the next meeting or handed out before the meeting is called to order. Rather than describing in detail the changes in the draft minutes, it is permissible to merely report that they were corrected at the meeting. It is rare that changes to the draft minutes are described in the minutes as adopted because it would require a majority of the quorum to approve including the statement; generally this memorialization occurs only on matters that remain contested and only to placate a vocal faction of the board.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.90 (6) Form: Election of Officers

§9.90 (6) Form: Election of Officers

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The chair stated that the election of officers was in order. The following persons were nominated for the offices set forth opposite their respective names:

_ _[*List names and offices*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1: Uncontested election]*

Hearing no further nominations, and on motion duly made and seconded, the chair declared that the persons named above were duly elected to the offices set forth opposite their respective names, to serve for _ _[*the coming year/*_ _[*specify length of term*]_ _]_ _.

[*Alternative 2: Contested election]*

Hearing no further nominations, the chair declared that nominations were closed. The chair called the question and, following a motion duly made and seconded, and with all in favor save _ _[*list names*]_ _**in opposition and** _ _[*list names*]_ _ **abstaining, the chair declared that the persons named below were duly elected to the offices set forth opposite their respective names, to serve for** _ _[*the coming year/*_ _[*specify length of term*]_ _]_ _**:**

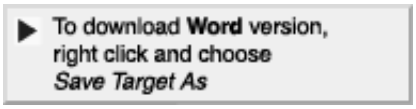
_ _[*List names and offices*]_ _.

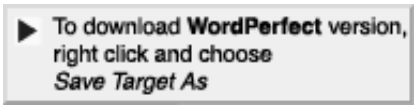
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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.91 (7) Form: Adoption of Resolution

§9.91 (7) Form: Adoption of Resolution

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_ _[*The chair/name of director*]_ _ **proposed that** _ _[*summarize proposed action*]_ _**. Discussion followed.** _ _[*Summarize discussion.*]_ _ **After motion duly made, seconded, and carried** _ _[*unanimously/by a vote of* _ _[*number*]_ _ *in favor and* _ _[*number*]_ _ *opposed, with these directors abstaining,* _ _[*list names*]_ _]_ _**, the following resolutions were adopted:** _ _[*Set forth resolutions*]_ _**.**

Comment: The names of any directors who abstain from the voting should always be stated in the minutes. The number of directors favoring and opposing should be stated if a supermajority is required (see §9.86) or if there is any other reason to believe that the validity of the vote might be questioned later; otherwise, this language may be omitted. The names of individual directors and their votes should be set forth if there is a possibility that any director may be involved in a self-dealing transaction with the corporation or in other conflict of interests situations (see §§9.131-9.150) or if desired by the individual.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.92 (8) Form: Establishment of Executive Committee

§9.92 (8) Form: Establishment of Executive Committee

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The chair proposed that an executive committee of the board be established, as authorized by Corporations Code §_ _[*5212(a)/7212(a)/9212(a)*]_ _. After discussion and motion duly made, seconded, and carried _ _[*unanimously*]_ _, the following resolutions were adopted:

RESOLVED that the board of directors establish an Executive Committee of the board, consisting of _ _[*number*]_ _ persons.

RESOLVED that _ _[*name*]_ _ is hereby appointed as chair, and _ _[*names*]_ _ are hereby appointed as members, of the Executive Committee, each to serve at the pleasure of the directors.

RESOLVED that the executive committee shall have all the authority of the board at times when the board is not in session, except with respect to those matters specified in Corporations Code §§_ _[*5212(a)(1)-(8)/7212(a)(1)-(8)/9212(a)(1)-(6)*]_ _, which are reserved for action by the board or the members, as the case may be.

RESOLVED that the executive committee shall exist and serve at the pleasure of the board.

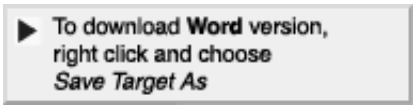
Comment: On executive committees, see §§9.5-9.10. In drafting resolutions generally, it is advisable to avoid the practice of adding "FURTHER" to the beginning of a subsequent resolution. This is because occasionally a third party may request a secretary's certificate to attest to a board action. If the relevant action is one which is preceded by "FURTHER," the third party may inquire what preceded the requested resolution, resulting in the disclosure of matters that the corporation had otherwise hoped to keep confidential.

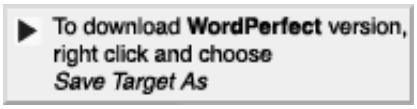
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§9.93 (9) Form: Establishment of Special Committees

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The chair suggested that a committee be established by the board to _ _[*specify function of committee, e.g., to investigate the corporation's future needs for funds and the sources from which funding to meet those needs might be available and to report to the board regarding the various possibilities*]**_ _. After discussion and motion duly made, seconded, and carried _ _**[*unanimously*]**_ _, the following resolutions were adopted:**

RESOLVED that the board of directors establishes a special committee, titled the _ _[*e.g., Finance*]**_ _ Committee, consisting of _ _**[*number*]**_ _ persons.**

RESOLVED that _ _[*name*]**_ _ is hereby appointed as chair, and _ _**[*names*]**_ _ are hereby appointed as members, and _ _**[*names*]**_ _ are hereby appointed as alternates, of the _ _**[*e.g., Finance*]**_ _ Committee.**

RESOLVED that the _ _[*e.g., Finance*]**_ _ Committee shall _ _**[*specify function*]**_ _ and shall meet and act at the call of its chair.**

RESOLVED that the _ _[*e.g., Finance*]**_ _ Committee shall make its _ _**[*interim*]**_ _ report to the board at the _ _**[*next regular*]**_ _ meeting of the board on _ _**[*date*]**_ _.**

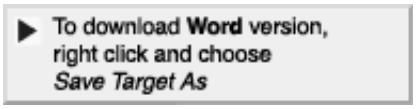
Comment: On executive committees, see §§9.5-9.10.

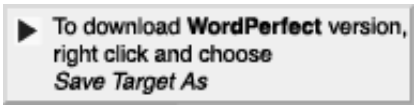
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§9.94 (10) Form: Amendment of Articles or Bylaws

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The board considered an amendment to the _ _[*articles/bylaws*]**_ _ that would _ _**[*insert summary of amendment*]**_ _. After discussion _ _**[*if desired, summarize discussion*]**_ _ and motion duly made, seconded, and carried _ _**[*unanimously*]**_ _, the following resolutions were adopted: _ _**[*Set forth resolution adopting amendment*]**_ _.**

[*If applicable, add one or more of the following options*]

[*Option 1: Amendment sent to members for approval]*

RESOLVED that the foregoing amendment shall be submitted to the members for approval at the next annual membership meeting, and that this amendment shall not become effective until and unless it has been duly approved by the members as required by _ _[*statute/the articles of incorporation/the bylaws*]**_ _.**

[*Option 2: Secretary to prepare certificate of amendment]*

RESOLVED that _ _[*after the foregoing amendment has been duly approved by the required vote of the members*]**_ _ the secretary shall prepare, and the** [*president and secretary/appropriate officers*] **shall sign, a certificate of amendment of the articles of incorporation in proper form and file it with the California Secretary of State.**

Comment: Certain amendments may require approval, either before or after the board's action, by the members, classes of members, the Attorney General, or others. If the resolution was previously approved by the members, the Attorney General, or another person as required by the Corporations Code or the governing documents, this approval should be noted. Amendments to the articles of incorporation are not effective until they are filed with the Secretary of State. See §6.42.

It is also permissible for the directors to call a special meeting of the members to consider a proposed revision to the articles or bylaws. If desired, the board can adopt separate resolutions calling for such a meeting.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.95 (11) Form: Adjournment or Recess to Another Time or Place

§9.95 (11) Form: Adjournment or Recess to Another Time or Place

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_ _[*Set forth reason, e.g., because of the lack of a quorum*]_ _**, the meeting was adjourned to** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

[*If applicable, add the following option*]

[*Option: Secretary to give notice]*

The secretary was ordered to give notice of the time and place of the foregoing adjournment to all absent directors.

[*Continue*]

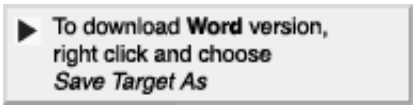
_ _[*Set forth reason, e.g., The chair noted it would be appropriate to recess for committee meetings/lunch*]_ _ **and, hearing no objection, recessed the meeting to resume at** _ _[*time*]_ _ **on** _ _[*date*]_ _**, at** _ _[*place*]_ _**.**

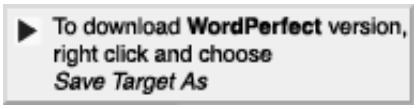
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§9.96 (12) Form: Final Adjournment

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There being no further business, the meeting was, on motion duly made and seconded, adjourned at _ _[*state time*]_ _.

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§9.97 (13) Form: Submission and Approval

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Respectfully submitted,

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Secretary of the Meeting

Approved:

Date: _ _ _ _ _ _ __[*Signature of director*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _ __[*Signature of director*]__
_ _[*Typed name*]_ _

Comment: It is traditional that minutes be signed either by the chair or secretary of the meeting or by each director. A dated signature line is advisable only if it is intended that the directors' approval of the minutes will act to waive any defect in the notice of the meeting. See §9.74. For another form of written approval of the minutes, see the form in §9.75.

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B. Board Action by Written Consent

§9.98 1. General Considerations

Unanimous written consent. Boards of directors and committees of the board may act by unanimous written consent of the directors without a meeting. Unlike most actions taken at board meetings, this type of action requires the approval of all members of the board or committee. Corp C §§5211(b)-(c), 7211(b)-(c), 9211(b)-(c). In public benefit corporations, for this purpose only, "all members of the board" does not include an "interested director" in a self-dealing transaction. Corp C §5211(b). On self-dealing transactions, see §§9.131-9.143.

NOTE: Directors cannot authorize fellow directors or others to sign a written consent on their behalf as that would constitute an unlawful proxy vote. Corp C §§5077, 5211(c), 7211(c), 9211(c).

Form of consent. The written consent may be in the form of one or more documents signed by the directors, facsimiles of those documents, or telegraphic or electronic communications. Corp C §5079; see also Corp C §20. Consents must be filed with the minutes of board proceedings. Corp C §§5211(b), 7211(b), 9211(b). The consent is effective as of the date the last signature is obtained, but it can specify that the action taken be effective on a different date, including an earlier one.

Use by small or medium boards. For matters that do not require discussion by the full board, corporations that have a small- or medium-size board often prefer action by written consent to action at a formal meeting. Some nonprofit corporations almost always act by written consent. This practice is acceptable if the board continues to hold regular meetings, but it is questionable if it is used as a substitute for regular board meetings as it does not accommodate the free exchange of ideas that is expected of a deliberative body.

Use by large boards. In corporations with a large board, action by written consent may be useful if the directors are scattered geographically, opinion on the matter at hand is known to be unanimous, unanimous board approval on the record is desired, and it is practicable to expect all consents to be signed and returned within any applicable time limitations. However, if time is an important consideration or if discussion or modifications by the directors are anticipated, a meeting by conference telephone call may be preferable. See §9.78.

PRACTICE TIP: When a matter requiring board action is likely to be disputed, such as when considering approval of a transaction involving an interested direction, fiduciary principles may dictate that a meeting be called so that the directors can properly consider and discuss the matter and receive input from others having greater information or expertise.

For discussion of the propriety of directors' taking action by unanimous written consent when the approved transaction involves an interested director, see Frankle & Friedman, *The Validity of a Unanimous Written Consent Approving a Transaction Involving an Interested Director Under the California Corporations Code*, 15 Bus L News 7 (Summer 1993).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/ 2. Board's Consent to Action Without Meeting/§9.99 a. Form: Unanimous Written Consent

2. Board's Consent to Action Without Meeting

§9.99 a. Form: Unanimous Written Consent

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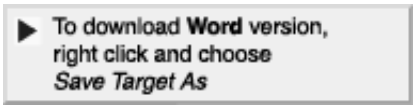
_ _[*NAME OF CORPORATION*]_ _ **WRITTEN CONSENT TO ACTION BY BOARD OF DIRECTORS WITHOUT A MEETING**

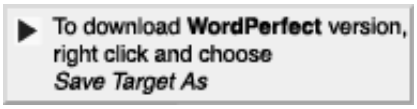
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§9.100 b. Form: Directors' Signing of Document

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[*Add one of the following alternatives*]

[*Alternative 1: All directors to sign single document]*

We, the undersigned, constituting all the directors of _ _[*name of corporation*]**_ _, a California nonprofit _ _**[*public benefit/mutual benefit/religious*]**_ _ corporation, take the following _ _**[*action/actions*]**_ _ by this unanimous written consent, which consent may be executed in counterpart:**

[*Alternative 2: Individual directors to sign separate documents]*

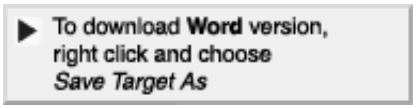
The undersigned director of _ _[*name of corporation*]**_ _, a California nonprofit _ _**[*public benefit/mutual benefit/religious*]**_ _ corporation, consents to the following action of the board of directors without a meeting by this unanimous written consent:**

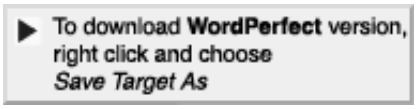
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§9.101 c. Form: Action Taken by Board

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[*Add one of the following alternatives*]

[*Alternative 1: Action taken by adoption of resolution]*

The following resolution(s) of the board of directors was adopted: _ _[*Set forth text of resolution*]**_ _.**

[*Alternative 2: Ratification of actions]*

The following acts taken on behalf of the corporation are ratified, approved and confirmed: _ _[*Set forth acts ratified*]**_ _.**

[*If applicable, add the following option*]

[*Option: Effective date]*

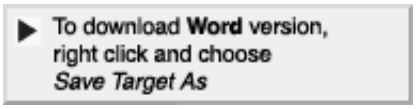
This action is effective as of _ _[*date*]**_ _.**

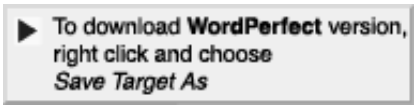
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§9.102 d. Form: Signature Block

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Date: _ _ _ _ _ _ __[*Signature of director*]__

_ _[*Typed name*]_ _

Comment: A dated signature line should be provided for each director. The consents should be filed with the corporation's minutes. Corp C §§5211(b), 7211(b), 9211(b).

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V. STANDARDS OF CONDUCT FOR DIRECTORS; DIRECTOR LIABILITY

A. Fiduciary Responsibilities Generally

§9.103 1. Fiduciary Duties Owed by Directors

A nonprofit director's fiduciary duties include the duty of care, which includes an obligation of due inquiry; the duty of loyalty; the duty to comply with investment standards; and, for community associations, duties imposed by the Davis-Stirling Common Interest Development Act (CC §§1350-1378). The Code makes no distinction between directors chosen by election and directors chosen by selection or designation in the application of fiduciary duties.

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§9.104 2. General Scope of Fiduciary Duty

"Fiduciary" defined. The term "fiduciary" refers to anyone who holds a position requiring trust, confidence, and scrupulous exercise of good faith and candor. It includes anyone who has a duty, created by a particular undertaking, to act primarily for the benefit of others in matters connected with the undertaking. A fiduciary relationship is one in which one person reposes trust and confidence in another person, who "must exercise a corresponding degree of fairness and good faith." Black's Law Dictionary (8th ed 1999). The type of persons who are commonly referred to as fiduciaries include trustees, attorneys, and corporate directors. On fiduciary standards for trustees, see California Trust Administration, chap 2 (2d ed Cal CEB 2001).

Strict trustee standard of duty inapplicable to nonprofits. A strict trustee standard of duty, which would prohibit any self-dealing with the corporation regardless of the benefit conferred, is not imposed on directors of California nonprofit corporations. "A trustee is uniformly held to a high standard of care and will be held liable for simple negligence, while a director must often have committed 'gross negligence' or otherwise be guilty of more than mere mistakes of judgment." *Stern v Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries* (D DC 1974) 381 F Supp 1003, 1013; *Burt v Irvine Co.* (1965) 237 CA2d 828, 850, 47 CR 392. Too strict a standard would make it difficult if not impossible to get qualified individuals to serve on nonprofit boards. Applying the strict trustee standard would also require charities to decline to participate in transactions in which their directors were willing to provide goods or services at below-market rates. See Sproul, *Director and Officer Liability in the Nonprofit Context*, 15 Bus L News 7 (Spring 1993).

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§9.105 3. Standard of Care for Officers

Code silent. The Nonprofit Corporation Law provides no specific standards that corporate officers must observe in performing their duties. See former Corp C §820 (prior corporate law applying directors' standard of care to officers). Although the standard of care and duty of loyalty of officers may be similar to those of directors, an officer's obligation may be even greater than that of a director to conduct diligent inquiry under certain circumstances, owing to the officer's more active involvement in day-to-day operations. See *Gaillard v Natomas Co.* (1989) 208 CA3d 1250, 256 CR 702 (relatively permissive standard of review under business judgment rule; see §§9.107-9.108) should not apply to officers' conduct because of such day-to-day oversight). On the other hand, because officers are simply carrying out the directors' orders, it may be inappropriate to impose the ultimate responsibility or liability of a director on officers who are not directors. An officer's liability may also be influenced by an employment contract between the officer and the corporation. See *Michaelis v Benavides* (1998) 61 CA4th 681, 71 CR2d 776 (discussing liability of corporate officers for official actions that cause harm to third persons).

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§9.106 4. To Whom Directors Owe Fiduciary Duty

Duty to corporation and members. Directors of nonprofit corporations owe a fiduciary duty to the corporation they serve and to its members, if any. See *Raven's Cove Townhomes, Inc. v Knuppe Dev. Co.* (1981) 114 CA3d 783, 799, 171 CR 334; *Burt v Irvine Co.* (1965) 237 CA2d 828, 852, 47 CR 392.

Duty to general public. Directors of a nonprofit charitable corporation will also owe fiduciary duties to the general public. *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 754, 40 CR 244; *Queen of Angels Hosp. v Younger* (1977) 66 CA3d 359, 136 CR 36. The assets of a nonprofit charitable organization are deemed held in charitable trust. The charity's directors must conduct the corporation's affairs in a manner that is consistent with the purposes for which it is formed. See Corp C §5250. If the directors fail to comply with the terms of any charitable trust in which the assets are held, or if they operate the organization in a manner that departs from its stated charitable purposes, they can be held liable for the loss or misapplication of the assets. See *Health Maintenance Network v Blue Cross* (1988) 202 CA3d 1043, 1056, 249 CR 220.

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5. Business Judgment Rule

§9.107 a. Definition and Application

The "business judgment rule" is the standard the courts apply in deciding whether a director, acting without a financial interest in the decision, satisfied the requirements of careful conduct imposed by the Corporations Code. See *Gaillard v Natomas Co.* (1989) 208 CA3d 1250, 1264, 256 CR 702. The rule remains a creature of common law. Some California courts define it as a standard of reasonable conduct (see, *e.g., Burt v Irvine Co.* (1965) 237 CA2d 828, 47 CR 392), while others speak of actions taken in good faith (see, *e.g., Marble v Latchford Glass Co.* (1962) 205 CA2d 171, 22 CR 789), and still others examine whether the director "rationally believes that the business judgment is in the best interests of the corporation" (see, *e.g., Lee v Interinsurance Exch.* (1996) 50 CA4th 694, 57 CR2d 798).

NOTE: The rule works as a defense to allegations that a director violated the duty of care and is supported by a presumption in favor of the director, which places the burden of proof on the accuser. See Evid C §§500, 521; 50 CA4th at 715.

Elements. The principal elements of the business judgment rule are as follows (1 American Law Institute, Principles of Corporate Governance §4.01(c) (1994); see also Revised Model Nonprofit Corporation Act §8.30 (1987)):

> A director who makes a good faith business judgment fulfills the duty of care if the director (1) is not interested in the subject matter of the business judgment, (2) is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate in the circumstances, and (3) rationally believes that the business judgment is in the best interests of the corporation.

Unincorporated associations. The California Supreme Court has held that the business judgment rule does not apply to a defendant homeowners' association that is an unincorporated entity, stating that neither the California courts nor the legislature have determined that the rule should be extended to unincorporated entities. *Lamden v La Jolla Shores Clubdominium Homeowners Ass'n* (1999) 21 C4th 249, 87 CR2d 237.

Nevertheless, the Supreme Court, relying on previous decisions addressing the business judgment rule, such as *Francis T. v Village Green Owners Ass'n* (1986) 42 C3d 490, 229 CR 456, adopted a rule analogous to the business judgment rule and held that when "a duly constituted community association board, upon reasonable investigation, in good faith and with regard for the best interests of the community association and its members, exercises discretion within the scope of its authority under relevant statutes… courts should defer to the board's authority and presumed expertise." *Lamden*, 21 C4th at 265. See also *Dolan-King v Rancho Santa Fe Ass'n* (2000) 81 CA4th 965, 97 CR2d 280; *Cunningham v Superior Court (Fountain Valley Chateau Blanc Mgmt. Ass'n)* (1998) 67 CA4th 743, 79 CR2d 248; *Lee v Interinsurance Exch.* (1996) 50 CA4th 694, 57 CR2d 798. For more detailed discussion of the *Francis T*. case, see §9.116.

Accordingly, it seems established that nonprofit corporations will likewise enjoy the protections of the business judgment rule.

NOTE: The prevailing view of legal commentators in California is that the business judgment rule protects directors from personal liability for the results of their official actions as long as (1) the decision made, or action taken, was in compliance with the standards of care articulated in Corp C §§5231(a), 7231(a), 9241(a), and (2) the decision was not irrational. See 28 Business Judgment Rule, Cal L Rev'n Comm'n Reports 1 (1998).

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§9.108 b. Business Judgment Rule and Interested Directors

Rule does not shield interested directors. The business judgment rule applies only if the director has no interest in the subject matter on which business judgment is being exercised. See *Heckmann v Ahmanson* (1985) 168 CA3d 119, 214 CR 177. If a director is an interested director (particularly if the board is dominated by interested directors), there is no presumption in favor of the director's compliance with the statutory standards for careful conduct; the courts could apply the strict trustee standard of conduct. See §9.104. See also *Raven's Cove Townhomes, Inc. v Knuppe Dev. Co.* (1981) 114 CA3d 783, 171 CR 334.

Theories supporting higher standard of care. In *Raven's Cove,* a nonprofit incorporated association of property owners alleged that, during the time the association's board was under the developer's domination and control, the board breached its fiduciary duty by inadequately funding reserves for replacement of capital assets. The court held the developer liable on a theory of strict liability for failure to supervise the association. 114 CA3d at 799. See also *Cohen v Kite Hill Community Ass'n* (1983) 142 CA3d 642, 191 CR 209 (indicating possibility of greater judicial scrutiny of developer-directors).

Actions of interested directors assessed more conservatively. Neither *Raven's Cove* nor *Cohen* expressly states that a higher standard of care, similar to that of a trustee, will be used in assessing an interested director's adherence to his or her fiduciary duties. However, the courts appear to examine the actions of interested directors more conservatively because of the inherent conflicts of interest that result from directors participating in decisions made by the board that directly or indirectly benefit the director.

Further support for this heightened standard comes from a parallel line of cases holding that majority or controlling shareholders owe a fiduciary duty to their corporation and to the minority shareholders, requiring the majority to refrain from exercising control authority in a manner that harms the interests of minority shareholders. See, *e.g., Jones v H. F. Ahmanson & Co.* (1969) 1 C3d 93, 81 CR 592; *Kirschner Bros. Oil Co. v Natomas Co.* (1986) 185 CA3d 784, 229 CR 899.

NOTE: Although these cases involve profit-making enterprises, the same legal principles should apply with equal force to nonprofit corporations if a director is claimed to have breached his or her duty to the corporation and evidence is presented that the director was seeking to defend his or her position against hostile member factions or to protect a material financial interest. This exposure appears even more pronounced if the nonprofit entity is affiliated in some respect with a profit-making enterprise in which a director has an interest, such as occurs when a real estate developer serves as a member of the board of directors of a community association having jurisdiction and assessment authority in the common interest development that the developer/director is marketing as a commercial venture.

For a comprehensive review and analysis of the business judgment rule, see Block, Barton & Radin, The Business Judgment Rule (5th ed 1998).

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B. Standards of Conduct for Directors

§9.109 1. Directors' Duty of Care

Public benefit and mutual benefit corporations. The standard of conduct for directors of nonprofit public benefit and mutual benefit corporations requires that a director "perform the duties of a director… in good faith, in a manner that director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Corp C §§5231(a), 7231(a).

This standard is nearly identical to that imposed on business corporations. See Corp C §309.

Religious corporations. For religious corporations, the standard is modified in that director must act "with such care, including reasonable inquiry, *as is appropriate under the circumstances*." Corp C §9241(a) (emphasis added).

Delegation permitted. Unlike trustees, nonprofit directors may delegate corporation management "to any person or persons, management company, or committee." Corp C §§5210, 7210, 9210(b). However, the activities and affairs of the corporation must continue to be managed, and all corporate powers exercised, under the ultimate direction of the board. Corp C §§5210, 7210, 9210(b).

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§9.110 2. Director's Duty of Inquiry; Right to Rely on Advice of Others

When duty arises. The director's obligation to make reasonable inquiry, the "duty of inquiry," arises only when the circumstances indicate that further inquiry is needed. See Report of the Assembly Select Committee on Revision to the Corporations Code 50 (1975) (director may not close his or her eyes to conduct of corporate business, and if put on notice by suspicious circumstances, may be required to make "reasonable inquiry").

Reliable information. Directors may rely on information, opinions, reports, or statements, including financial statements, prepared or presented by the following (Corp C §§5231(b), 7231(b), 9241(b)):

- One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;
- Counsel, independent accountants, and other persons in matters that the director believes to be within their professional or expert competence;
- A committee on which the director does not serve and which the director believes to merit confidence as to matters within the committee's designated authority, composed exclusively of any, or any combination of, directors or persons described in paragraphs (1) or (2); and
- For religious corporations, religious authorities and ministers, priests, rabbis, or others with a position or duties in the religious organization.

When duty of inquiry arises. In relying on the opinions or reports of others, the director must act in good faith and conduct reasonable inquiry when the situation indicates a need for such inquiry. The director must also be free of any knowledge that would cause reliance on data received from others to be unwarranted. Corp C §§5231(b), 7231(b), 9241(b). A director may rely on a good faith belief in the qualifications and competence of the person on whose report the director intends to rely. Further inquiry and evaluation as to each such person is not required unless the director has reason to believe, under the circumstances, that further inquiry about that person's qualification is warranted.

PRACTICE TIP: A director who receives advice from corporate counsel or other experts or consultants retained by the board to assist in its decision-making and who disagrees with the advice received should make his or her misgivings known to the board as a whole rather than acting independently. If the director feels that a second opinion is necessary or desirable to aid the board in its decision, he or she should present a motion to this effect. If the director solicits an independent opinion on the issue, he or she should share that opinion with the board unless the director is precluded from doing so by advice of independent counsel.

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3. Duty of Loyalty

§9.111 a. Definition

A director must act in a manner that the director believes to be in the best interests of the corporation and all its members, including the members of minority factions, and to administer his or her corporate powers for the common benefit. Corp C §§5231, 7231, 9241; *Remillard Brick Co. v Remillard-Dandini Co.* (1952) 109 CA2d 405, 241 P2d 66. This element of the fiduciary standard articulated in the Corporations Code is commonly referred to as the "duty of loyalty." The duty of loyalty in the Nonprofit Corporation Law does not refer to members (as does Corp C §309(a), applicable to business corporations), probably because many nonprofit corporations have no members and, for those that do, the members often have no proprietary interest in corporate assets (*i.e.*, assets that are, by the express terms of the articles of incorporation, dedicated to a public or charitable purpose).

The overriding objective of public benefit corporations (and other nonprofit corporations) is to advance and achieve the corporation's purposes as stated in its governing documents, rather than to advance the interests of individuals. Directors are obligated to champion the best interests of their organization (and the organization's constituents), rather than personal interests. In the context of charitable organizations, that constituency is deemed to be the segment of the public that the charity is intended to serve, according to its stated purposes.

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§9.112 b. Corporate Opportunity Doctrine

Full disclosure required. If a director becomes aware of an opportunity or a transaction that would be of interest or benefit to the corporation, the director must disclose the opportunity to the corporation and permit it to take advantage of the opportunity, if it so desires. If the director makes full disclosure of the opportunity and the corporation declines to act, the director is free to pursue the transaction for his or her own advantage. The basis for this common law component of the director's duty of loyalty, referred to as the "corporate opportunity doctrine," is the unfairness of a director's taking personal advantage of an opportunity that should rightfully accrue to the corporation. See *Industrial Indem. Co. v Golden State Co.* (1953) 117 CA2d 519, 256 P2d 677.

Application to nonprofits unclear. It is unclear how the corporate opportunity doctrine applies in the context of charitable organizations and their directors. However, a director's pursuit of certain opportunities for financial gain could violate obligations imposed by the governing documents to avoid even the appearance of conflicts of interest and self-dealing (see §9.131-9.145) or could even threaten the charity's tax-exempt status if impermissible private inurement is found (see §9.22).

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§9.113 4. Investment Standards

Public benefit corporations. Assets of a public benefit corporation that are not directly related to the corporation's public or charitable programs are considered assets held for investment and are subject to special rules. See Corp C §5240. In dealing with such investment assets, the board must do the following:

- Avoid speculation and look instead to permanent disposition of the funds, considering the probable income and the probable safety of the corporation's capital (Corp C §5240(b)(1));
- Comply with any additional standards imposed by the corporation's articles or bylaws or by the express terms of an instrument or agreement under which the assets were contributed (Corp C §5240(b)(2)); and
- Meet the general standard of care requirements applicable to directors of public benefit corporations (Corp C §5240(d)).

An investment does not violate these standards if it was authorized or required by the instrument or agreement under which the assets were contributed. Corp C §5240(c). (However, if the instrument or agreement merely authorizes rather than requires the investment, the investment may still violate the directors' general duty of care.) The Corporations Code does not preclude application of the Uniform Prudent Management of Institutional Funds Act (Prob C §§18500-18510) if it is otherwise applicable. The Act applies to funds held by an educational, charitable, or religious organization for its exclusive use or benefit when the fund is subject to restrictions on its application to current expenditures by the organization, but the status of governing boards and the duties and liabilities of directors continue to be governed by the Code. Corp C §5240(e).

Mutual benefit corporations. There are no special investment standards for mutual benefit corporations. As to assets held in charitable trust, the general rules applicable to directors of public benefit corporations apply (*i.e.,* Corp C §§5230-5238), but the special investment standards of Corp C §5240 do not. See Corp C §7238.

Religious corporations. Directors of religious corporations need meet only the general standard of care in connection with the investment, reinvestment, purchase, acquisition, exchange, sale, or management of the corporation's investments. See Corp C §§9241, 9250. However, §9250 does not abrogate or restrict a court's power to direct or permit a religious corporation to deviate from the terms of a trust or agreement on making or retaining investments. Corp C §9251.

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§9.114 5. Special Duties—Directors of Community Associations

The Davis-Stirling Common Interest Development Act (CC §§1350-1378) further refines the duties of directors of community associations. The Act requires the directors to

- Provide members with detailed financial information (CC §§1365, 1365.2-1365.5);
- Regularly monitor the condition of the association's assets and finances (CC §1365.5);
- Provide numerous disclosures to the members (see particularly CC §§1354, 1363, 1368.5, 1375); and
- Provide greater opportunities for members to attend board meetings and to participate in the formation of association management policies (see CC §1363.05).

Failure to observe these statutory duties may serve as a basis for alleging a breach of fiduciary duty by community association directors. On Davis-Stirling Act duties that must be observed by association management, see Advising California Common Interest Communities, chap 2 (Cal CEB 2003).

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C. Effect of Compliance With Standard of Care

§9.115 1. No Personal Liability for Directors

With the exception of liability for "self-dealing transactions" (see §§9.131-9.143), a director who performs his or her duties according to the statutory standard of care has no liability based on any alleged failure to discharge his or her duties as a director. This exemption from personal liability applies even when the director's actions or omissions exceed or defeat the corporation's charitable purpose. Corp C §§5231(c), 7231(c), 9241(c).

Evidently, the director enjoys the presumption that he or she has met the standard of care only if the director has no personal interest in the action that is the subject of the board's decision (other than the common interest of all directors in acting in ways that will make the corporation successful in its endeavors). See Evid C §§500, 521; *Lee v Interinsurance Exch.* (1996) 50 CA4th 694, 57 CR2d 798.

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§9.116 2. Liability for Tortious Conduct

Statutory limits on liability do not bar liability. Corporations Code §§5231(c), 7231(c), and 9241(d) (limitations on personal liability; see §9.115) do not bar liability if an individual director, acting in his or her official capacity, participates in tortious conduct. *Francis T. v Village Green Owners Ass'n* (1986) 42 C3d 490, 509, 229 CR 456. In *Frances T.,* the plaintiff alleged that the association's directors owed a duty to her, had specific knowledge that a hazardous condition existed which threatened her personal safety, and failed to take action to avoid the harm. In ruling that the plaintiff had stated a cause of action against the directors *as individuals,* the court explained that the directors could not seek protection behind the veil of the business judgment rule because a director is liable to third persons injured by the director's tortious conduct regardless of whether he or she acted on behalf of the corporation and regardless of whether the corporation is also liable, and because directors "individually owe a duty of care, independent of the corporate entity's own duty, to refrain from acting in a manner that creates an unreasonable risk of personal injury to third parties." 42 C3d at 504.

Elements of tort claim. To maintain a tort claim against a director individually, the plaintiff must show that (1) the director specifically authorized, directed, or participated in the tortious conduct or (2) the director knew or should have known that a condition under the board's control was hazardous and could cause injury, and yet the directors negligently failed to take action to avoid the harm; and that an ordinarily prudent person, possessing the same knowledge as the director, would have acted differently. 42 C3d at 508.

Not clearly unreasonable defense. Despite the court's specific rejection of the business judgment rule as a shield from personal liability, individual directors named in a personal injury suit have a defense against personal liability if their conduct was not clearly unreasonable under the circumstances, or if they reasonably relied on the expert advice or the decision of a subordinate who was in a better position to know. Any director who did not vote in favor of the action that caused the injury has a defense to personal liability. 42 C3d at 509. See *Seagate Technology v A.J. Kogyo Co.* (1990) 219 CA3d 696, 702, 268 CR 586.

PRACTICE TIP: To avoid personal liability, a director should demand that his or her dissenting vote be recorded.

Limitations on liability. Although directors and officers of a corporation may be held liable in an action brought by a third party for tortious acts committed on the corporation's behalf, they are not responsible to third persons for negligence amounting merely to nonfeasance or a breach of duty owing to the corporation alone (and not to the third person). *United States Liab. Ins. Co. v Haidinger-Hayes*, *Inc.* (1970) 1 C3d 586, 595, 83 CR 418.

Cases in which liability has been imposed on corporate agents for active participation in the principal's tortious acts have been mostly restricted to cases involving physical injury. However, the court of appeal declined to apply the *Haidinger-Hayes* decision when the president and director of a defendant corporation was sued for construction defects in a patio and driveway personally designed and supervised by the defendant. In imposing liability on the president, the court distinguished between mere economic loss (as in *Haidinger-Hayes*) and the president's personal involvement in tortious conduct that resulted in physical damage to the plaintiff's property. *Michaelis v Benavides* (1998) 61 CA4th 681, 71 CR2d 776. Although this loss was economic in nature, the court observed that personal injuries could have resulted from the defective conditions. 61 CA4th at 687.

In *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 93 CR2d 663, the court distinguished *Haidinger-Hayes* as a negligence action, holding that a corporate officer or director may be liable for an intentional tort, such as misappropriation of trade secrets, under certain circumstances involving the director's investment in and control of the target entity. See also *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 353, 49 CR 825; *Accuimage Diagnostics Corp. v Terarecon, Inc.* (ND Cal 2003) 260 F Supp 2d 941.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.117 3. Liability to Third Parties for Falsehood or Fraud

§9.117 3. Liability to Third Parties for Falsehood or Fraud

Directors, officers, employees, and agents of a nonprofit corporation are liable to any injured person who relied on their acts, as well as to the corporation, for:

- Knowingly making or publishing materially false reports or statements about the corporation, its memberships, or its financial affairs (Corp C §§6215(a), 8215(a), 9660(a));
- Knowingly making materially false entries in the corporation's books, minutes, records, or accounts (Corp C §§6215(b), 8215(b), 9660(a)); or
- Altering any entry in the corporation's books or records with intent to deceive (Corp C §§6215(c), 8215(c), 9660(a)).

These provisions are enforced by the Attorney General. See §9.121.

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§9.118 4. Liability Under Alter-Ego Doctrine

The "alter-ego" doctrine, although not specifically mentioned in the Nonprofit Corporation Law, might apply if a director were to use control of a nonprofit corporation to further his or her own interests, for private gain, or to conceal or divert assets to the damage of third parties. In this situation, a court might presumably "pierce the corporate veil" and find the director liable as though the corporation did not exist. Such a finding would also indicate that the corporation's tax-exempt status is suspect. See Locke, *Corporate Officer or Director as Alter Ego of Corporation*, 9 Proof of Facts 2d 57 (1976). See also *U.S. v Normandy House Nursing Home* (D Mass 1977) 428 F Supp 421 (factors courts use in applying alter-ego doctrine).

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§9.119 5. Liability for Certain Employment Matters

If the corporation has employees, its directors can be held liable for penalties assessed against the corporation for failure to collect and pay federal or state withholding taxes. See *U.S. v Graham* (9th Cir 1962) 309 F2d 210, 212. See also Un Ins C §1735. A director could also be found guilty of a misdemeanor, along with the corporation, for willfully failing to register the corporation as an employer, failing to submit required returns and reports, or failing to withhold or pay disability fund contributions to the state. Un Ins C §§2109-2110, 2110.3.

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§9.120 6. Liability for Taxes Imposed on Private Foundation's Self-Dealing Transactions

Public benefit corporations or nonprofit religious corporations that have "private foundation" status (IRC §509) must comply with IRS requirements for private foundations, including those on self-dealing. Corp C §§5260, 9260; see §§4.23-4.55. A director could also be liable, as a disqualified person, for a tax on self-dealing between the director and the private foundation. IRC §4941. On self-dealing transactions, see §§4.25-4.35.

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D. Persons With Standing to Bring Actions for Breach of Fiduciary Duty or Charitable Trust Obligations

§9.121 1. Attorney General

Public benefit corporations. The Attorney General may examine public benefit corporations at all times to ascertain the extent to which they may have departed from the purposes for which they were formed or have failed to comply with charitable trusts they have assumed. The Attorney General may institute any proceedings necessary to correct such a departure or noncompliance. Corp C §5250. See also *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 755, 40 CR 244; *Hardman v Feinstein* (1987) 195 CA3d 157, 161, 240 CR 483.

Mutual benefit corporations. The Attorney General is also empowered to examine mutual benefit corporations that hold assets in charitable trust in order to ascertain whether the corporation failed to comply with the charitable trust and to institute proceedings against any person or persons if necessary to correct such a failure. Corp C §7240. See Blasko, Crossley & Lloyd, *Standing to Sue in the Charitable Sector*, 28 USF L Rev 37 (Fall 1993).

NOTE: The Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) affords the Attorney General enhanced powers to bring actions to enforce charitable trusts and the corporate governance provisions of that Act, and to regulate commercial fundraisers for charitable corporations.

Religious corporations. The Attorney General has a more limited role in regulating religious corporations to avoid unnecessary infringement on first amendment religious freedoms through state interference with religious organizations. Here, the Attorney General's regulatory jurisdiction is limited to the following rights and powers:

- The right to enforce California's criminal laws. Corp C §9230(a), (c)(2).
- The right to institute an action to obtain a judicial determination that a corporation is not properly qualified or classified as a religious corporation. Corp C §9230(b). The Attorney General also has the right to receive notification and to intervene in any proceeding to establish the status of a nonprofit corporation as public benefit, mutual benefit, or religious. Corp C §9912(d).
- The right to initiate an action to compel compliance with the Nonprofit Corporation Law on required periodic filings and reports, such as the annual statement of officers and directors (Corp C §6210), designation of agents for service of process (Corp C §§6211-6212), and the obligation to make certain disclosures to the county assessor (Corp C §6214). Corp C §§9230(c)(1), 9660.
- The right to represent as legal counsel any agency or department of the State of California that is expressly empowered to regulate activities in which religious corporations may engage. Corp C §9230(c)(3).
- The right to initiate an action to enforce a specific charitable purpose that limits the manner in which the religious corporation may use a gift. Corp C §9230(d).

For religious corporations, the Attorney General may bring an action to compel compliance only in the proper county. Corp C §9660(b).

Actions for fraud. The Attorney General may initiate actions for falsehood or fraud before any appropriate tribunal or administrative agency for public benefit and mutual benefit corporations and may join as parties all persons or entities responsible for or affected by the acts complained of. Corp C §§6216, 8216. Directors whose acts amount to fraud against members, creditors, or the corporation, and directors who knowingly concur in such acts, may be subject to criminal penalties, including fines and imprisonment. Corp C §§6811-6815, 8811-8817, 9690.

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§9.122 2. Statutory Members of Corporation

Statutory members have the right to bring an action for a director's breach of the duties of care and loyalty to the corporation. A member of a public benefit or mutual benefit corporation must maintain any breach of duty claim as a derivative action because charitable organizations are supposed to be operated to serve broad public interests and constituencies, and are prohibited from being operated solely to benefit their defined membership base. See Corp C §§5142, 7142, 9142 (members have standing to bring action to enjoin, correct, or seek damages for breach of charitable trust, but only in corporation's name). See also Corp C §§5420, 7420 (member who desires to maintain action challenging distribution of corporate assets to any person must comply with derivative action procedures of Corp C §§5710, 7710 (no similar provision for religious corporations)).

Supporters lack standing. Supporters of a public benefit or mutual benefit nonprofit organization who are not given any of the voting or other rights of statutory members, even if they are referred to as members, do not have standing to enforce a charitable trust. *Hardman v Feinstein* (1987) 195 CA3d 157, 240 CR 483. This limitation on standing protects trustees from vexatious litigation initiated by persons who may not be in a position that enables them to fairly and responsibly investigate the facts and circumstances giving rise to the alleged claims that a charitable trust has been violated. 195 CA3d at 161.

NOTE: While the Attorney General's enforcement powers against religious corporations are limited, supporters have a greater role in enforcing the corporation's charitable trust obligations.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.123 3. Directors and Officers

§9.123 3. Directors and Officers

Officers and directors of a charitable organization have standing to bring an action to enjoin, correct, or obtain damages for breaches of charitable trust or fiduciary duty. See Corp C §§5142(a)(2)-(3), 7142(a)(2)-(3), 9142(a)(2)-(3).

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§9.124 4. Commissioner of Corporations

Securities law violations. If membership interests or other instruments issued by a nonprofit corporation constitute a security (see §§10.13-10.15), the Commissioner of Corporations has the right to bring an action in the name of the people of the State of California to enjoin any act or practice constituting a violation of the Corporate Securities Law of 1968 or to enforce compliance with that law. Corp C §§25530-25536.

Nonprofit health service plans. The Commissioner of Corporations has broad regulatory powers over the business and affairs of nonprofit health service plans, including all regulatory powers and authority normally vested in the Attorney General regarding nonprofit charitable organizations. Ins C §§1391, 1396; Corp C §10841. See Corp C §§5142, 5233, 5250, 5420, 5813.5, 5913, 6010, 6216. Thus, the Commissioner of Corporations has the principal authority to protect the public's interests in the operations and affairs of nonprofit health care service providers.

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§9.125 5. Persons Granted Relator Status

The Attorney General may confer "relator status" on others to maintain actions that would otherwise come under the Attorney General's jurisdiction. Corp C §§5142(a)(5), 7142(a)(5) (religious corporations no longer have this provision, which was removed as part of the backlash for overreaching (see §9.121). A "relator" is a party in interest who is permitted to institute a proceeding in the name of the people. See *Brown v Memorial Nat'l Home Found.* (1958) 162 CA2d 513, 536, 329 P2d 118 (action against public charity or trust generally will not be entertained unless Attorney General is party).

NOTE: A settlor of a charitable trust who retained the right to enforce the terms of the trust in the trust instrument may, under the terms of the trust, enforce the trust's terms. Thus, a settlor may object to an accounting if he or she reserved that power in the trust instrument under Prob C §24(d). See *Patton v Sherwood* (2007) 152 CA4th 339, 341, 61 CR3d 289. For further discussion, see §§16.46-16.50.

The appointment of a relator is a quo warranto proceeding, which generally requires an application by the person who desires leave to sue in the name of the Attorney General. 11 Cal Code Regs §1. In a suit by a relator, the relator generally takes an active part in the proceeding and is responsible for court costs (subject to CCP §1021.5), but the Attorney General controls the action and can withdraw, dismiss, or compromise it at any time.

NOTE: Relator status is rarely granted by the Attorney General.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.126 6. Commissioner of Department of Real Estate--Community Associations

§9.126 6. Commissioner of Department of Real Estate—Community Associations

For as long as the developer of a common interest real estate development or the sponsor of a time-share project holds more than 25 percent of the voting power of the members of a community association, many material transactions can be undertaken only with prior notification to, and approval by, the Commissioner of the California Department of Real Estate. Bus & P C §11018.7; 10 Cal Code Regs §2800.

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E. Actions Relating to Abuse of Authority or Breach of Trust

§9.127 1. Ultra Vires Acts

Actions that may be asserted. A corporation, its members, or its directors or officers commit ultra vires acts when they undertake actions that exceed limits expressly or impliedly imposed on their powers or authority by the articles or bylaws or that, in the context of a corporate dissolution, violate statutory limits on permitted corporate action. Only the following may be asserted as between the corporation (or the member, officer, or director acting on its behalf) and a third party (Corp C §§5141(a), 7141(a), 9141(a)):

- An action by a member or the state to enjoin unauthorized activities, but only as long as third parties have not acquired any rights by such activities. For religious corporations, such actions may also be initiated by anyone so authorized by the articles or bylaws (see §9.142).
- Proceedings to dissolve a public benefit or mutual benefit corporation.
- An action against the officers or directors for violation of their authority, by the corporation or a member suing in a representative suit. Anyone authorized by the articles or bylaws may also initiate such an action.

NOTE: Member actions can only be initiated by the "authorized number" of members. Corp C §5036; see §10.37.

Dissolution proceedings. In voluntary and involuntary dissolution proceedings, creditors, head organizations, persons named in the articles, and others are granted specific rights that are unaffected by the rule stated here. See Corp C §§6510, 6613, 8510, 8613, 9680.

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§9.128 2. Actions for Breach of Trust

Standing. Actions for breach of a charitable trust under which any corporate assets are held may be maintained by the following (Corp C §§5142(a), 7142(a), 9142(a)):

- The corporation or a member suing in the name of the corporation (or, for religious corporations, former members asserting claims derivatively);
- Any officer or director of the corporation;
- Anyone having a reversionary, contractual, or property interest in the assets held in charitable trust; or
- For public benefit corporations and mutual benefit corporations, the Attorney General or anyone granted relator status by the Attorney General.

Notice to Attorney General. Persons other than the Attorney General who initiate an action to enjoin or otherwise remedy a breach of charitable trust must give notice to the Attorney General, who then has the right to intervene in the action. Corp C §§5142(a), 7142(a). No similar notice requirement applies to religious corporations. On standing to sue religious corporations if funds are inappropriately expended, see §9.129.

Religious corporations. A religious corporation's assets are deemed to be impressed with a trust, express or implied, only if (Corp C §9142(c)):

- The assets were received by the corporation with an express commitment by resolution of its board to hold them in trust;
- The articles or bylaws of the corporation, or the governing instruments of a superior religious body or general church of which the corporation is a member, require that assets be held in trust; or
- The donor expressly imposes a trust in writing at the time the gift or donation is made.

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§9.129 3. Actions to Enjoin Breach of Express Terms of Gift—Religious Corporations

Standing. If a religious corporation receives property from someone directly affiliated with the corporation and if the property is contributed on an affirmative representation that it will be used for a specific purpose other than the general support of the organization, the property must be applied solely to that purpose. If the property is used in a manner contrary to the specific purpose for which it was contributed, an action may be brought by the contributor, by the corporation, by any officer or director of the corporation, or by a member or former member suing derivatively, after notifying the corporation in writing that an action will be brought unless the corporation takes immediate steps to correct the improper diversion of funds. Corp C §9143(a).

Impracticality, impossibility, and divergence. Occasionally, it becomes impractical or impossible for the corporation to devote the property to the specific purpose for which it was contributed, or the restricted purpose no longer accords with the corporation's policies or best interests. In this event, the directors or members of the corporation may, in good faith, approve or ratify the use of the property for the general purposes of the corporation. When the approval or ratification is based on a good faith finding that the stated purpose no longer accords with the policies of the organization or its best interests, that finding must be made in writing. Corp C §9143(b).

Specifically solicited public funds. No public officer may bring an action to prevent an improper use of gifted property, even on behalf of a private individual. Corp C §9143(c). However, if property comes to the religious organization from the general public in response to a representation by the soliciting religious corporation that the property would be used for a specific charitable purpose and not for general support of the organization, the Attorney General may institute an action to enforce that purpose. The Attorney General must first notify the corporation of its intention to file if the corporation fails to take immediate action to correct the improper diversions of funds. If it becomes impractical or impossible to devote the property to the specified purpose, the directors or members may approve or ratify a different use as discussed above. Corp C §9230(d).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.130 4. Actions to Compel Compliance With Corporate Filing and Membership Rights--Public Benefit and Mutual Benefit Corporations

§9.130 4. Actions to Compel Compliance With Corporate Filing and Membership Rights—Public Benefit and Mutual Benefit Corporations

Notice to principal office. The Attorney General, acting on the complaint of a member, director, or officer that a public benefit or mutual benefit corporation is failing to comply with laws on required filings (Corp C §§6210-6216, 8210-8217), membership meetings and voting rights (Corp C §§5510-5617, 7510-7616), or corporate recordkeeping and member/director inspection rights (Corp C §§6310-6338, 8310-8338), may send notice of the complaint to the principal office of the corporation (or, if none, to the office or residence of the chief executive officer or secretary of the corporation) in the name of the people of the State of California. Corp C §§6216(a), 8216(a).

NOTE: The Attorney General may also act on its own initiative without first giving notice of a complaint. Corp C §§6216(b), 8216(b).

Available relief. If the corporation does not provide a satisfactory answer to the complaint within 30 days, the Attorney General may institute, maintain, or intervene in proceedings for relief, and any person or entity responsible for, or affected by, the corporation's actions may be joined. Available relief includes injunction, dissolution of the corporation, appointment of receivers, or any other temporary, preliminary, provisional, or final remedies as appropriate to protect the rights of members or undo the consequences of the corporation's failure to comply with the requirements. Corp C §§6216(a), 8216(a).

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VI. TRANSACTIONS BETWEEN NONPROFIT CORPORATIONS AND DIRECTORS

§9.131 A. Self-Dealing Transactions—Public Benefit Corporations and Religious Corporations

Definition. Strict sanctions are imposed on directors of public benefit and religious corporations who engage in a self-dealing transaction involving the corporation the directors are serving. Corp C §§5233, 9243. "Self-dealing transactions" are any transactions to which the corporation is a party and in which one or more of its directors has a material financial interest, unless the transaction

- Is specifically excluded from coverage by statute (*i.e.,* Corp C §§5233(b), 9243(b); see §9.132); or
- Although otherwise covered by the prohibition, is approved or validated (see Corp C §§5233(d), 9243(d); see §§9.133-9.138).

Material financial interest. A director who has a material financial interest in a transaction involving the nonprofit public benefit or religious corporation is an "interested director." The statute does not define "financial interest" or "material." Some suggest that Corp C §5233 applies only when the director is personally involved in the transaction, and not when the director has an interest in an entity which is a party to the transaction. See 3 Ballantine & Sterling, California Corporation Laws §406.02 (4th rev ed 1962). It is unlikely that the prohibitions of Corp C §5233 or §9243 extend to most transactions involving relatives of a director (other than the director's spouse) or to transactions between the corporation and another corporation in which the director is merely an officer.

The prohibition on self-dealing transactions applies regardless of whether the director is compensated for services as a director. Corp C §§5230(a), 9240(a).

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§9.132 1. Transactions Excluded From Definition of Self-Dealing Transactions

Transactions excluded from the definition of "self-dealing transactions" include the following (Corp C §§5233(b), 9243(b)):

- Actions of the board fixing directors' or officers' compensation;
- For religious corporations, board action making a loan of money or property to, or guaranteeing the obligation of, a director or officer;
- Transactions that are part of the corporation's public, charitable, or (for religious corporations) religious programs and that are approved by the corporation in good faith and without unjustified favoritism, even if one or more directors or their families benefit as part of a class of persons intended to benefit from the program; and
- Transactions of which the interested director has no actual knowledge and that do not exceed the lesser of 1 percent of the gross receipts of the corporation for the preceding fiscal year, or $100,000.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.133 2. Approving Self-Dealing Transactions

§9.133 2. Approving Self-Dealing Transactions

A charitable organization can participate in a self-dealing transaction if it is approved or validated, either before or after the transaction is consummated, in any one of the ways discussed in §§9.133-9.138. Corp C §§5233(d), 9243(d).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.134 a. Attorney General's Approval

§9.134 a. Attorney General's Approval

The Attorney General may approve a self-dealing transaction either before or after it is consummated. Requests for the Attorney General's approval must be submitted in writing to the Charitable Trusts Section of the Attorney General's office in Sacramento, San Francisco, or Los Angeles, whichever is nearest to the corporation's principal office. 11 Cal Code Regs §999.1(a). The request for approval must contain the following (11 Cal Code Regs §§999.1(a), 999.2, 999.4):

- A letter from the corporation giving all material facts about the transaction and the extent to which any director has a material interest in the transaction. "Material facts" include a description of the goods or services to be provided to or by the corporation, the price and estimated fair market value of the goods or services, the benefit the transaction would confer on the corporation, and a statement indicating whether the board has approved the transaction. 11 Cal Code Regs §999.1(c). If the board approved the transaction, the letter must state the factual basis for the board's approval and the disclosure made to the board by the interested director, describe any alternative transactions considered, and state the reasons they were not adopted. 11 Cal Code Regs §§999.2-999.3.

NOTE: Sections 999.1 and 999.3 also apply to mutual benefit corporations, but only to the extent that the corporation holds assets in charitable trust. 11 Cal Code Regs §999.1(f).

- Copies of the corporation's current financial statement, articles, and bylaws unless these documents are already on file with the Registrar of Charitable Trusts.
- Copies of the minutes of board meetings at which the transaction was discussed or evaluated.
- A letter signed by the interested director disclosing the director's interest, unless the letter would merely reiterate information in the corporation's letter.
- Any additional information required by the Attorney General. 11 Cal Code Regs §§999.2(b) (public benefit corporations), 999.3(b) (mutual benefit corporations as to assets held in charitable trust).

The Attorney General attempts to respond to requests for approval within 60 days after their receipt. 11 Cal Code Regs §999.1(d).

The Attorney General may disapprove the request or decline to comment. 11 Cal Code Regs §999.1(d). Further, the request and the Attorney General's response ordinarily become a part of the corporation's public file at the Registrar of Charitable Trusts. 11 Cal Code Regs §999.1(e). (However, any corporation required to file periodic reports with the Registrar of Charitable Trusts (see §12.58) must provide virtually the same information in its periodic report, which is also a public record.)

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§9.135 b. Court Approval

The court can approve a self-dealing transaction. The Attorney General is an indispensable party in any such action. Corp C §§5233(d)(1), 9243(d)(1).

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§9.136 c. Board Validation

The board of a public benefit or religious corporation can validate a self-dealing transaction if, *before* consummating the transaction or any part of it, all of the following are established (Corp C §§5233(d)(2), 9243(d)(3)):

- The corporation entered into the transaction for its own benefit or, for religious corporations, for the benefit of the affiliated religious organization;
- The transaction was fair and reasonable as to the corporation at the time the corporation entered into it, or, for a religious corporation, the transaction furthers the corporation's religious purposes;
- The board authorized or approved the transaction in good faith in advance with knowledge of the director's interest and by a majority vote (excluding the vote of any interested director); and
- Before authorizing or approving the transaction, the board considered alternative arrangements and in good faith found, after reasonable investigation, that the corporation could not obtain a more advantageous arrangement with reasonable effort from disinterested parties or sources or the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances (or, for religious corporations, that the transaction furthers the corporation's religious purposes even if more advantageous arrangements are available).

For a checklist of items to cover before, during, and after the board meeting, see §9.141; for suggested provisions to include in the minutes, see §9.142.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.137 d. Approval by Other Authorized Persons

§9.137 d. Approval by Other Authorized Persons

A board-authorized committee or person can approve a self-dealing transaction on an interim basis, provided that (Corp C §§5233(d)(3), 9243(d)(4)):

- The approving committee or person followed the standards that the board would be required to follow to validate the transactions;
- It was not reasonably practicable to obtain the full board's prior approval; and
- The board, after finding that the requirements for committee approval had been satisfied, ratifies the transaction at its next meeting by a vote of a majority of the directors (excluding the vote of any interested director).

CAUTION: Given the changes in communications technology facilitating the conduct of board meetings (see §9.78), interim validation by committee action seems ill-advised, except perhaps for corporations with very large boards of directors.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.138 e. Approval by Members of Religious Corporations

§9.138 e. Approval by Members of Religious Corporations

The members of a religious corporation can ratify a self-dealing transaction if it is approved in good faith by a majority of the members present at a meeting at which a quorum was present (without counting the vote of the interested director), after notice and disclosure to the members of the material facts about the transaction and the director's interest in it. Corp C §9243(d)(2).

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§9.139 3. Defenses; Statutes of Limitation for Actions to Challenge Self-Dealing Transactions

Defenses. Approval of a self-dealing transaction by one of the means described in §§9.133-9.138 serves as a complete defense to any action challenging the transaction. See Corp C §§5233, 9243. A person challenging a director self-dealing transaction must plead and prove the absence of any of the permissible methods for approving the deal, providing an opportunity for the director or corporation to seek dismissal of the action by demurrer or summary judgment.

PRACTICE TIP: Because the burden of proof is on the plaintiff, the corporation should place a premium on thoroughly documenting the transaction and building a record to support one of the requisite methods for approving the transaction. See 3 Ballantine & Sterling, California Corporation Laws §406.02 (4th rev ed 1962).

Statute of limitations. The statute of limitations for initiating an action challenging an alleged self-dealing transaction is 2 years after written notice setting forth the material facts of the transaction and the director's interest is filed with the Attorney General by the board. If no such notice is filed, the limitations period is 3 years (for public benefit corporations) or 5 years (for religious corporations) after the cause of action has accrued. Corp C §§5233(e), 9243(e). For public benefit corporations, the Attorney General has 10 years after the transaction occurred to file an action. Corp C §5233(e).

Equitable relief. If the corporation breaches an obligation owed to an interested director arising from a self-dealing transaction that was not properly approved, the court, by way of offset only, may make any equitable and fair order, even if the 2-year statute of limitations period specified in Corp C §5233(e) or §9243(e) has expired. Corp C §§5233(f), (h), 9243(f), (h).

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§9.140 4. Remedies for Self-Dealing Transactions; Liability of Interested Directors

The liability of interested directors for self-dealing transactions is to the corporation. For public benefit corporations, the corporation, its directors or officers, its members (in a derivative action; see §9.122), the Attorney General, or persons granted relator status by the Attorney General may sue. Corp C §5233(c). For religious corporations, the corporation, its directors or officers, its members, or persons so authorized in the bylaws may sue. Corp C §9243(c).

Remedies. If an action is timely filed and a self-dealing transaction is found to have occurred, the court may provide any "equitable and fair remedy to the corporation, taking into account any benefit received by the corporation and whether the interested director or directors acted in good faith and with intent to further the best interest of the corporation." Corp C §§5233(h), 9243(h). A self-dealing transaction is not void, voidable, or invalid. Instead, the statute makes the interested director disgorge his or her profits in the matter to make the corporation whole. Remedies specified in Corp C §§5233(h), 9243(h) include requiring the interested director to:

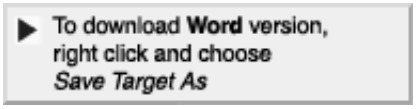
- Account for any profits made in the transaction and pay them to the corporation;
- Reimburse the corporation for the value of any corporate property used in the transaction; and
- Return or replace corporate property lost in the transaction or to account to the corporation for the proceeds of any property sold and to pay those proceeds, plus interest, to the corporation.

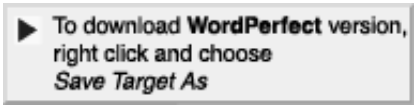
Prejudgment interest; punitive damages. The court may also award prejudgment interest (see CC §§3287-3288) and has discretion to award exemplary damages for fraudulent or malicious violations of the self-dealing bar. Corp C §§5233(h), 9243(h).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.141 5. Checklist: Board Approval of Transactions With Interested Directors

§9.141 5. Checklist: Board Approval of Transactions With Interested Directors





Before board meeting:

- Identify interested director's material financial interest and ascertain whether the transaction falls within any exceptions.
- Gather material facts for disclosure to the board about the proposed transaction and the director's interest.
- Appoint disinterested person or committee to investigate possible reasonable alternatives for report to board.

At board meeting:

- Disclose all material facts about the proposed transaction and the director's interest.
- Hear report by disinterested person or committee on possible alternatives.
- Have board find and resolve the following, by vote of majority of directors then in office, without counting vote of interested director (each director's vote or abstention should be recorded):
- That the proposed transaction is in the corporation's best interests and for the corporation's own benefit or for the benefit of the affiliated religious organization;
- That the proposed transaction is fair and reasonable to the corporation or furthers the corporation's religious purposes; and
- That, after reasonable investigation, the board has found that the corporation cannot obtain a more advantageous arrangement with reasonable efforts under the circumstances or that the transaction furthers the corporation's religious purposes.
- Have board approve proposed transaction, by vote of majority of directors then in office, excluding vote of interested director (record each director's vote or abstention).

After board meeting:

- Prepare minutes of meeting, reflecting:
- Full disclosure to the board;
- Investigation and report to the board;
- Findings of the board; and
- Board approval of the transaction, including vote of each director.
- If desired, file notice of the transaction with the Attorney General.

This checklist can be modified to apply when an authorized committee or person gives interim approval of the transaction and the board ratifies this approval at its next meeting (see §9.136).

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§9.142 6. Form: Minutes Reflecting Approval of Transaction—Public Benefit and Religious Corporations

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To download **WordPerfect** version, right click and choose *Save Target As*

The chair stated that the next order of business was the approval of a proposed transaction involving _ _[*describe proposed transaction*]_ _ in which _ _[*name of interested director*]_ _ has a material financial interest. The chair said that, because _ _[*name of interested director*]_ _ is an "interested director" as defined in Corporations Code §_ _[*5233/9243*]_ _, it is advisable for the board to consider the transaction in advance, using procedures set forth in the Code. The chair disclosed to the board all material facts about the proposed transaction, as follows: _ _[*Specify*]_ _. The chair disclosed to the board all material facts about the interested director's interest in the proposed transaction, as follows: _ _[*Specify*]_ _.

The chair called for a report on the investigation of alternative arrangements to the proposed transaction made by _ _[*name of committee or person*]_ _. _ _[*Insert summary or attach copy of report.*]_ _ After discussion and motion duly made, seconded, and carried by the required vote, without counting the vote of _ _[*name of interested director*]_ _, the board adopted the following resolutions:

WHEREAS, it has been proposed that the corporation enter into the following transaction: _ _[*briefly describe proposed transaction*]_ _, in which _ _[*name of interested director*]_ _ has the following interest: _ _[*briefly describe director's interest*]_ _; and

WHEREAS, there has been full disclosure to the board of all material facts, and there has been reasonable investigation and consideration by the board of possible alternatives to the proposed transaction;

[*Add one of the following alternatives*]

[*Alternative 1: Findings for public benefit corporation]*

RESOLVED that the board finds as follows:

(1) The proposed transaction is in the corporation's best interest and for the corporation's own benefit; (2) the proposed transaction is fair and reasonable to the corporation; and (3) the corporation cannot obtain a more advantageous arrangement with reasonable effort under the circumstances.

[*Alternative 2: Findings for religious corporation]*

RESOLVED that the board finds as follows:

(1) The proposed transaction is in the corporation's best interest and for the corporation's own benefit or for the benefit of its affiliated religious organization; (2) the proposed transaction is fair and reasonable to the corporation or furthers the corporation's religious purposes; and (3) the corporation cannot obtain a more advantageous arrangement with reasonable effort under the circumstances or the proposed transaction furthers the corporation's religious purposes.

[*Continue*]

It is therefore:

RESOLVED that the proposed transaction be approved as follows: _ _[*specify terms and conditions of transaction*]_ _; and _ _[*any of the corporation's officers/_ _[list names or titles*]_ _]_ _ are authorized to execute all agreements and documents and take all actions necessary on behalf of the corporation to enable the corporation to enter into the transaction.

The following directors voted in favor: _ _[*List names*]_ _.

The following directors voted against: _ _[*List names*]**_ _.**

The following directors abstained: _ _[*List names*]**_ _.**

Comment: This form can be modified to apply when the board ratifies an interim approval by an authorized committee or person.

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§9.143 B. Self-Dealing Prohibitions—Mutual Benefit Corporations Holding Assets in Charitable Trust

Generally, mutual benefit corporations are subject to much less stringent rules regarding transactions involving the corporation and one or more of its directors. However, if a mutual benefit corporation holds assets in charitable trust, the conduct of that corporation's directors with respect to the trust assets are governed by the standards applicable to directors of public benefit corporations. Corp C §7238. See §§9.131-9.140.

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§9.144 C. Statutory Regulation of Transactions With Interested Directors—Mutual Benefit Corporations

Liberal approach. The Corporations Code takes a liberal approach to regulating transactions between a mutual benefit corporation and one or more of its directors who have a material financial interest in the transaction. If these transactions were prohibited entirely or subjected to the stringent self-dealing provisions applicable to public benefit and religious corporations, mutual benefit corporations would often be precluded from taking advantage of services, products, or materials that various members of the board might be willing to provide at either no cost or below-market rates. Thus, transactions involving directors of mutual benefit corporations are regulated in much the same way as business corporations. See Corp C §310.

Not void or voidable if approved. Contracts and other transactions between a corporation and one or more of its directors in which the directors have a material financial interest, or between a corporation and any entity in which one or more of the directors have a material financial interest, are neither void nor voidable because the interested director, directors, or the entity are parties to the transaction, or the interested director or directors are present at the meeting at which the transaction is approved, if any of the following applies (Corp C §7233(a)):

- The material facts of the transaction and the director's interest in it are fully disclosed to the corporation's members, who approve the transaction (the required vote of the members is a majority of a quorum of the members, unless the articles or bylaws specify a higher percentage; see Corp C §5034) in good faith and without the vote of the interested director or directors;
- The material facts of the transaction and the director's interest in it are fully disclosed or known to the board; the board authorizes or ratifies the transaction by a vote that is sufficient, excluding the vote of any interested director, and the contract or transaction is just and reasonable to the corporation at the time it is authorized, approved, or ratified; or
- For transactions that are not so approved by the members or the board as provided above, the person asserting the validity of the contract or transaction sustains the burden of proving that it was just and reasonable to the corporation at the time it was authorized, approved, or ratified (this third manner of approval applies if no disinterested membership base or board is available to approve the transaction).

Court approval. If such approval is not possible, the interested director may petition the superior court for approval (see Corp C §7515) rather than risk that the transaction will be challenged in a derivative action.

NOTE: The regulation of transactions with interested directors does not modify the prohibition against a director's making decisions for the corporation that benefit the director's own interests at the expense of the corporation and its members. See *Raven's Cove Townhomes, Inc. v Knuppe Dev. Co.* (1981) 114 CA3d 783, 171 CR 334.

Material financial interest. The Corporations Code does not use the terms "conflict of interest" or "self-dealing transaction," but refers instead to transactions involving the corporation in which one or more of its directors has a "material financial interest." Thus, absent a material impact on the director's pocketbook, no conflict of interest exists from a corporate law standpoint, even if the transaction benefits a class of individuals that includes the director (such as real estate brokers or contractors) or favors a relative of the director. A mere common directorship does not constitute a material financial interest for purposes of the statute, and directors can vote on another director's compensation without coming within the scope of the statute, even if all directors are compensated. Corp C §7233(a).

NOTE: For discussion of the propriety of directors' taking action by unanimous written consent when the approved transaction involves an interested director, see Frankle & Friedman, *The Validity of a Unanimous Written Consent Approving a Transaction Involving an Interested Director Under the California Corporations Code*, 15 Bus L News 7 (Summer 1993).

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§9.145 D. Transactions Between Nonprofit Corporations and Other Corporations With Interlocking Directorships

Absent a director's material financial interest, transactions between a nonprofit corporation and another corporation or association with which it has common directors are neither void nor voidable merely because of the common director's presence at the meeting in which the transaction was approved, authorized, or ratified, as long as any of the following applies:

- The board or its authorized committee, being fully informed of the common directorship, approved the transaction in good faith (without counting the vote of the common director or directors) (Corp C §§5234(a)(1), 9244(a)(1));
- The contract or transaction is just and reasonable as to a public benefit corporation at the time it is authorized, approved, or ratified (Corp C §5234(a)(2));
- For a mutual benefit corporation, its members, being fully informed of the common directorship, approved the transaction in good faith (in which event board approval is not required) (Corp C §7233(b)(1));
- For a mutual benefit corporation, it is established that the transaction was just and reasonable to the corporation at the time it was authorized, approved, or ratified (Corp C §7233(b)(2)); or
- For religious corporations, if there is no board approval, the transaction was either just and reasonable to the corporation, considering its religious purposes, or the transaction furthered the corporation's religious purposes at the time it was authorized, approved, or ratified (Corp C §9244(a)(2)).

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E. Loans and Guaranties

§9.146 1. Public Benefit Corporations

Loans and guaranties generally barred. A public benefit corporation is generally prohibited from making loans to, or guaranteeing obligations of, its directors or officers unless the Attorney General approves the transaction. Corp C §5236(a). For procedural requirements for requesting the Attorney General's approval of loans and guaranties, which are generally the same as procedures for requesting the Attorney General's approval of a self-dealing transaction, see 11 Cal Code Regs §999.2(c).

Exceptions. Excluded from the prohibition are the following (Corp C §§5236(a)-(c), 5238(f)):

- Advances for expenses reasonably expected to be incurred by directors and officers in performing their duties;
- Payment of premiums on a policy insuring the life of a director or officer, if repayment is secured by the policy's proceeds and cash surrender value;
- A loan made to an officer to finance the purchase of the officer's principal residence, if the directors find that the loan is necessary to obtain or retain the officer's services and if the loan is secured by California real property; and
- Advances made to provide for a director's or an officer's defense against charges arising from the director's or officer's actions as an agent of the corporation or charges that the director or officer breached a duty relating to corporate assets, if the director or officer acknowledges the loan in writing and agrees to repay it, unless it is ultimately found that the officer or director is entitled to indemnification.

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§9.147 2. Mutual Benefit Corporations

Loans and guaranties generally permissible. Unless prohibited by the articles or bylaws, mutual benefit corporations may lend money or property to, or guarantee obligations of, any officer or director of the corporation or of its parent, affiliate, or subsidiary, provided that (Corp C §7235(a)):

- The board finds that the loan or guaranty is reasonably expected to benefit the corporation; and
- The loan or guaranty is approved by either the members or the board, without counting the vote of the benefited officer or director, before the transaction or any part of it is consummated.

Exceptions. The above approval requirements on loans to officers and directors do not apply to credit unions (Corp C §7235(c)) and they also do not apply to:

- Advances for expenses reasonably expected to be incurred in the performance of their duties if, in the absence of the advance, the director or officer would be entitled to reimbursement for the expenses. Corp C §7235(b).
- The payment of premiums on a policy insuring the life of a director or an officer, if repayment is secured by the policy's proceeds and cash surrender value. Corp C §7235(c).
- Loans permitted under any statute regulating any special class of corporations. Corp C §7235(c).
- Advances made to provide for an officer's or director's defense in any proceeding if the director or officer acknowledges the loan in writing and agrees to repay it, unless it is ultimately determined that the officer or director is entitled to indemnification. Corp C §7237(f).

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§9.148 3. Religious Corporations

Loans and guaranties not barred. A religious corporation is not prohibited from making loans to, or guaranteeing obligations of, its directors or officers. The liability of directors who approve such loans or guaranties is governed by the general standard of care requirements for ordinary transactions. An otherwise valid obligation, including a loan or a guaranty, is not voidable merely because one or more benefited directors participated in the board resolution authorizing the loan, guaranty, or other obligation. Corp C §9241(c).

Advances for defense. A religious corporation may also make advances to an officer or a director to provide for the officer's or director's defense in any proceeding if the director or officer acknowledges the loan in writing and agrees to repay it, unless it is ultimately determined that the officer or director is entitled to indemnification. Corp C §9246(f).

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§9.149 4. Liability for Distributions, Loans, and Guaranties

For public benefit and religious corporations, a directors' liability for approval of illegal distributions, loans, and guaranties is directly to the corporation. Corp C §§5237(a), 9245(a). For mutual benefit corporations, the liability is to the corporation for the benefit of all creditors. Corp C §7236(a). Subject to the general standard of care requirements applicable to the type of nonprofit corporation, directors are jointly and severally liable for approval of the following:

- Any distribution except a distribution for a mutual benefit corporation to purchase or redeem memberships or a mutual benefit corporation's distribution on dissolution (Corp C §§5410, 5237(a)(1), 7411, 7236(a)(1), 9610(a), 9245(a)(1));
- Any distribution of assets made in corporate dissolution proceedings (see chap 20) without paying or adequately providing for all known corporate liabilities (Corp C §§5237(a)(2), 7236(a)(2), 9245(a)(2));
- Any prohibited loan or guaranty of obligations (Corp C §§5236, 7235, 9241(c) (see §§9.146-9.148)).

Presence; telephone participation. A director who is present at a meeting at which any such action is taken and who abstains from voting is considered to have approved the action. Corp C §§5237(b), 7236(b) (no similar provision for religious corporations). Participating in a meeting by telephone constitutes presence at the meeting for this purpose. See §9.78.

WARNING: A director's conduct regarding assets held in charitable trust by a mutual benefit corporation is governed by the standards of conduct for directors of public benefit corporations. This rule does not limit any additional requirements that may be specifically imposed on mutual benefit corporations holding assets in charitable trust. Corp C §7238. This standard may be stricter than would otherwise apply, particularly in transactions between corporations and their directors.

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§9.150 F. Additional Conflict of Interest Regulations

Areas of potential conflict of interest. Some nonprofit corporations do not consider the limits imposed on self-dealing and interested director transactions sufficiently protective of the corporation's interest in avoiding the appearance of impropriety by its directors. For example, a charity that champions animal welfare issues may consider it undesirable for anyone serving on the organization's board to have an interest in any cosmetic company, fur company, or company selling pet products of any kind. Alternatively, a corporation with substantial real estate holdings may want to ensure that its development plans have positive impacts on adjoining properties, and it may want its directors to disclose any interests in neighboring properties even if no transactions are contemplated between the corporation and adjacent owners. Conflicts could also exist if a director is a realtor or contractor confronted with issues such as the regulation of commercial signs or the use of particular construction products or materials that do not involve a material financial interest.

Bylaw or resolution requiring disclosure. Many nonprofit corporations want directors to disclose conflicts that may influence their corporate decisions, even if no material financial interest is involved. A corporation may adopt a bylaw or a board resolution imposing more stringent conflict of interest or financial or investment disclosure requirements on its directors than those imposed by the Corporations Code.

NOTE: It is not uncommon for nonprofit corporations to adopt a formal code of conduct for directors, officers, and employees. This trend has been greatly influenced by the passage of the federal Sarbanes-Oxley Act of 2002 (SOX) (Pub L 107-204, 116 Stat 745) (15 USC §§7201-7266) and the revelations in recent years of malfeasance in major business corporations. In addition to addressing conflict of interest situations, these policies may also cover business ethics, workplace decorum, and protections for persons who report violations of the code of conduct.

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VII. STATUTORY LIABILITY PROTECTIONS

§9.151 A. Evolution of Statutory Liability Protection

The California Supreme Court decision in *Francis T. v Village Green Owners Ass'n* (1986) 42 C3d 490, 229 CR 456, sent shock waves through the nonprofit community by blasting a hole in the protective armor enjoyed by corporate directors under the business judgment rule. The court expressly acknowledged that, although the directors/defendants had fulfilled their fiduciary duties to the plaintiff in her capacity as a member of the corporation, they could still be held liable for her personal injuries. 42 C3d at 511. Following this case, many nonprofit organizations found it difficult or prohibitively expensive to secure adequate directors' and officers' errors and omissions insurance. In response to this insurance crisis, the California Legislature extended some measure of protection to directors of nonprofit corporations. See Corp C §§5047.5, 5239, 9247; CCP §425.15; CC §1365.7; see also §§9.152-9.153.

The array of inconsistently worded liability protection statutes, with curious categories of included and excluded organizations, is indicative of hastily negotiated compromises reached by lobbyists for various segments of the fractionalized nonprofit community.

For further discussion, see Myles, *Statutory Protections for Volunteers of Nonprofit Corporations*, 14 CEB Cal Bus L Prac 21 (Spring 1999).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.152 B. Charities and Trade Associations-- Protection Under Corp C §5047.5

§9.152 B. Charities and Trade Associations— Protection Under Corp C §5047.5

Protection from personal liability. Uncompensated directors and officers of IRC §501(c)(3), (c)(6) organizations formed for religious, charitable, literary, educational, scientific, social, and other forms of public service are protected from personal liability for monetary damages from negligent acts or omissions occurring within the scope of their duties as an uncompensated director or officer and in the exercise of their policy-making judgment, as long as the act or omission was made in good faith and in a manner the director or officer believed to be in the corporation's best interests. An uncompensated director or officer is one who receives no compensation of any sort from the organization. See Corp C §5047.5(i). However, reimbursement for actual expenses (as opposed to a per diem allowance) incurred in attending meetings or otherwise in the execution of the duties of a director or officer is not counted as compensation. Corp C §5047.5(f).

Exclusions from liability shield. The following are specifically excluded from the liability protection benefits of Corp C §5047.5 (see Corp C §5047.5(c)):

- Actions alleging that the director is guilty of self-dealing (see Corp C §§5233, 9243);
- Conflicts of interest (see Corp C §7233);
- Actions challenging distributions, loans, and guaranties (see Corp C §§5237, 7236, 9245);
- For charitable trusts, actions against trustees brought by beneficiaries;
- Actions maintained by the Attorney General against the director or officer;
- Liabilities arising from intentional, wanton, or reckless acts, gross negligence, fraud, oppression, or malice by the director or officer; and
- Actions brought under the Cartwright Act (Bus & P C §§16700-16770).

Insurance requirements. For an uncompensated director or officer to claim protection under Corp C §5047.5, the corporation must maintain liability insurance applicable to the claim with minimum coverage of at least $500,000 if the corporation's annual budget is under $50,000 and minimum coverage of at least $1 million if the corporation's annual budget is $50,000 or more. Corp C §5047.5(e).

Exceptions. Liability protection under Corp C §5047.5 is unavailable to any corporation that unlawfully restricts membership, services, or benefits conferred on the basis of political affiliation, age, sex, race, color, religion, ancestry, national origin, disability, medical condition, marital status, or sexual orientation. Corp C §5047.5(h); see CC §51(b), (e).

PRACTICE TIP: Corporations Code §5047.5 contains so many exceptions, exclusions, and qualifications that its liability protections may prove illusory even to directors and officers of corporations that at first appear to be covered by the statute. Even uncompensated directors and officers who arguably come under the statute's umbrella of liability protection are likely to face months or even years of litigation exposure as they challenge allegations that they were acting outside their official capacity; in bad faith; or in a reckless, willful, or wanton manner. Therefore, even nonprofit corporations included in the scope of §5047.5 should maintain adequate liability insurance, not only to qualify for the thin veil of protection offered by the statute but also to provide a fund for the defense of directors initially named in liability suits.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.153 C. Public Benefit and Religious Corporations--Protection Under Corp C §§5239, 9247; CCP §425.15

§9.153 C. Public Benefit and Religious Corporations—Protection Under Corp C §§5239, 9247; CCP §425.15

Corporations Code §§5239, 9247. Volunteer directors and executive officers of public benefit and religious corporations are not personally liable for damages caused by their negligent acts or omissions in performing their duties as directors or officers. Corp C §§5239, 9247. Included in the definition of "executive officer" are the president, vice president, secretary, treasurer, and others who serve in a like capacity and assist in establishing corporate policy. Corp C §5239(c). Eligibility for this statutory protection from liability requires that damages caused by the act or omission must be covered by an insurance policy issued to the corporation or to the director or officer individually, either in the form of a general liability policy or a directors' and officers' liability policy.

NOTE: The law does not specify a minimum level of insurance or address the issue of insurance deductibles, and the requirement that damages be "covered" by insurance is ambiguous.

All reasonable efforts to secure insurance. If no insurance is applicable to the claim, the director or executive officer can still be protected from liability by establishing that both the board and the director or officer made "all reasonable efforts in good faith to obtain available liability insurance." See Corp C §§5239(a)(4), 9247(a)(4). A charitable organization exempt from tax under IRC §501(c)(3) and having an annual budget under $25,000 makes "all reasonable efforts in good faith to obtain available liability insurance" if (1) it makes at least one inquiry per year about the cost of purchasing a general liability insurance policy that provides at least $500,000 in coverage and (2) such coverage could not be obtained for less than 5 percent of the prior year's annual budget. If the charitable corporation is in its first year of operation, this provision applies regardless of inquiries about coverage as long as the charity's budget does not exceed $25,000 during its first year of operation. Corp C §5239(h).

Shield only protects volunteers. Directors and officers of nonprofit charitable organizations are not free of all personal liability concerns. The protections of Corp C §§5239 and 9247 are available only to volunteer directors or executive officers; *i.e.,* they are not available to any director or executive officer who receives a salary, fee, or other consideration (other than per diem or expense reimbursements). See Corp C §§5239(b), 9247(b).

Burden of proof. Moreover, directors or executive officers seeking liability protection have the burden of establishing the following (see Corp C §§5239(a), 9247(a)):

- That the act or omission was within the scope of the officer's or director's duties;
- That the director or officer acted in good faith;
- That the act or omission did not involve self-dealing (see Corp C §§5233, 9243) or improper loans, guaranties, and distributions (see Corp C §§5237, 9245); and
- That the act or omission was not reckless, wanton, intentional, or grossly negligent.

Additional exclusions. A director or an executive officer claiming protection is thus likely to remain mired in litigation, with the associated anxiety and stress of personal liability exposure and burden of litigation expenses (absent insurance coverage) for many months, while the lawyers seek to establish that all requirements for statutory liability protection were met and that none of the exceptions to the statutory protections apply. These personal liability protections do not apply in any action or proceeding brought by the Attorney General or in any action claiming that the director engaged in a self-dealing transaction. See Corp C §§5239(e), 9247(e).

Code of Civil Procedure §425.15. Uncompensated directors and officers of nonprofit corporations organized for "charitable, educational, social, scientific or public service" purposes have what is commonly described as a "pleading hurdle" to shield them from certain suits. Claims arising from any negligent act or omission by the director or officer within the scope of the person's duties as such can only be included in a complaint following a judicial determination (based on a verified petition and supporting affidavits) that evidence exists to substantiate the claim. CCP §425.15.

Limitations. Unfortunately, there are many exceptions, exclusions, and qualifications:

- Despite the broad reference to "charitable, educational … and scientific" organizations, the pleading hurdle of

CCP §425.15 is available only to organizations that are exempt from tax under IRC §501(c)(1) (except credit unions), §501(c)(4), §501(c)(5), §501(c)(7), or §501(c)(19). It is not available to IRC §501(c)(3) charitable or educational organizations.

- The director or officer of a listed exempt organization can receive no compensation, which is defined as remuneration by salary, fee, or other consideration for services rendered, but excludes per diem, mileage, or other expense reimbursement. CCP §425.15(d).
- Filing a petition under CCP §425.15 seeking approval to sue the director or officer tolls the running of any applicable statute of limitations and requires a vigorous defense of the petition's allegations. CCP §425.15(a).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.154 D. Community Associations--Protection Under CC §1365.7

§9.154 D. Community Associations—Protection Under CC §1365.7

Qualifications for protection. Volunteer directors and officers of community associations have no personal liability in excess of the insurance coverage requirements imposed by CC §1365.7 for claims of bodily injury, emotional distress, wrongful death, or property damage if all the following conditions are satisfied (see CC §1365.7(a)):

- The development is exclusively residential;
- The director or officer is not affiliated with the developer or a financial institution that owns a lot or unit in the development;
- The director or officer is either a tenant of a residence in the development or owns no more than two lots or units in the development;
- The director or officer receives no compensation, other than reimbursement of actual expenses incurred in the execution of his or her duties;
- The act or omission was within the scope of the officer's or director's association duties;
- The act or omission was performed in good faith;
- The act or omission was not willful, wanton, or grossly negligent; and
- The association has in effect, both at the time of the occurrence and at the time the claim is made, general liability insurance in favor of the association and directors' and officers' liability insurance with minimum coverage of $500,000 if the development has 100 or fewer lots or units, or $1 million if the development has more than 100 lots or units.

Because of the many qualifications and exceptions to CC §1365.7 coverage, the directors' and officers' true protection comes only from having the association maintain adequate general liability and directors' and officers' liability insurance. Suits against community associations for personal injury or other tort claims are likely to contain allegations that the directors or officers acted recklessly or with gross negligence. Resolving these allegations often turns on factual issues that make it difficult to obtain summary dismissal of individual liability claims.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.155 E. Volunteer Protection Act of 1997

§9.155 E. Volunteer Protection Act of 1997

No compensation exceeding $500 annually. The Volunteer Protection Act of 1997 (42 USC §§14501-14505) limits lawsuits against volunteers who perform services to a nonprofit organization for no compensation, covering volunteers serving in any capacity (*e.g.,* officers, directors, trustees, or program services) who receive no compensation or other things of value (other than reimbursement of expenses) in excess of $500 a year. Nonprofit organizations covered by the Act are either tax-exempt under IRC §501(c)(3) or "any not-for-profit organization which is organized and conducted for public benefit and operated primarily for charitable, civic, education, religious, welfare or health purposes" (42 USC §14505(b)), which would include social welfare organizations exempt from tax under IRC §501(c)(2).

Qualifications for protection. Under the Act, no volunteer can be held liable for harm caused by the volunteer's act or omission on behalf of the organization if (42 USC §14503(a)):

- The volunteer was acting within the scope of his or her responsibilities;
- The volunteer possessed any required license or certification;
- The harm did not result from willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious flagrant indifference to the rights or safety of the individual harmed; or
- The harm was not caused by the volunteer operating a motor vehicle, vessel, aircraft, or other vehicle which must either be insured or operated with a license under state law.

Exceptions. The limitation on liability does not apply to (42 USC §14503(f)):

- Misconduct stemming from crimes of violence (see 18 USC §16) or acts of terrorism (18 USC §2331) for which the defendant is convicted;
- A hate crime (28 USC §534 note; see 28 USC §534 (definition));
- An act involving a sexual offense under state law for which the defendant is convicted;
- An act involving misconduct for which the defendant is found to have violated a state or federal civil rights law; or
- The harm resulting while the defendant was under the influence of alcohol or drugs.

NOTE: Some of these exclusions apply only if the defendant is convicted of the crime or act while others apply only if the defendant is "found" to have engaged in the misconduct. The Act does not elaborate further on how that determination is to be made.

The Act also excludes from coverage suits by the nonprofit organization against the volunteer. See 42 USC §14503(b). It also does not limit the liability of the organization. 42 USC §14503(c).

Preemption. The Act preempts state law to the extent inconsistent with the Act, but a state statute may provide additional liability protection to volunteers. A state may also elect to have the Act not apply to its citizens. States may impose additional conditions expressly approved by the Act, including the following (42 USC §14503(d)):

- Requirements that the nonprofit organization for which the volunteer serves adhere to risk management procedures, including mandatory training of volunteers;
- Provisions imposing liability on nonprofit organizations for the acts or omissions of its volunteers to the same extent as an employer is liable for the acts or omissions of its employees;
- Provisions denying liability exemption when the action is brought by the state or local government;
- Provisions that make the limitation of volunteer liability contingent on the nonprofit organization's providing a financially secure source of recovery for the individual who is harmed, such as an insurance policy or other arrangement to ensure that the entity will be able to pay losses up to a specified dollar amount.

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VIII. INDEMNIFICATION OF DIRECTORS, OFFICERS, AND AGENTS; INSURANCE

§9.156 A. Statutory Scheme of Indemnification

The Corporations Code permits corporations to indemnify directors and officers under a strict and technical statutory provision. Corp C §§5238, 7237, 9246. However, rights of indemnity are only as good as the financial strength of the corporation providing the indemnity.

Directors, officers, and agents. The authority for indemnification applicable to nonprofit corporations extends beyond directors to include all officers (not just "executive officers") and all other agents of the corporation, such as corporate employees. The scope of the permitted indemnity extends to any threatened, pending, or completed action or proceeding, whether civil, criminal, administrative, or investigative. Corp C §§5238(a), 7237(a), 9246(a). The power to indemnify depends on several factors, including the nature of the proceedings; their outcome; the director's conduct in the matter complained of; and approval of the indemnification by the corporation, the Attorney General, or the appropriate tribunal. The statute aims to cover all legal threats asserted against a director or an officer for which he or she may be forced to retain counsel or otherwise incur expenses.

NOTE: No indemnification is permitted if a director breaches his or her fiduciary duties to the corporation. See Corp C §§5238(e), 7237(e), 9246(e).

Limits on indemnification of agents. A corporate agent cannot demand indemnification in all instances. The corporation can usually authorize indemnification only in a specific case, after the agent's indemnification is found to be proper under the circumstances because the agent's conduct satisfied the minimum standards of care. Corp C §§5238(e), 7237(e), 9246(e). Different standards of care are imposed for agents named in suits brought by third parties, on one hand, and for agents named in derivative suits brought on behalf of the charitable corporation, suits challenging a self-dealing transaction, or suits brought by the Attorney General, on the other. See §§9.121-9.126.

Who may authorize indemnification. Assuming that the corporate agent met the applicable standard of care, authorization for indemnification may be made by the following (Corp C §§5238(e), 7237(e), 9246(e)):

- A majority vote of a quorum of directors, excluding the vote of any director who is a party to the proceeding;
- Approval of the members (if the corporation has members), excluding the vote of any member who is a party to the proceeding; or
- Approval of the court in which the proceeding is or was pending, on application by the corporation, the defendant agent, or the attorney providing the agent's defense.

NOTE: Independent legal counsel cannot approve indemnification if it is impossible to obtain a majority vote of disinterested directors (contrary to the rule applicable to for-profit corporations; Corp C §317(e)).

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.157 B. Minimum Standard of Care Required for Indemnification Eligibility

§9.157 B. Minimum Standard of Care Required for Indemnification Eligibility

Nonderivative actions. A corporation may authorize indemnification for a director or officer sued by a third party plaintiff (*i.e.,* in a nonderivative action) only if it finds that the agent acted in good faith and in a manner he or she reasonably believed to be in the corporation's best interests. If the case is a criminal proceeding, the corporation must also establish that the agent had no reasonable cause to believe that his or her conduct was unlawful. Corp C §§5238(b), 7237(b), 9246(b).

NOTE: The director need not exercise the care that an "ordinarily prudent person" would use in the same or similar circumstances, presumably because the director is being held liable to a third party precisely because the director failed to use that level of care.

Derivative actions. For actions brought "in the right of the corporation" (*i.e.,* a derivative action) under Corp C §5233, §7238, or §9243 (self-dealing transactions) or by the Attorney General, indemnification is proper only if the corporation concludes that the agent was acting in good faith, in a manner he or she believed to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use in similar circumstances. Corp C §§5238(c), 7237(c), 9246(c).

NOTE: Thus, in third party actions, the agent must have reasonably believed that his or her actions were in the best interests of the corporation, whereas in a derivative action it is only necessary that he or she actually believed that this was the case.

Agent need not win suit to be indemnified. The agent need not win the lawsuit to qualify for indemnification. However, indemnification may not be made as to any claim, issue, or matter as to which an agent is adjudged liable to the corporation in the performance of his or her duty to the corporation, unless the court determines that the agent is, in view of all the circumstances, fairly and reasonably entitled to indemnity. Corp C §§5238(c), 7237(c), 9246(c). Accordingly, the court in its discretion may find that the agent is entitled to indemnification for expenses, even if the agent loses the case and did not meet the standard of conduct quoted above.

Attorney General approval. A director or an officer may also be indemnified for expenses incurs in defending a threatened or pending action that is settled or otherwise disposed of without court approval, if the Attorney General approves the settlement. Corp C §§5238(c)(3), 7238(c)(3), 9246(c)(3).

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§9.158 C. Agents' Right to Demand Indemnification

Indemnification against expenses. Indemnification is generally contingent on the director's or officer's obtaining proper corporate approval. However, directors or officers have the right to be indemnified for expenses actually and reasonably incurred in defending a proceeding (whether third party or derivative) if they are successful on the merits. Corp C §§5238(d), 7237(d), 9246(d). This absolute right to indemnification on demand exists even if the Attorney General brought the suit.

Apportionment for partial success. If a corporate agent is successful only in a part of a suit, expenses must be apportioned among the various claims. Corp C §§5238(d), 7237(d), 9246(d). The agent has a right to file an independent suit against the corporation to collect the amounts to which he or she is entitled if the corporation resists indemnification. Alternatively, the agent has the right to apply for indemnification to the court in which the action is pending, whether or not the corporation opposes the application.

Indemnification of employees. An employer must indemnify an employee for all necessary expenditures or losses incurred by the employee or lost in direct consequence of (1) the discharge of his or her duties as an employee or (2) his or her obedience to the employer's directions, even if they are unlawful, unless at the time the employee obeyed the directions he or she believed them to be unlawful. Lab C §2802. "Necessary expenditures or losses" are defined to include all reasonable costs, including attorney fees incurred by an employee in enforcing his or her rights under the section. Lab C §2802(c).

NOTE: It is unclear whether the Corp C §§5238(d), 7237(d), and 9246(d) protections, as they relate to employees, were intended to apply in addition to or instead of indemnification.

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§9.159 D. Amount of Indemnification

Indemnification that is properly authorized by the corporation (or that the director or officer may claim as a right) may include all expenses that the agent incurred in defending the case, including attorney fees and expenses incurred to establish the director's or officer's right to indemnity. However, the statute distinguishes between third party actions and derivative actions if a director or an officer seeks indemnification not only for expenses but also for sums paid in response to an adverse judgment or in settlement. Indemnification is proper for expenses and "judgments, fines, settlements and other amounts actually and reasonably incurred" for a third party claim. Corp C §§5238(b), 7237(b), 9246(b).

Limitations. In derivative actions, actions involving self-dealing transactions, and actions involving breach of duty regarding assets held in charitable trust, indemnification is limited to "expenses actually and reasonably incurred," and no indemnification is permitted for a judgment amount or an amount paid in settlement of such actions. Corp C §5238(c), 7237(c), 9246(c). The settlement or judgment in a derivative action may require the defendant to pay amounts to the corporation, because it is the party in whose favor judgment is being sought. Indemnification in such an action would reverse that payment, perhaps with additional rebates of legal fees and court costs, and therefore indemnification of expenses requires express authorization by the board or the members (without counting the vote of the party/director) or by the court in which the action was heard or is pending. Corp C §§5238(c), 7237(c), 9246(c).

Private foundations. Corporations that are private foundations (see IRC §509(a); §§4.23-4.55) may not engage in certain acts or omissions defined in IRC §§4941-4945. Corp C §§5260, 9260. Those prohibitions must be included in the articles or bylaws of any corporation that is a private foundation, including a religious corporation. IRC §508(e). See Treas Reg §53.4941(d)-2(f)(1), (3); Rev Rul 82-223, 1982-2 Cum Bull 301; IRS Letter Rulings 8920041, 8726070, 8708029, 8615076 (applicability of IRC §§4941 and 4945 to indemnification of officers and directors of private foundations and payment of premiums on insurance protecting them from liability). Thus, even if a public benefit corporation or religious corporation whose articles or bylaws comply with IRC §508(e) could otherwise indemnify or provide insurance to an officer or director under other California laws, Corp C §§5260 and 9260 prohibit it from doing so.

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§9.160 E. Litigation Expense Advances

A nonprofit corporation may pay legal fees and other expenses incurred by a director, an officer, or another corporate agent in defending an action, before final disposition of the action and without having to make a final determination on whether indemnification will be authorized, if the agent signs an undertaking to repay amounts advanced unless the agent is ultimately entitled to be indemnified. Corp C §§5238(f), 7237(f), 9246(f). The more liberalized approval for the advancement of expenses reflects the fact that many actions against corporations and their directors and officers are frivolous and therefore an advancement of expenses should be fairly easy to obtain to enable individual defendants to present an adequate defense, which they might not otherwise be able to afford.

PRACTICE TIP: If it is ultimately found that the director or officer is not entitled to indemnification, the corporation must pursue appropriate legal remedies to enforce the agent's commitment to reimburse the corporation.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.161 F. Expansion of Indemnification Rights Prohibited

§9.161 F. Expansion of Indemnification Rights Prohibited

Nonprofit corporations may not expand indemnification rights beyond those set forth in the Corporations Code. Corp C §§5238(g), 7237(g), 9246(g). The corporation is also prohibited from making any indemnifications or advances otherwise consistent with the applicable statutory indemnification provision when the agent has not been successful on the merits or in his or her defense, if it appears that (Corp C §§5238(h), 7237(h), 9246(h)):

- The indemnification or advance would be inconsistent with the articles, the bylaws, a resolution of the members, or an agreement in effect at the time the alleged cause of action accrued, which inconsistent provision is asserted in the proceeding in which the expenses were incurred or other amounts were paid and prohibits or otherwise limits indemnification; or
- The indemnification or advance would be inconsistent with any condition expressly imposed by a court in approving a settlement.

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Source: Business Law/Advising California Nonprofit Corporations/9 Directors and Officers/§9.162 G. Insurance

§9.162 G. Insurance

A nonprofit corporation is generally permitted to purchase and maintain insurance on behalf of its directors covering any liability asserted against them as directors, other than liability for self-dealing violations, whether or not the corporation may indemnify them directly. Corp C §§5238(i), 7237(i), 9246(i).

Private foundations. Nonprofit corporations that have "private foundation" status (see §§4.23-4.55) may purchase insurance covering directors' liability for the following, as long as premium payments constitute reasonable compensation:

- Taxes on private foundations, including taxes on self-dealing transactions, under IRC §§4940-4948 (see Treas Reg §§53.4941-53.4942);
- Expenses, judgments, and settlements in proceedings for taxes under IRC §§4940-4948 or for mismanagement under state law (see IRS Letter Ruling 7825042); and
- Violation of securities laws (see Rev Rul 74-405, 1974-2 Cum Bull 384).

Brokers. Forms of liability insurance policies for directors and officers (often called "D & O" policies) vary widely. Because not all insurance companies offer this coverage, which may be quite expensive, the corporation should secure the services of an insurance broker who is knowledgeable in this area. See generally Counseling California Corporations, chap 2 (2d ed Cal CEB 2000).

WARNING: No insurance policy may provide any coverage, indemnity, or duty to defend with respect to a claim for, or in payment of any fine, penalty, or restitution in any criminal or civil action involving unfair competition under Bus & P C §§17200-17210 or false advertising under Bus & P C §§17500-17509. Ins C §533.5.

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IX. DIRECTORS' INSPECTION RIGHTS

§9.163 A. Scope of Directors' Rights

Absolute right to inspect. Every director has the absolute right, at any reasonable time, to inspect and copy all books, records, and documents of every kind that are maintained by the association and to inspect the physical properties of the association. Corp C §§6334, 8334, 9513. The range of documents that a director can inspect is far broader than the documents available to a member. Compare Corp C §§6333, 8333, 9512 (members' inspection rights) with Corp C §§6334, 8334, 9513 (directors' inspection rights).

No formalities required. Unlike members' enforcement of inspection rights (see §§10.108-10.120), a director need neither tender a written demand as a prerequisite to the exercise of inspection rights nor present a statement about the director's purpose. The director need not specify or demonstrate that his or her inspection rights are being exercised for a purpose reasonably related to the director's interests in the corporation. Evidently, the California Legislature believed that a director's general fiduciary obligations to perform his or her duties in good faith and in a manner that the director believes to be in the corporation's best interests (Corp C §§5231(a), 7231(a), 9241(a)) are a sufficient constraint on directors to avoid the exercise of inspection rights for personal gain or to further interests that are contrary to the best interests of the corporation as a whole.

Ethical and legal considerations. A director's inspection rights can present difficult ethical and legal issues for the corporation and its legal counsel. For instance, what if a director elected solely by votes controlled by the developer in a community association demands to inspect correspondence between the association and its legal counsel concerning construction-defect litigation? What if the board appoints a select committee (composed of a cross-section of community leaders) to investigate allegations that the treasurer made investments that were contrary to the corporation's published investment policies and a maverick director demands the right to inspect the committee's working papers before the committee is scheduled to present its final report to the board? What if a director who ran for office on a platform critical of the present general manager's conduct and salary demands the right to inspect the manager's personnel file and to disclose its contents to the members because, in the director's opinion, "they have a right to know"?

PRACTICE TIP: When inspection by a director involves clear conflicts of interest or the likely disclosure of information in violation of the director's fiduciary duties to the corporation and its members as a whole, the board should seek the advice of its legal counsel on whether the director should be given access. See *Hoiles v Superior Court* (1984) 157 CA3d 1192, 204 CR 111.

Balanced against competing constitutional rights. The director's absolute right at any reasonable time to inspect and copy all books, records, and documents of every kind is a statutory right that must be balanced against competing constitutional rights. *Chantiles v Lake Forest II Master Homeowners Ass'n* (1995) 37 CA4th 914, 923, 45 CR2d 1 (members have constitutional privacy right in their voting decisions). *Chantiles* addressed a contested election of directors of the defendant community association. Although the plaintiff was elected, he suspected that certain property owners who had promised him proxies had, in fact, given their proxies to others. He asserted his right as a director to personally inspect the ballots and proxies. Out of concern for other members' privacy rights regarding the manner in which they had cast their ballots, the trial court appointed the plaintiff's attorney to review and tally the ballots, on condition that he did not disclose the name of any individual voter or how any member voted. The plaintiff refused this resolution and appealed. The court of appeal held that the trial court's conditions were appropriate because association members have a constitutional privacy right in their voting decisions, even when the vote is conducted by the use of proxies, and the director's statutory right to inspect the records of the association must be balanced against this privacy right. The court also held that the plaintiff was not entitled to an award of attorney fees, because the association was justified in refusing to honor the inspection demand.

Privileged communications. A similar balancing of interests justifies a limitation on a director's inspection demand if the director is seeking access to privileged communications between the board of directors and its legal counsel on a

matter in which the director is an adverse party. Providing access to the confidential and privileged correspondence or documentation would waive the privilege and only the corporation, acting through its board, has the power and authority to do that.

NOTE: In the business corporation context, corporate directors have no right (see Corp C §§1602-1603) to inspect corporate documents subject to attorney-client privilege in a director's suit for damages against the company. *Tritek Telecom, Inc. v Superior Court (Mak)* (2009) 169 CA4th 1385, 87 CR3d 455.

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§9.164 B. Alternative Methods of Responding to Directors' Requests for Inspection

A nonprofit corporation may deliver to directors demanding to inspect membership lists a written offer of an alternative method of achieving the purpose identified in the demand, without providing access to the list itself. See §10.110. The unqualified language of Corp C §§6334, 8334, and 9513 and the absence of any requirement that a director demonstrate a proper purpose for inspection suggest that a director has the absolute right to have access to the list and that the rules on alternative disclosures do not apply. If the board feels that the director intends to use the list in a prohibited fashion (see Corp C §§6338, 8338 (no similar provision for religious corporations)), the board may seek injunctive relief to block access. Corp C §§6338, 8338(c) (no similar provision for religious corporations). See also Corp C §§6331(j), 8331(j).

COMMENT: The contrary argument is that, unless specific authority is delegated to a specific director by the board, the corporation communicates the actions of its directors to the members through formal board resolutions. In the author's experience, when an individual director demands access to the membership list, the intent is to further the interests of a membership faction sympathetic to the director rather than to promote the best interests of the corporation and its members as a whole. If the director is actually doing no more than acting as a proxy to represent and further the views of a member faction, there seems to be little justification to treat the director's demand differently from a demand received from a membership faction representing the authorized number of members. See §10.111.

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10

Members and Other Interested Persons

Gary L. Wollberg

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§10.1 I. SCOPE OF CHAPTER

This chapter discusses the role of members of nonprofit corporations, as well as other interested persons who are not members. It covers preliminary decisions regarding members (see §§10.2-10.6) and the different types of memberships (see §§10.7-10.11). It also addresses the application of state and federal securities laws to the issuance of memberships. See §§10.12-10.24. The chapter discusses admission of members (see §§10.25-10.33), members' voting rights and rights in corporate governance (see §§10.34-10.74), as well as membership meetings (see §§10.75-10.107). Member inspection rights are covered in §§10.108-10.120, while obligations of membership are discussed in §§10.121-10.124. The termination and transfer of memberships are addressed in §§10.125-10.135. Derivative suits are discussed in §10.136, and distributions to members are covered in §§10.137-10.142.

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II. PRELIMINARY DECISIONS REGARDING MEMBERS

A. Roles of Individuals in Nonprofit Corporations

§10.2 1. Definitions of "Member" and "Membership"

Definitions. The term "member" (or "statutory member") is a term of art specifically defined at Corp C §5056(a). A member means any person who, under a specific provision of the articles or bylaws:

- Has the right to vote on (1) the election of directors, (2) dissolution, (3) merger, or (4) disposition of all or substantially all the corporate assets (but not if the right to vote is only effective because the person voting holds indebtedness issued by a mutual benefit corporation and the voting right was conferred for that reason under Corp C §7132(a)(2)); or
- Is designated as a member in the articles or bylaws and has the right to vote on changes to the articles or bylaws by reason of a specific provision in those governing documents.

The articles or bylaws do not have to use the term "member" or "membership" to authorize members. All that is required is to authorize persons to exercise the rights described in Corp C §5056(a).

NOTE: A person is *not* a statutory member merely because he or she is a delegate, director, or person entitled to designate or select a director. Corp C §5056(d).

The articles or bylaws may confer some or all the rights of a member on persons who are not granted the voting rights of statutory members. Corp C §5056(b). These persons would have only the rights conferred on them (*e.g.,* the right to receive notice of meetings or to use corporate facilities or services) and would not be statutory members. See 3 Ballantine & Sterling, California Corporation Laws §403.07[13] (4th rev ed 1962).

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§10.3 2. Corporations Without Members; Exercise of Membership Rights by Directors

Members not required. A nonprofit corporation is not required to have members. Unless its articles or bylaws provide for members, a nonprofit corporation is deemed to have none. Corp C §§5310(a), 7310(a), 9310(a).

Rights vested in directors. If a corporation has no members, actions that would otherwise require membership approval require only board approval, and rights that would otherwise vest in the members are vested in the directors. Corp C §§5310(b), 7310(b), 9310(b). Only a religious corporation may, through its articles or bylaws, alter the statutory rules vesting in directors the powers of members in a nonmember corporation. Corp C §§9310(b), 9410(b); see also Corp C §§5310(b), 7310(b).

Formal memberships not required. Directors need not be given formal memberships in an otherwise nonmember nonprofit corporation in order to exercise membership rights. Directors do not need to call and notice members' meetings, to which only they would be invited, to take actions that the Corporations Code otherwise vests in the members. These actions can be taken during a directors' meeting or by unanimous written consent. See Corp C §§5211, 5310, 7211, 7310, 9211, 9310.

PRACTICE TIP: Counsel may occasionally encounter a nonmember corporation organized before the adoption of the Nonprofit Corporation Law (Corp C §§5000-10841) with articles or bylaws that require the directors of a nonmember corporation to hold member meetings in order for the directors to exercise membership rights. These provisions were required under the prior statute. Such corporations should consider amending their articles or bylaws to adopt the more direct approach of the current Code.

If the articles or bylaws authorize memberships, it is permissible to issue memberships only to directors. However, if there are no members other than the directors, the corporation is treated by law as having no members. See Corp C §§5310(c), 7310(c), 9310(c).

NOTE: Some attorneys take the position that directors should be issued memberships in an otherwise nonmember corporation in the belief that it provides indicia of ultimate control over the corporate enterprise, and precludes others from gaining control of the corporation and changing management. The merit in this position is debatable because when memberships are not authorized in the governing documents, or when the directors are the only members, the corporation is deemed by law to be governed solely by the directors as a nonmember corporation. Corp C §§5310(c), 7310(c), 9310(c).

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.4 3. The Decision to Issue or Dispense With Memberships

§10.4 3. The Decision to Issue or Dispense With Memberships

Deciding whether to have members is a key decision in organizing a nonprofit corporation. There are benefits and detriments to both the existence and absence of members, and the decision must be addressed anew for each corporation with reference to the corporation's anticipated functions and resources. An initial consideration should be whether memberships will advance or frustrate the corporation's charitable, civic, or other nonprofit goals. When it is believed that stakeholders must be given a voice, yet accommodating them on the board would be unwieldy, the corporation can create a defined class of voting members to prevent control from being dissipated among too many persons. If the organizers believe that their control of the corporation's work is a critical component to accomplishing its nonprofit ends, counsel may advise issuing few memberships, or going without members and leaving control to the directors. Corp C §§5310, 7310, 9310. If the corporation will be dependent on a principal benefactor, that person could be the sole member with the right to designate the directors. See §9.28.

PRACTICE TIP: If the organizers can voice no compelling reason to issue memberships, the corporation should be organized without members. Members have enforceable rights (see §§10.35-10.36) that may create administrative burdens, add expense, distract management, and otherwise frustrate the organizers' objectives.

Public benefit corporations. The persons in control of a public benefit corporation must be mindful of the prohibition against operating the corporation for their benefit or private inurement. See §3.15. Memberships in a public benefit corporation may provide some measure of checks and balances, if not a moral stricture, against managing the corporation for personal gain. The existence of voting members may help a tax-exempt corporation develop financial support among the public, and demonstrate broad community involvement, particularly if the defined membership base is representative of the constituency served or supports its mission. Unfortunately, memberships can introduce factional divisions to distract management and interfere with the corporation's objectives. Memberships also add administrative burdens in having to organize periodic meetings, and sometimes delaying important corporate decisions while meetings are pending or written consents are being solicited, as well as requiring staff to use valuable time in maintain accurate membership lists.

Mutual benefit corporations. Mutual benefit corporations frequently have members if only because they are formed to benefit a particular group of people, and the members tend to be active because they are the beneficiaries of the corporation's efforts. However, it is not unknown for mutual benefit corporations to be formed without members and permit some definable group to receive the benefit of the corporation's operations. Corp C §§7310, 7333(b). For example, a corporation organized to present an annual sporting event should probably not grant membership status to all participants, because they are likely to change from year to year, the athletes may have little or no interest in the organizational aspects of the event, and they may be difficult to locate. Nevertheless, individuals who are present or former participants in the event may be a source of continued financial support for the sponsor organization even if no membership rights are granted.

Religious corporations. The doctrinal views of a religious corporation will likely determine whether it is organized with members. Where a doctrinal position is not controlling, a religious corporation may assess the benefit of having members much in the same way as a public benefit corporation, including the discouragement of private inurement and the administrative burdens and threat of factional divisions.

Alternatives to membership. Membership is not the only way that persons can influence, or help sustain, a nonprofit corporation. The following may be alternative methods for securing participation in a nonprofit corporation:

- As delegates (Corp C §§5152, 7152, 9152; see §10.5);
- As honorary or nonstatutory "members" (Corp C §§5332(a), 7332(a), 9332(a); see §10.6);
- As persons with the power to approve of the repeal or amendment of articles or bylaws, or particular provisions of articles or the bylaws, of a public benefit or mutual benefit corporation (Corp C §§5131(c)(4), 5150(d), 7132(c)(5), 7150(d)).
- As officers and directors (Corp C §§5047, 5213, 7213, 9213; see chap 9);

- As contributors (Corp C §§5332(b), 7333(b), 9332(b); see chap 15); and
- As persons who benefit from the activities, services, or mission of the organization (Corp C §§5332(b), 7333(b), 9332(b); see §10.6).

Articles or bylaws must precisely describe rights and duties. While various structures exist to encourage participation in a nonprofit corporation, the articles and bylaws must clearly describe the respective roles to minimize confusion. The lack of precision in describing the rights and obligations of the participants can lead to litigation challenging the validity of the actions taken by directors and members. On articles of incorporation, see chap 6; on bylaws, see chap 7.

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§10.5 4. Delegates

Role of delegates. Nonprofit corporations with large memberships often resort to delegates to conduct membership meetings (frequently organized as conventions). Nonprofits may provide for delegates having some or all of the members' authority. Delegates are individuals authorized to represent or vote on behalf of members; they are not members under the Code, even though they are acting on behalf of a group of members and in that capacity are exercising membership rights. Corp C §5056(d)(1).

NOTE: Delegates are sometimes described as something other than "delegates." See Corp C §§5152, 7152, 9152. However, a person authorized through the governing documents to act in a representative capacity similar to that exercised by a proxyholder will not, in that capacity, be a member regardless of title.

Authorization. Delegates are authorized only through the articles or bylaws. Corp C §§5132(c)(5), 5152, 7132(c)(5), 7152, 9132(c)(5), 9152. When delegates are provided for, the bylaws must specify the delegates' terms of office; a reasonable method for selection and removal; and a reasonable method for calling, noticing, and holding delegates' meetings. Although not required, if the corporation intends to permit delegates to act by written ballot, the manner of delegate balloting may also be set forth. Corp C §§5152, 7152, 9152.

Delegates must act in person or by written ballot. Delegates must act personally at a meeting or by written ballot, and may not act by proxy. Corp C §§5152, 7152, 9152.

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§10.6 5. Associated Persons

No voting rights unless statutory members. A nonprofit corporation may benefit, serve, or assist persons who are not members. Corp C §§5332(b), 7333(b), 9332(b). It is not uncommon for nonprofit corporations to use the term "member" to refer to interested persons who are not statutory members but either support, or receive a benefit from, the corporation (see §10.3). See Corp C §§5332(a), 7333(a), 9332(a). For example, public benefit corporations frequently classify their contributors as "members," "lifetime members," "sustaining members," "senior members," or "associate members." Homeowners' associations organized as mutual benefit corporations often make their recreational facilities available for free to family members of owners, and for a fee to other non-owners, giving them the status of "associate members." If these interested persons are not statutory members, they will have no voting rights even if they are called "members."

PRACTICE TIP: If the articles or bylaws use the term "member" to refer to persons who are not intended to be statutory members, it is good practice to include an explicit statement that such persons are not statutory members. For a bylaw provision to this effect, see §7.15.

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B. Types of Memberships

§10.7 1. General Rule: Same Rights for All Members

All memberships have the same rights, privileges, preferences, restrictions, and conditions unless the articles or bylaws provide otherwise. Corp C §§5331, 7331, 9331. With limited exceptions, a person may hold only one membership (see §10.11), and each membership has only one vote (see §10.49).

Homeowners' associations. Unlike most other nonprofit corporations, homeowners' association governing documents generally distinguish between membership voting rights and all other rights of members. For example, a person who owns more than one unit in a real estate common interest development is typically considered as a single member with respect to the use and enjoyment of common facilities but will have separate voting and liquidation rights with respect to each unit owned. If several individuals own a single unit, they each may be considered as members with a right to use the association's common facilities but often must designate one co-owner as the voting member to avoid conflicts or confusion regarding how co-owners intended to cast their single vote.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.8 2. Different Rights for Different Members

§10.8 2. Different Rights for Different Members

A nonprofit corporation can be organized to give to certain members rights that differ from those of other members on matters such as voting, transferability of memberships, or (for mutual benefit corporations) the redemption, dissolution, or use of corporate facilities. See §§10.9-10.11.

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§10.9 a. Classes of Members

A nonprofit corporation may issue memberships with different rights, privileges, preferences, restrictions, or conditions, as authorized by its articles or bylaws. Corp C §§5330, 7330, 9330. A membership "class" is either (Corp C §5041):

- A category of memberships specifically identified in the articles or bylaws as differing from other memberships; or
- A group of members, all of whom have the same rights with respect to voting, dissolution, redemption, and transfer.

Rights are considered the same if they are determined by a formula applied uniformly. Corp C §5041.

Purpose. A principal reason to use classes of memberships is to allow for weighted voting. For example, one class can have the right to vote on some matters but not others, or can be given a virtual veto power by requiring that the class approve particular corporate actions, perhaps by a supermajority or unanimous vote. See §10.50.

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§10.10 b. Class Voting

Public benefit corporations. Amendments to the articles or bylaws of a public benefit corporation that would materially and adversely affect the rights of a class of members on voting or transfer in a manner different from the way that action affects another class must be approved by the affected class even if that class is not ordinarily entitled to vote on the particular matter. Corp C §§5150(b), 5813.

Mutual benefit corporations. Class voting is required for any bylaw or articles amendments that would (Corp C §§7150(b), 7813):

- Materially and adversely affect the rights, privileges, preferences, restrictions, or conditions of a particular class as to voting, dissolution, redemption, or transfer differently from its effect on another class;
- Materially and adversely affect a particular class as to voting, dissolution, redemption, or transfer by changing the rights, preferences, privileges, restrictions, or conditions of another class;
- Increase or decrease the number of memberships authorized for the affected class;
- Increase the number of memberships authorized for another class;
- Effect an exchange, reclassification, or cancellation of all or part of the memberships of the affected class; or
- Authorize a new class of memberships.

Religious corporations. Amendment of the bylaws of a religious corporation does not require a class vote, unless otherwise required by the bylaws or articles. Corp C §9150(b). However, amendment of the articles of a religious corporation with classes of members will require a class vote under the same circumstances applicable to a public benefit corporation. Corp C §§5813, 9620(a).

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§10.11 c. One-Person-One-Membership Rule; Exceptions

General rule. In general, one person cannot hold more than one membership in a nonprofit corporation, and cannot hold a fractional membership. Corp C §§5312, 7312, 9312. This general rule prohibits one person from increasing his or her voting or other rights in an organization by increasing the number of memberships issued to him or her, and prohibits one person from having a claim to the rights and privileges of members without possessing a full membership interest.

Exceptions. The one-person-one-membership rule, however, has certain exceptions and modifications:

- **Membership in more than one class.** A person may hold memberships in more than one class if the articles or bylaws so provide. Corp C §§5312(b), 7312(b), 9312(b).
- **Branches, divisions, and offices.** Branches, divisions, or offices of an entity member may hold separate memberships in a mutual benefit corporation as long as the branch, division, or office was not formed primarily to be a member. Corp C §7312(c).
- **Homeowners' associations and mutual water companies.** The articles or bylaws of a homeowners' association may permit owners of more than one lot, parcel, area, apartment, or unit to hold a separate membership for each real estate interest owned. Corp C §7312(d); see Bus & P C §11004.5(f). Similarly, the articles or bylaws of a mutual water company (see Corp C §14300) may permit a person to hold a separate membership for each lot, parcel, or other service unit that the person owns, leases, or occupies. Corp C §7312(e). Because membership is derived from the ownership of property within the development, the governing documents ordinarily provide that the owner's membership is "appurtenant" to the owner's lot or unit and may not be transferred or conveyed separately from a conveyance of the lot or unit. See also 10 Cal Code Regs §2792.18(a) (homeowners' associations in common-interest subdivisions must allocate one vote for each subdivision interest).
- **Mobile home park acquisition corporation.** A bona fide secured party who has taken title to membership in a mobile home park acquisition corporation (see Bus & P C §11010.8) by way of foreclosure, repossession, or voluntary repossession, and who is actively attempting to resell the membership to a prospective homeowner or resident of the mobile home park, may own more than one membership. Corp C §7312(f).
- **Indivisible interests in a single membership.** If so provided in the articles or bylaws, two or more persons may have an indivisible interest in a single membership. Corp C §§5312(a), 7312(a), 9312(a); see §10.44. See also Corp C §§5612, 7612 (fiduciaries, members of a partnership, joint tenants, tenants in common, tenants by the entirety, and husband and wife may be joint holders of a membership).

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C. Application of California Corporate Securities Law to Nonprofit Memberships

§10.12 1. Qualification or Exemption From Qualification Required

As a practical matter, the issuance of memberships by most nonprofit corporations will not require qualification under California's securities laws. Nevertheless, serious consequences arise from even the inadvertent issuance of memberships otherwise requiring qualification. See Corp C §§25500-25550. A nonprofit corporation should therefore consider whether it must seek qualification of the sale of its memberships before offering them for sale.

Sale must be qualified or exempt. It is unlawful for any person to offer or sell any security in California unless (Corp C §25110):

- The security has been qualified and a permit has been issued by the Commissioner of Corporations;
- A specific exemption applies to the issuer of the security or to the particular transaction; or
- The security or transaction is not subject to qualification.

A sale includes any contract of sale of, contract to sell, or disposition of, a security or interest for value or, if securities are outstanding, any change in the rights, preferences, privileges, or restrictions of the outstanding securities. Corp C §25017(a).

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§10.13 2. Memberships Generally Included in Definition of "Security"

Voting or ownership rights as securities. The Corporate Securities Law of 1968 (Corp C §§25000-25707) defines "security" in its broadest possible sense by presenting a long list of contracts, instruments, and other devices offered to investors as investment opportunities, including membership in an incorporated or unincorporated association, evidences of indebtedness, and investment contracts. Corp C §25019. Although the statute does not specifically address *nonprofit* associations, the California Commissioner of Corporations takes the position that the issuance of memberships in nonprofit corporations possessing either voting rights or rights of ownership of the corporation's assets or earnings are securities. Cal Comm'r Corps Release No. 15-C (rev Oct. 7, 1970).

Whether transaction falls within legislative purpose. The principal question is whether the transaction falls within the legislative purpose to protect the public against unsubstantial, unlawful, and fraudulent investment schemes. See *People v Figueroa* (1986) 41 C3d 714, 224 CR 719; *People ex rel Bender v Wind River Mining Project* (1990) 219 CA3d 1390, 269 CR 106. Thus, each nonprofit venture must be analyzed to ascertain whether a "security" is present, and thus whether the corporation must comply with the Corporate Securities Law, by examining the corporation's organizational structure, its members' rights, the manner in which its memberships are marketed, and the presence or absence of equity capital for the nonprofit organization derived from sources other than the offer and sale of memberships.

Two separate tests. California courts have applied two separate tests to determine whether the circumstances of a particular transaction give rise to a security requiring qualification. See §§10.14-10.15.

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§10.14 a. *Howey* Test

Some California courts have applied the United States Supreme Court's *Howey* test under which the court must examine whether the scheme involves an investment of money in a common enterprise, with profits to come solely from the efforts of others. See *SEC v W.J. Howey Co.* (1946) 328 US 293, 90 L Ed 1244, 66 S Ct 1100. Conferring on investors minor responsibilities in a venture does not remove an investment vehicle from the coverage of the *Howey* test if managerial efforts that will significantly affect the success or failure of the venture are contributed by persons other than the investors. See *People v Graham* (1985) 163 CA3d 1159, 210 CR 318. For further discussion of the *Howey* test, see §§10.22-10.23.

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§10.15 b. Risk Capital Test

California courts most often resort to the "risk capital" test, which finds that a security is created when the promoters of a corporation offer stock or memberships in order to raise the risk capital needed to initiate business, particularly when the offering is to the public at large, the persons solicited are selected at random, and the investors will have a passive position in the management and control of the enterprise. *Silver Hills Country Club v Sobieski* (1961) 55 C2d 811, 13 CR 186. The transaction need not contemplate that investors profit from the enterprise or receive other material benefits customarily associated with a stock investment in a for-profit enterprise.

NOTE: Corp C §25100(j) precludes the application of the risk capital test for most public benefit, mutual benefit, and religious corporations that issue memberships (as opposed to debt instruments), even when the funds raised are used to construct or otherwise acquire facilities for the use of members, and, therefore, would be considered at risk under *Silver Hills Country Club v Sobieski*, *supra*. See 1 Marsh & Volk, Practice Under the California Securities Laws §5.06[2][a] (rev 1973).

Under the risk capital test, even when the memberships are nonproprietary (such as a mere right to use facilities), counsel must ascertain whether the promoters have either contributed sufficient equity capital derived from other sources or undertaken other measures to ensure that all investor funds will be held in escrow until funds are sufficient to completely build the organization's facilities and until revenue needed to sustain operations is secured from sources other than investor contributions. See Ops Cal Comm'r Corps 70/107C (Aug. 20, 1970); Ops Cal Comm'r Corps 73/45C (Mar. 21, 1973); Ops Cal Comm'r Corps 73/51C (Mar. 22, 1973).

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§10.16 3. General Exemption for Nonprofit Corporation Memberships

Exchange of value required for security. As noted in §10.12, most membership issuances by nonprofit corporations are exempt from securities qualification requirements. Only securities that have been offered for sale or sold require qualification, or an exemption from qualification. Corp C §§25110, 25120, 25130. The term "sale" includes a contract to sell or dispose of a security for value. Corp C §25017(a). It should follow that if memberships are offered on satisfaction of criteria that do not involve an exchange of value, no securities law issues are presented.

In addition, under Corp C §25100(j), except for evidence of indebtedness, a security is exempt from registration if issued by an organization formed:

- Exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit, as long as no part of the net earnings of the issuer inures to the benefit of a private shareholder or individual (see §3.15); or
- As a chamber of commerce or trade or professional organization.

NOTE: The Commissioner of Corporations takes the position that the latter exemption is limited to trade associations formed for nonpecuniary purposes and is not available for trade associations formed to enhance the economic gain or position of their members. See Cal Comm'r Corps Policy Letter No. 10 (July 10, 1969); Ops Cal Comm'r Corps 75/8C (Mar. 7, 1975); Ops Cal Comm'r Corps 75/3C (Jan. 29, 1975).

This exemption applies, for example, to proprietary memberships with voting rights offered in a social club when neither the issuing club nor its promoters will profit from any club activity (including the sale of nonvoting memberships). Ops Cal Comm'r Corps 70/89C (July 23, 1970). It is also available even if amounts received from memberships, dues, or both may be used to construct or otherwise acquire facilities for use by the members. If a nonprofit corporation offering membership interests does not qualify for exemption under Corp C §25100(j), counsel must apply the risk capital test (see §10.15) to ascertain whether memberships will constitute a security.

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§10.17 4. Interpretive Regulations and Commissioner's Releases

The broad definition of a security found in Corp C §25019 (see §10.13), on the one hand, and the equally broad exemption from qualification requirements found in Corp C §25100(j) (see §10.16), on the other, create some confusion as to when a membership interest in a nonprofit corporation is a security. Two principal interpretations of these statutory provisions offer guidance. See §§10.18-10.19.

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§10.18 a. Commissioner of Corporations Release No. 15-C

When memberships are securities. Memberships constituting "securities" (see Corp C §25019) are those that confer rights on the holder of the membership similar to those conferred by stock ownership; *i.e*., a membership constituting the security should have some or all of the attributes of a proprietary interest in the enterprise. See Corp C §184; Cal Comm'r Corps Release No. 15-C (rev Oct. 7, 1970). A proprietary right that would cause a membership to be a security includes the right to the ownership of the organization's assets or earnings or the right to control the organization, typically through voting rights conferred by the governing documents or the Corporations Code. Release No. 15-C. However, merely providing that the assets of the nonprofit corporation will be distributed to the members on liquidation or dissolution will not make the memberships a security unless, at the time of formation, the corporation's organizers intended to confer profits on the members by increasing the value of the corporation's assets and distributing the increment to the members in a liquidation.

When memberships are not securities. A membership is not a security if it is merely a licensee to use certain facilities or services of a membership organization. Thus, a membership that confers on the holder nothing more than the right to enjoy the facilities provided by the organization, such as key club privileges, the use of a swimming pool, or the use of golf facilities, is not a membership within the meaning of Corp C §25019 and, in the absence of the "risk element," is not a security. Release No. 15-C. For discussion of the risk element, see *Silver Hills Country Club v Sobieski* (1961) 55 C2d 811, 13 CR 186. However, a security is present even when the membership is a mere license to use facilities if the issuing entity is formed as a for-profit business and the proceeds of the sale of securities will be used to build the facilities contemplated by the license arrangement (*e.g.,* a club facility). Release No. 15-C. See also Ops Cal Comm'r Corps 70/107C (Aug. 20, 1970); Ops Cal Comm'r Corps 73/45C (Mar. 21, 1973); Ops Cal Comm'r Corps 73/51C (Mar. 22, 1973).

NOTE: Both Corp C §25100(j) (see §10.16) and Release No. 15-C focus on whether the issuer's net earnings are intended to inure to the benefit of private shareholders or individuals, particularly if they are promoters of the enterprise. An exemption is not available for securities of any nonprofit organization if a promoter intends to make a profit directly or indirectly from any business or activity associated with the organization or operation of the nonprofit organization. Release No. 15-C.

Use of fees to acquire facilities does not defeat exemption. As long as an entity covered by Corp C §25100(j) has not issued an evidence of indebtedness, is not organized for pecuniary profit, and has no net earnings that will inure to the benefit of any private shareholder or individual, and its organizer (*i.e.*, the promoter) does not expect or intend to make a profit, directly or indirectly, from the nonprofit's business or activities, then the mere fact that membership fees or dues received from members will be used to build or acquire the organization's facilities does not disqualify coverage under the exemption.

Evidences of indebtedness. Evidences of indebtedness, whether interest bearing or not, issued by nonprofit corporations are outside the exemption. Corp C §25100(j); Release No. 15-C. See *Silver Hills Country Club v Sobieski, supra*.

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§10.19 b. Commissioner Rule 260.105.20

Securities issued by a nonprofit organization are not exempt under Corp C §25100(j) if any promoter of the entity expects or intends to make a profit from the organization's business or activities, or intends to receive compensation from the organization. However, as long as a nonprofit organization otherwise comes within the scope of §25100(j), the organization's offer or sale of a security (other than an evidence of indebtedness, whether interest bearing or not) will be exempt for qualification under the Corporate Securities Law of 1968 (Corp C §§25000-25707) if all the conditions specified in Commissioner Rule 260.105.20 (as codified in 10 Cal Code Regs §260.105.20) are met. These conditions generally specify that the expectation or intention to make a profit be limited to a promoter, that the promoter not be in control of the nonprofit, that the profit will be derived only from a passive relationship with the nonprofit, that the initial offering was qualified, and that the nonprofit give notice to the Commissioner and files certain financial statements at least 30 days before any sale of memberships. See 10 Cal Code Regs §260.105.20.

Limited application of rule. Commissioner Rule 260.105.20 has limited application. In practice it applies only to organizations that had initially qualified a sale of memberships under the Corporate Securities Law of 1968 and desire to sell additional memberships after the expiration of the initial qualification, provided that the arrangements with the promoter are unchanged (or have become more favorable to the members) between the time of the initial qualification and the sale of the memberships. In addition, the promoter cannot receive the kinds of profits typically generated by the active participation in or operation of a business, nor can the promoter exercise control, directly or indirectly, of the organization.

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§10.20 5. Other Possible Corporate Securities Law Exemptions

Exemptions that are available to corporations generally may also be available to a nonprofit corporation whose plan for the issuance of memberships comes within the definition of a security. For example, exemptions exist for unadvertised small offerings of securities to 35 or fewer qualified investors. Corp C §25102(f), (h). For discussion of these exemption and qualification procedures, see Organizing Corporations in California, chap 4 (3d ed Cal CEB 2001).

NOTE: Exemptions from qualification requirements do not include exemption from antifraud requirements and sanctions. Corp C §§25400-25402.

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D. Application of Federal Securities Laws

§10.21 1. Registration, or Exemption from Registration, Required

Nonprofit membership securities must be registered with the Securities and Exchange Commission (SEC) if the promoter of the offering intends to market and sell memberships to persons domiciled in the United States unless the securities are exempt from registration requirements. 15 USC §§77d-77e. This requirement protects investors by promoting and requiring a full disclosure of information thought to be necessary to persons desiring to make informed investment decisions. *SEC v Ralston Purina Co.* (1953) 346 US 119, 124, 97 L Ed 1494, 1498, 73 S Ct 981. The statute is broadly construed to achieve that purpose. *Tcherepnin v Knight* (1967) 389 US 332, 336, 19 L Ed 2d 564, 569, 88 S Ct 548.

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§10.22 2. Definition of "Security"

Security defined broadly. Like the California statute (see §10.12), the Securities Act of 1933 and the Securities Exchange Act of 1934 define "security" broadly by presenting a long list of specific and general commercial forms that may be offered to investors as investment opportunities. The federal definition does not expressly mention interests in nonprofit corporations, but it does include any "stock… investment contract… or, in general, any interest or instrument commonly known as a 'security.' " 15 USC §§77b(a)(1), 78c(a)(10). The definition of a security in §77b(a)(1) is virtually identical to that in §3(a)(10) of the 1934 Act and may be considered the same; see *United Hous. Found. v Forman* (1975) 421 US 837, 847 n12, 44 L Ed 2d 621, 629 n12, 95 S Ct 2051.

Type of contract regulated by securities laws. In analyzing whether an interest in a nonprofit corporation is a security under federal law, one first must determine, under the circumstances surrounding the sale of the interest, whether the membership is the type of stock or investment contract that the federal securities acts are designed to regulate. Courts disregard the "form" of the interest and emphasize the "economic reality" of the transaction. See *Silver Hills Country Club v Sobieski* (1961) 55 C2d 811, 13 CR 186. Stock in a nonprofit cooperative housing corporation is not a security (even though the statutory definition of a security includes the words "any… stock") if there is no potential to receive dividends, realize capital appreciation, or vote. *United Hous. Found. v Forman* (1975) 421 US 837, 44 L Ed 2d 621, 95 S Ct 2051.

***Howey* test applied.** In evaluating the economic realities, federal courts apply the *Howey* test; *i.e.,* a security is present if there is an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *SEC v W.J. Howey Co.* (1946) 328 US 293, 301, 90 L Ed 1244, 1251, 66 S Ct 1100; see §10.14. The expected profits can be in the form of a normal investment return or capital appreciation resulting from the development of the initial investment. *Aldrich v McCulloch Props.* (10th Cir 1980) 627 F2d 1036, 1039.

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§10.23 3. Application of *Howey* Test to Nonprofit Membership Interests

Member reasonably expected profits at purchase. The first two prongs of the *Howey* test (*SEC v W.J. Howey Co.* (1946) 328 US 293, 90 L Ed 1244, 66 S Ct 1100) (see §10.13), an investment and a commonality, can usually be readily demonstrated for nonprofit memberships. The question is generally the third prong: whether the member reasonably expected profits when he or she purchased the membership.

Factors. The circumstances of each nonprofit venture must be analyzed to determine whether a "security" is present. That determination is often driven by the following:

- The manner in which memberships are marketed (*Bear's Paw Country Club*, SEC No-Action Letter (publicly available July 25, 1980));
- The presence or absence of equity capital derived from sources other than the offer and sale of the memberships (*Riviera Operating Co.*, SEC No-Action Letter (publicly available Apr. 10, 1978)); and
- The rights and expectations of members to receive income or earnings or otherwise realize a profit (see, *e.g., Glenmoor Country Club, Inc.,* SEC No-Action Letter (publicly available Dec. 29, 1989); *Boca West Club, Inc.,* SEC No-Action Letter (publicly available June 26, 1985); *Badger Real Estate Corp.*, SEC No-Action Letter (publicly available Apr. 12, 1984)).

Not securities absent some profit-sharing. Persons who acquire memberships in nonprofit corporations are often not led to expect, and have no reasonable expectation of deriving, "profits" from their memberships. The SEC staff has therefore held that membership interests in a nonprofit mutual benefit corporation are not securities if club members are not entitled to share in any income generated by the club, or receive dividends or distributions of any kind from the club except on liquidation. *Golf & Country Club of Palm Springs, Inc.*, SEC No-Action Letter (publicly available Mar. 28, 1989); *Tandika Corp.*, SEC No-Action Letter (publicly available Feb. 18, 1985). There is no security if a member's ability to realize any appreciation is not a part of the solicitation effort, is restricted and contingent, and cannot reasonably form the basis of a motive to acquire a membership, even if membership interests could increase in value. *Rancho Santa Fe Farms Golf Club, Inc.*, SEC No-Action Letter (publicly available Oct. 22, 1987).

Transferability issues. The SEC staff sometimes focuses on the transferability of membership interests. See, *e.g., American Interstate Prop.*, SEC No-Action Letter (publicly available July 8, 1985); *Riviera Operating Co.*, SEC No-Action Letter (publicly available Apr. 10, 1978). However, it has granted no-action requests for transferable memberships subject to restrictions on transferability. See, *e.g., Stagshead, Inc.*, SEC No-Action Letter (publicly available Aug. 12, 1985); *Woodway Country Club, Inc*., SEC No-Action Letter (publicly available May 25, 1981).

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§10.24 4. General Exemption for Eleemosynary Organizations

Exemption construed narrowly. Securities issued by a person or an organization "organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual" are exempt from registration requirements. 15 USC §77c(a)(4). This exemption is construed narrowly and is denied to nonprofit organizations whose purposes are primarily social, athletic, or recreational. See, *e.g., Western Am. Communities,* SEC No-Action Letter (publicly available Apr. 30, 1981) (golf course memberships not within exemption); *National Skeet Shooting Ass'n*, SEC No-Action Letter (publicly available July 5, 1979) (exemption did not apply to skeet shooting association); *Dual Valley Recreational Ass'n*, SEC No-Action Letter (publicly available Jan. 3, 1972) (interests in recreational real estate did not qualify for exemption); *SEC v American Found. for Advanced Educ.* (WD La 1963) 222 F Supp 828 (exemption not available to sale of debentures by organization not operating exclusively for educational purposes).

Other exemptions. If this exemption is not available, a nonprofit corporation may still be able to use other exemptions available to issuers generally. See 15 USC §§77c(a)(11), 77d(2), (6); SEC Regulation D (17 CFR §§230.501-230.508); Organizing Corporations in California §§4.2-4.28 (3d ed Cal CEB 2001).

NOTE: An exemption from registration does not exempt an offer or sale of a membership from the antifraud proscriptions of the Securities Act.

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III. ADMITTING MEMBERS

§10.25 A. Establishing Criteria for Membership

Unless the articles or bylaws provide otherwise, a nonprofit corporation may admit any person or entity to membership. Corp C §§5313, 7315, 9313. The sole exception to this rule is that a mutual benefit corporation may not admit to membership its subsidiary entity (*i.e.,* a corporation in which more than 25 percent of the voting power is owned directly or indirectly by the parent corporation). Corp C §5073(b).

PRACTICE TIP: The articles or bylaws should set forth any desired criteria for membership.

The bylaws should also provide for the following, none of which is covered by the Code (see §7.2):

- Identification of the person or group, such as officers or the board of directors, who have the power to admit or reject new members;
- Whether the admitting person or group may impose additional conditions for membership beyond those stated in the articles or bylaws; and
- Whether the admitting person or group has discretion to reject applicants who meet the criteria set forth in the articles or bylaws.

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B. Discriminatory Membership Criteria

§10.26 1. Nonprofit Corporation Law Does Not Address Discrimination

The Nonprofit Corporation Law (Corp C §§5000-10841) does not address the extent to which nonprofit corporations may use race, religion, sex, national origin, age, or ancestry as either criteria for membership eligibility or a basis for rejecting persons from membership.

NOTE: For many public benefit corporations, membership policies that exclude persons on the basis of criteria considered invidious could render the entity ineligible for public grants otherwise available to organizations with similar missions or could threaten the entity's tax-exempt status.

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§10.27 2. Privacy and First Amendment Rights Versus Barring Discrimination

Rights of religious freedom under the First Amendment of the United States Constitution allow religious corporations to limit membership to persons who are members of the sponsoring church's faith. However, it is less clear to what extent First Amendment rights of privacy and freedoms of expression and association protect discriminatory membership practices of public benefit or mutual benefit organizations. See *Bob Jones Univ. v Simon* (1974) 416 US 725, 40 L Ed 2d 496, 94 S Ct 2038.

If an organization is "purely private," it is not subject to state antidiscrimination laws with respect to membership criteria and eligibility. See *Pacific-Union Club v Superior Court* (1991) 232 CA3d 60, 73, 283 CR 287; *Bohemian Club v Fair Employment & Hous. Comm'n* (1986) 187 CA3d 1, 231 CR 769. The difficulty comes in determining whether an organization is, in fact, purely private. Case law addressing this issue is intensely fact driven. All of the reported decisions offer at least tacit support to the proposition that relationships that are very personal in nature (such as those between married persons) are sheltered by First Amendment constitutional protections from state regulation. See *Roberts v United States Jaycees* (1984) 468 US 609, 620, 82 L Ed 2d 462, 473, 104 S Ct 3244.

The factors most often cited in determining whether an organization is truly private, and thus not subject to state antidiscrimination laws, include the organization's selectivity in admitting members; the size of the organization; the degree to which members have the right to control the organization's governance; the degree to which access to the organization's facilities are restricted to members; and whether the organization's principal purpose is social or business in nature. See, *e.g*., *Warfield v Peninsula Golf & Country Club* (1995) 10 C4th 594, 620, 42 CR2d 50. Organizations with business attributes are more apt to run afoul of state antidiscrimination statutes applicable to business establishments.

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§10.28 3. The Unruh Civil Rights Act

The Unruh Civil Rights Act (CC §51) prohibits discrimination on the basis of sex, race, color, religion, ancestry, national origin, disability, medical condition, marital status, or sexual orientation. The list of discriminatory bases is descriptive only; invidious discrimination of any kind by a business establishment, such as discrimination on the basis of age, is prohibited. See *O'Connor v Village Green Owners Ass'n* (1983) 33 C3d 790, 191 CR 320. For example, the protections of the Unruh Civil Rights Act extend to domestic partners registered under the California Domestic Partner Rights and Responsibilities Act of 2003 (Fam C §§297-299.6). *Koebke v Bernardo Heights Country Club* (2005) 36 C4th 824, 31 CR3d 565.

Determining whether organization is "business establishment." In the context of nonprofit organizations, the most challenging issue is what activities or features of an organization will cause it to be a "business establishment" for purposes of the Act. See, *e.g.*, *Warfield v Peninsula Golf & Country Club* (1995) 10 C4th 594, 42 CR2d 50 (organization's facilities were "business establishment" because of regularly conducted business transactions with nonmembers); *Doe v Californian Lutheran High Sch. Ass'n* (2009) 170 CA4th 828, 88 CR3d 475 (religious school not "business establishment" because it is expressive social organization whose primary function is inculcating its values in youth members).

The issue most often arises for clubs, organized as mutual benefit corporations, which discriminate on the basis of age, gender, or sexual orientation. The California Supreme Court offered little guidance to address such discriminatory practices in *Curran v Mt. Diablo Council of Boy Scouts of Am.* (1998) 17 C4th 670, 72 CR2d 410. In that case, the Boy Scouts of America had denied the application of plaintiff, a former Eagle Scout, to become an adult troop leader because the plaintiff was gay and wished to remain involved with the Boy Scouts to communicate to youths that a gay lifestyle was legitimate. The Court concluded that given the overall purpose and function of the Scouts, the organization "cannot reasonably be found to constitute a business establishment whose membership decisions are subject to the Act." However, the Court left intact prior Unruh Act decisions involving challenges to discriminatory membership criteria involving the Rotary Club, residential community associations, and private golf country clubs, in which the challenged entities had been found to constitute business establishments that could not apply discriminatory criteria in membership selection. See *Board of Directors v Rotary Club* (1987) 481 US 537, 95 L Ed 2d 474, 107 S Ct 1940; *Warfield v Peninsula Golf & Country Club, supra; Isbister v Boy's Club* (1985) 40 C3d 72, 219 CR 150; *O'Connor v Village Green Owners Ass'n, supra.*

Factors supporting constitutional protection. The extent to which the First Amendment protections of freedom of speech and of association protect exclusionary membership polices considered invidious under today's public policies remains ill-defined. However, a review of decisions cited above involving challenges to private organizations that are not ideologically based suggests that the organizations most likely to be accorded constitutional protection with respect to their membership criteria and admissions policies are those that exhibit all of the following elements:

- Small total number of members (although one prominent San Francisco men's club has several thousand members);
- Highly restrictive membership criteria, application, and review procedures that are scrupulously observed;
- Limited access to or use by outside groups of club facilities;
- Consistent with the organization's small membership, a limited number of club facilities or venues; and
- For many of such organizations, policies that prohibit members from treating membership dues or other charges as tax-deductible payments.

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§10.29 C. Eligible Person's Right to Membership

No reported cases address whether persons who meet membership criteria can compel a corporation to admit them to membership. Detailed statutory due process requirements apply to public benefit and mutual benefit corporations for terminating or canceling existing memberships (Corp C §§5341, 7341 (no similar provision for religious corporations); see §10.129), but there are no such statutory protections for admitting new members. However, in certain situations, other legal considerations may create a right to membership in qualified persons or may require the corporation to exercise due process in accepting or rejecting membership applications. See §§10.30-10.31.

PRACTICE TIP: Whether qualified persons may be denied admission to membership may be addressed in the bylaws, either by denying or bestowing discretion to the person or persons charged with admitting members. A highly selective membership policy involving a corporate membership committee's exercise of considerable discretion is principal indicia of a truly private membership organization. Accordingly, the propriety of very restrictive membership criteria is likely to turn on factors such as the organization's size, the exclusivity of its membership criteria, and its need or desire to seek public funding for its operations.

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§10.30 1. Professional or Trade Organization

An arbitrary or unfair refusal of membership in a professional or trade organization may violate property rights, contractual rights, or other economic rights, thus justifying court intervention. See *James v Marinship Corp.* (1944) 25 C2d 721, 155 P2d 329; *Tatkin v Superior Court* (1958) 160 CA2d 745, 326 P2d 201; see also *O'Byrne v Santa Monica-UCLA Medical Center* (2001) 94 CA4th 797, 812, 114 CR2d 575 (issue is existence of intentional interference with right to pursue lawful business absent sufficient justification). An individual may have a right to become a member of a monopolistic professional or trade organization, particularly if membership is necessary or extremely helpful for a person seeking to make a living in that profession or trade. *Pinsker v Pacific Coast Soc'y of Orthodontists* (1974) 12 C3d 541, 116 CR 245.

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§10.31 2. Membership Based on Contract Rights or Property Ownership

Associated rights. While many nonprofit corporations condition membership only on a person's payment of annual dues, others tie membership to the acquisition of some other status. This may be the situation for franchisees to become part of a franchise marketing association, or lessees of retail space to become members in a mall marketing association. In these settings, denying membership could injure the associated contract rights.

Common interest developments. A special case of such associated rights is presented by real estate common interest developments. Although no law requires that all owners of land within a development belong to a homeowners' association (CC §1363), the governing documents of such associations commonly state that membership in the owners' association is mandatory and that the payment of annual and special assessments is an appurtenant obligation to ownership of an interest in the development. If membership is mandatory, the arbitrary denial of membership in an owners' association to a homeowner would constitute a denial of rights based on property ownership or contract. See 10 Cal Code Regs §§2705(*l*)-(m), 2792.8(a)(1), 2792.18(a), requiring that the governing instruments of a common-interest subdivision confer membership status on the purchaser of any lot or unit in the subdivision.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.32 D. Consideration of Memberships

§10.32 D. Consideration of Memberships

Memberships may be issued for no consideration, or for any consideration set by the board, unless the articles or bylaws provide otherwise. Corp C §§5311, 7311, 9311. On dues, assessments, and enforcement of obligations owed by members to the corporation, see §§10.121-10.122.

WARNING: If memberships are offered or sold for value, the offer or sale may require compliance with state and federal securities laws. See §§10.12-10.24.

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§10.33 E. Membership Certificates or Other Documents Identifying Members

All nonprofit corporations may issue cards, plaques, or other devices identifying their members, contributors, or associated persons. Corp C §§5140(e), 7140(f), 9140(e).

Only mutual benefit corporations, however, may issue membership certificates. Corp C §7140(f). A "membership certificate" is "a document evidencing a transferable property interest in a corporation." Corp C §5058. Any membership certificate must meet the requirements as to form provided by Corp C §7313. For a form of membership certificate, see 5 Ballantine & Sterling, California Corporation Laws, App A, Form 20.61 (4th ed 1962).

PRACTICE TIP: Mutual benefit corporations rarely issue certificates because of the transferable nature of a certificate. Most mutual benefit corporations seek some control over the admission of their members, while a certificate implies that each member may personally select his or her successor. To prevent such a result, the corporation would need to resort to the type of elaborate provisions for restriction of transfer normally found in the shareholder agreements for closely held business corporations. Therefore, before a corporation issues membership certificates, it should carefully consider whether membership cards or similar devices can serve substantially the same purpose.

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IV. MEMBERS' VOTING RIGHTS

§10.34 A. Role of Voting Members in Corporate Governance

Generally limited role. All corporate powers are vested in the board of directors unless the Nonprofit Corporation Law (Corp C §§5000-10841) provides otherwise, or the articles or bylaws limit the board's authority by requiring actions to be approved by the members (Corp C §5034) or by a majority of members (Corp C §5033). Corp C §§5210, 7210, 9210. See also §9.2. It follows (absent articles or bylaw provisions to the contrary) that the members' role in corporate governance is generally limited to electing directors and approving significant and extraordinary actions as described in the Code. See *e.g., Grosset v Wenaas* (2008) 42 C4th 1100, 1108, 72 CR3d 129 (shareholders of business corporation have no authority to commence actions on behalf of corporation except by derivative suit). See §10.35.

Board required. Regardless of the limitations placed on a board in the articles or bylaws (*e.g.*, limitations on the authority to spend corporate funds without member approval), a corporation cannot entirely dispense with a board of directors.

However, nonprofit corporations do not commonly place significant limitations on the authority of a board. Because member apathy runs high in many organizations, conditioning the board's authority on member approvals could frustrate many corporate actions, as well as provide an opportunity for a small faction of members to dominate the corporation's agenda. In addition, close member supervision of directors may not (in theory) be needed because directors are limited by fiduciary principles to act only after reasonable investigation and in a manner they believe to be in the best interests of the membership as a whole. See §§9.103-9.108.

Same duties and liabilities. If members exercise powers generally reserved to the directors, they may bear the same duties and liabilities.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.35 B. Actions Requiring Members' Approval

§10.35 B. Actions Requiring Members' Approval

The members may undertake the actions listed below in a corporation formed with statutory (*i.e.,* voting) members.

- In a public benefit or mutual benefit nonprofit corporation, election of directors, if the articles or bylaws of provide that one or more directors be elected by the members of any class voting as a class. Corp C §§5220, 7220. The articles or bylaws of religious nonprofit corporations may provide for the tenure, election, selection, and designation of directors. Corp C §9220. Designated directors need not be approved by the members. See §9.28.
- Removing directors without cause. Corp C §§5222, 7222, 9222.
- Filling director vacancies caused by the removal of a director unless the articles or a bylaw approved by the members permits the board to do so. The members may also fill a director vacancy, however caused, if the board fails to fill the vacancy when it has the power to do so under the articles or bylaws. Corp C §§5224(a)-(b), 7224(a)-(b), 9224(a)-(b).
- Bylaw amendments materially and adversely affecting rights on voting or transfer in a public benefit or mutual benefit corporation. Corp C §§5150(a), 7150(a)(1) (no similar provision for religious corporations, although articles or bylaws may provide for members and classes of members and the rights, privileges, preferences, restrictions, and conditions attaching to each class). Corp C §§9132(c)(2), 9151(c)(1).
- Bylaw amendments materially and adversely affecting rights on voting or transfer for one class of members differently from another class in a public benefit or mutual benefit corporation. Corp C §§5150(b), 7150(a)(1) (no similar provision for religious corporations).
- Bylaw amendments changing the number of directors. Corp C §§5151(b), 7151(b), 9151(b). The articles or bylaws of a religious corporation may eliminate this member voting right. Corp C §9151(b).
- Articles or bylaw amendments extending director terms beyond that for which the director was elected or any bylaw increasing director terms in a public benefit or mutual benefit corporation. Corp C §§5220(a), 7220(a) (no similar provision for religious corporations).
- Articles or bylaw amendments adopting, amending, or repealing provisions for designating directors for a public benefit or mutual benefit corporation. Corp C §§5220(d), 7220(d) (no similar provision for religious corporations).
- Bylaw amendments increasing the quorum for conducting membership meetings of a public benefit or mutual benefit corporation. Corp C §§5512, 7512 (no similar provision for religious corporations).
- Articles or bylaw amendments affecting proxy rights in a public benefit or mutual benefit corporation. Corp C §§5613(e), 7613(f)(1) (no similar provision for religious corporations, although proxies are allowed (Corp C §9417)).
- Articles or bylaw amendments changing or eliminating cumulative voting provisions for a public benefit or mutual benefit corporation. Corp C §§5616(a), 7615(a) (no similar provision for religious corporations, although articles and bylaws can permit cumulative voting (Corp C §9415)).
- Articles or bylaw amendments terminating membership rights in a public benefit corporation. Corp C §5342 (no similar provision for mutual benefit or religious corporations).
- Most amendments to articles. Corp C §§5812, 7812, 9620(a).
- Sale, lease, exchange, transfer, or other disposal of all or substantially all assets not in the usual and regular course of the corporation's activities. Corp C §§5911(a)(2), 7911(a)(2), 9631(a)(2).
- Agreements of merger. Corp C §§6012, 8012, 9640(c).
- Amendments to merger agreement. Corp C §§6015(a), 8015(a), 9640(a).
- Most elections to voluntarily wind up and dissolve. Corp C §§6610, 8610, 9680(b).
- Revocation of voluntary election to wind up and dissolve if election was previously approved by the members. Corp C §§6612(a), 8612(a), 9680(a).
- In homeowners' associations only, members may make certain assessments or assessment increases (CC §1366) and may also make most amendments to the recorded declaration of covenants, conditions, and restrictions. The declaration may provide, however, that certain amendments may be adopted on board action

alone. CC §1355.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.36 C. Statutory Members' Other (Nonvoting) Rights

§10.36 C. Statutory Members' Other (Nonvoting) Rights

Statutory members of nonprofit corporations have the following rights in addition to the right to vote (see §10.35):

- **Books and records.** The right to inspect corporate books and records for reasons reasonably related to the requesting member's interest in the organization. Corp C §§6333, 8333, 9512; see §10.108.
- **Membership list.** The right either to inspect and copy or to receive a copy of the corporation's membership list, unless the corporation provides a reasonable alternative to the direct exercise of those rights and that proposed alternative will achieve the purpose specified in the member's demand. Corp C §§6330, 8330, 9511; see §10.108.
- **Nominating directors.** For members of public benefit or mutual benefit corporations who have the right to vote for directors, the right to participate in nominating directors. Corp C §§5520, 7520.
- **Financial reports.** For members of mutual benefit corporations, the right to receive a financial report for the corporation on request if gross revenues or receipts are $10,000 or more (Corp C §8321), except that, for community associations, reports are required only if the gross income exceeds $75,000. CC §1365(b).
- **Annual reports.** For members of public benefit corporations, the right to receive an annual report for years in which gross revenues or receipts are $25,000 or more. However, if the corporation has members and solicits contributions from 500 or more persons, the corporation may instead include with any written material used to solicit contributions a written statement that its latest annual report will be mailed on request, and the name and address of the person to whom requests should be sent. The corporation must make the report available to any member on request. Corp C §6321.
- **Attorney General reports.** The right to receive copies of certain reports that must be filed with the Attorney General under Govt C §§12580-12599.7. Corp C §§6324, 8324.

NOTE: This right is not applicable to members of a religious corporation because these organizations do not file reports with the Attorney General.

- **Notice of involuntary dissolution.** The right to receive notice of the commencement of a proceeding to cause the involuntary dissolution of the corporation. Corp C §§6515(c), 8515(c), 9680(c).
- **Fair expulsion and suspension procedures.** The right to fair disciplinary procedures before being expelled or suspended from membership in a public benefit or mutual benefit corporation. Corp C §§5341, 7341; see Corp C §9340(d) (no similar provision for religious corporations).

NOTE: For community associations, the members and the association must try to resolve their disputes through alternative dispute resolution before commencing a civil action seeking only declaratory or injunctive relief with respect to the corporation's governing documents. This rule encompasses actions coupled with claims for monetary damages not in excess of $5000. See CC §§1363.810-1363.850, 1369.510-1369.590.

- **Community association rights.** The rights granted to community association members by the Davis-Stirling Common Interest Development Act (CC §§1350-1378). See CC §§1363, 1363.05; Advising California Common Interest Communities (Cal CEB 2003).
- **Voting tabulations.** For members of a public benefit or mutual benefit corporation who make a written request received by the corporation within 60 days following the conclusion of any annual, regular, or special meeting of the members, the right to receive a report of the result of any particular vote of members taken at the meeting, including the number of memberships voting for, the number of memberships voting against, and the number of memberships abstaining or withheld from voting. If more than one class of memberships voted, the report must state the appropriate numbers by class of membership. Corp C §§6325, 8325.

NOTE: Corporations Code §§6325 and 8325 require a report of the "vote," which is defined to include actions by unanimous written consent of directors and written ballots by members. Corp C §5077. See §§10.66-10.71.

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D. Statutory Terms Pertaining to Member Voting Rights

§10.37 1. Authorized Number of Members

Several actions under the Corporations Code, such as a demand for a list of all members' names, addresses, and voting rights (Corp C §8330; see §10.108), allow for approval by "the authorized number of members." Generally, the "authorized number" is 5 percent of the voting power (see §10.38) of the membership. Corp C §5036(a). If the total voting power of the association is between 1000 and 4999 members, the authorized number is 2½ percent of the voting power (but not less than 50 members). Corp C §5036(b). If the corporation has 5000 or more voting members, the authorized number is 1/20 of 1 percent of the voting power (but not less than 125 members). Corp C §5036(c).

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§10.38 2. Voting Power

"Voting power" is defined as "the power to vote for the election of directors at the time any determination of voting power is made." Corp C §5078. Members who have the right to vote "upon the happening of some condition or event which has not yet occurred" are not counted in determining voting power. Corp C §5078. It follows that members whose voting rights have been suspended are also excluded from the count of voting power. See §§10.127-10.131.

The term "voting power" is used in many instances related to membership approval. For example, a "majority of the voting power" constitutes a quorum in the absence of a contrary bylaw provision. Corp C §§5512, 7512, 9412. The term is also used in connection with membership approvals of changes in the status of a mutual benefit corporation. Corp C §7813.5.

PRACTICE TIP: When drafting bylaws it should be recognized that use of the term "voting power" will essentially impose an eligibility requirement on voting privileges. For example, if directors are elected by the holders of a majority of the voting power, the election will be decided by a majority of those members in good standing. Consideration should be given to whether certain actions might be approved by a stated percentage of the members, thus increasing the electoral burden of the proponents of the action, such as for a merger or a sale of substantially all assets.

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§10.39 3. Approval by Majority of All Members

An action that must be approved "by a majority of all members" must be approved by the affirmative vote or written ballot of a majority of the votes entitled to be cast with respect to that action. For example, if the corporation has 100 members and this phrase is used to define the member approval requirement, at least 51 must approve, regardless of how many attend a meeting or return ballots. Corp C §5033.

Class voting. If the corporation has more than one class of membership, the action must additionally be approved by a majority of the members of *each class* entitled to vote on the matter. Any class entitled to a supermajority or unanimous vote on the matter must approve it by such higher percentage or unanimous vote. Corp C §5033.

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§10.40 4. Approval by Members

Affirmative vote; majority of quorum. Approval "by the members" or "of the members" means that the action must be approved or ratified by the affirmative vote of at least a majority of the votes represented and voting at a duly held meeting at which a quorum is present. Corp C §5034. The affirmative votes must also constitute a majority of the required quorum, an additional requirement that was imposed because nonprofit corporations may allow proxies to be used only for establishing a quorum and not for voting on issues that come before the meeting. See §10.60; 2 Marsh & Finkle, Marsh's California Corporation Law §12.25 (4th ed 2000). Moreover, if any article or bylaw requires a membership vote to be conducted by class, unit, or grouping of members, then the action must be approved by the affirmative vote of a majority of the outstanding memberships of each class, unit, or grouping.

Supermajority or unanimous voting. If the articles or bylaws state that the desired action requires the affirmative vote or written ballot of a greater proportion (supermajority vote) or all votes (unanimous vote) of the memberships of any class, unit, or grouping of members (see Corp C §§5151(e), 7151(e), 9151(e); §10.50), then "approval of the members" for that action additionally requires satisfaction of the higher percentage or unanimous approval requirement. Corp C §5034.

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§10.41 5. Comparison of Statutory Member Approval Requirements

Approval by the members (Corp C §5034) is the more common required approval for most corporate actions. Although the corporation may require approval of a majority of all members (Corp C §5033) for any action, the Code rarely imposes this requirement. Unless the articles or bylaws establish the more stringent §5033 requirement, "membership approval" usually means §5034 approval. See Corp C §§5512(a), 7512(a), 9412(a).

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§10.42 6. Electronic Transmission by or to the Corporation

Members and directors may receive notice of, and participate in, meetings by "electronic transmission." Corp C §§5211(a)(6), 5510(a), (f), 7211(a)(6), 7510(a), (f), 9211(a)(6), 9411(a). "Electronic transmission" refers to (Corp C §§20-21):

- Fax or e-mail delivered to a fax number or e-mail address that the corporation and the member have provided to each other to receive notices or to communicate at the meeting;
- A posting on an electronic message board or network similarly designated (and if directed by the corporation to the member, together with a separate notice of the posting); or
- "Other means of electronic communication." (The reference to "other means" in the statute is apparently intended to capture subsequent advances in communication technology.)

CAUTION: Corporations should proceed carefully in delivering notices via text messages to cell phones or in instant messages to computers, cell phones, and PDAs; although the Code aspires to flexibility in accommodating future advances in communication technologies, that very flexibility provides an opening for courts to determine whether a particular technology satisfactorily records and communicates messages. A sufficiently clear provision in the bylaws that allows the use of new or emerging technologies should be enforceable. See Corp C §§5151(c)(2), 7151(c)(2), 9151(c)(2). See also §7.27. Certain technologies, such as short message service (SMS), social networking, and micro-blogging services, may never be suitable because they cannot accommodate communication of all of the information required in a meeting notice.

Requirements. Any electronic transmission must create a record that is capable of retention, retrieval, and review for later rendering into a tangible form. Corp C §§20-21. Electronic transmission by the corporation is effective only if the director or member has provided an unrevoked consent to communicate in such a fashion. In addition, if the recipient is a natural person receiving the communication in his or her capacity as a member (as opposed to receiving the communication in the role of a director or officer), the consent to electronic transmission must be preceded by or include (Corp C §20)

> a clear written statement to the recipient as to (a) any right of the recipient to have the record provided or made available on paper or in nonelectronic form, (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the recipient must use to withdraw consent.

Electronic transmission to the corporation is effective only if the corporation has placed in effect reasonable measures to verify that the sender is the member or director purporting to send the communication. Corp C §21.

Use at member and board meetings. When electronic communication is used for member meetings, the corporation must implement reasonable measures to provide participants the opportunity to vote, read, or hear the proceedings on a substantially concurrent basis with other participants, and a record of votes must be kept. Corp C §§5510(f), 7510(f), 9411(f). When electronic communication is used for board meetings, all participants must be able to communicate concurrently and propose or interpose objections to actions. Corp C §§5211(a)(6), 7211(a)(6), 9211(a)(6).

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E. Right to Vote

§10.43 1. Voter Eligibility Requirements

Governing documents commonly impose eligibility requirements as a condition for the exercise of member voting rights. The Corporations Code does not expressly sanction the imposition of eligibility requirements, but their validity is implied. The articles can specify the "rights, privileges, preferences, restrictions, and conditions attaching to each class" of membership. Corp C §§5132(c)(2), 7132(c)(3), 9132(c)(2). Similarly, the articles or bylaws can provide for the manner of suspension of membership rights subject to certain minimum due process requirements on the discipline of members of public benefit and mutual benefit corporations. Corp C §§5151(d), 7151(d), 9151(d).

NOTE: The governing documents of most nonprofit corporations condition a member's right to vote on not being delinquent in any dues or assessment obligations and not under suspension of other membership privileges as a result of any infraction of the articles, bylaws, or published rules and regulations.

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§10.44 2. Voting Rights of Co-Members

If a membership is held by two or more persons and only one votes, that vote generally binds all; if more than one votes, the act of the majority so voting binds all. This rule can be modified by specific allocation of voting rights or authority if the corporate secretary is given written notice of the modification and is furnished with a copy of the instrument or order creating the relationship. Corp C §§5612, 7612 (no similar provision for religious corporations, although the articles or bylaws may specify circumstances in which two or more persons hold indivisible interests in a single membership; Corp C §9312). See Advising California Common Interest Communities, chap 2 (Cal CEB 2003) for discussion of voting rights of co-members of community associations.

NOTE: If a membership is held jointly by only two persons and each person votes differently, there would be no majority between them voting either way. Absent a contrary written notice to the secretary, both votes would presumably be invalid under Corp C §5612 or §7612.

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§10.45 3. Record Date for Notice, Voting, and Other Rights

Because the membership roll of any corporation is not necessarily static, the Code requires a record date for determining the members of public benefit and mutual benefit corporations authorized to exercise their franchise. As described below, the Code allows the bylaws or the board of public benefit and mutual benefit corporations to fix record dates within certain limits, and provides record dates by default if the board does not act or the bylaws are silent on the topic. The Code does not address record dates for religious corporations.

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§10.46 a. Notice

The bylaws may provide, or the board may fix in advance, a record date for determining the members entitled to receive notice of a membership meeting. This record date must be not more than 90 nor less than 10 days before the meeting date. If no record date has been fixed, notice must be given to all who are members as of the close of business on the business day preceding the day notice is sent (and at any adjournment of the meeting (see §10.101) unless the board fixes a new record date for the adjourned meeting). For meetings held without notice, members as of the close of business on the business day preceding the day of the meeting are entitled to waive notice. Corp C §§5611(a), 7611(a) (no similar provision for religious corporations).

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§10.47 b. Voting

The bylaws may provide, or the board may fix in advance, a record date for determining the members entitled to vote at a membership meeting not more than 60 days before the meeting date. If no record date has been fixed, all otherwise eligible members as of the meeting date are entitled to vote at the meeting (and at any adjournment of the meeting, unless the board fixes a new record date for the adjourned meeting). Corp C §§5611(b), 7611(b) (no similar provision for religious corporations). The bylaws may provide, or the board may fix in advance, a record date for determining members entitled to cast written ballots not more than 60 days before the day on which the first written ballot is mailed or solicited. If no record date has been fixed, otherwise eligible members as of the day the first written ballot is mailed or solicited are entitled to cast written ballots. Corp C §§5611(c), 7611(c) (no similar provision for religious corporations). For meetings or written ballots held pursuant to court order, the court may designate in its order a record date for determining the members entitled to vote at the meeting or to cast a written ballot. Corp C §§5511(c), 7511(c), 9411(c).

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§10.48 c. Other Rights

The bylaws may provide, or the board may fix in advance, a record date for determining the members entitled to exercise rights with respect to any other lawful action not more than 60 days before the action by the members is to be taken. If no record date has been fixed, the persons entitled to exercise these rights are the members as of the close of business on the day on which the board adopted its resolution or on the 60th day before the membership action is to be taken, whichever is later. Corp C §§5611(d), 7611(d) (no similar provision for religious corporations).

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F. Member Voting Structures; Modification of Statutory Voting Rules

§10.49 1. One-Member-One-Vote Rule and Its Modifications

Generally, each member of a nonprofit public benefit and mutual benefit corporation has one vote. Corp C §§5610, 7610 (no similar provision for religious corporations). The articles or bylaws, however, may allow any member to have more or less than one vote in any election or other matter presented to the members for a vote. Corp C §§5132(c)(3), 7132(c)(4), 9132(c)(3).

Unequal voting rights can be created by establishing different classes of members with different voting rights, by apportioning the number of votes per member within a class through a uniformly applied formula, or by providing for voting based on chapters, regions, or other organizational or geographical groupings. See §10.51. The one-member-one-vote rule can also be modified by cumulative voting provisions. Corp C §§5616, 7615, 9415; see §10.52.

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§10.50 2. Supermajority or Unanimous Vote Requirements

The bylaws may require a supermajority or unanimous vote of the members, or of any class, unit, or grouping of members, for any corporate action, except for member votes to remove directors without cause (Corp C §§5222(a), 7222(a), 9151(e), 9222(a)) and member votes to elect to voluntarily wind up and dissolve (Corp C §§6610, 8610, 9924). Unless the bylaws provide otherwise, altering, amending, or repealing such a bylaw requires the specified greater vote. Corp C §§5151(e), 7151(e), 9151(e).

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§10.51 3. Class Voting

Generally, a corporation may have classes of members whose voting or other rights differ from those of other members or classes. Corp C §§5041, 5330, 7330, 9330. On what constitutes a class of members, see §10.9. Class approval is required for corporate changes that would materially and adversely affect voting or other important rights of that class of members. See chap 20.

Formula allocation. The rights of all members in a single class are considered the same, and separate classes are not necessarily created if those rights are determined by a formula applied uniformly. Corp C §5041. Using a formula allows a corporation to allocate more votes to some class members than to others without violating the general rules that all members of a class have the same rights and that each member has one vote. Corp C §§5610, 7610. For example, a mutual benefit corporation composed of retailers might allocate votes to members based on dollar volume of business, square footage of showroom space, or number of outlets; a public benefit corporation might allocate votes to members based on the amount of their contributions.

Units; groupings. The Corporations Code refers to "units" or "groupings" of members (see, *e.g.,* Corp C §§5033-5034, 5151(e), 7151(e), 9151(e)), which do not necessarily have the status of classes. Corporations may provide for voting by members or delegates on the basis of "chapter or other organizational unit" or by "region or other geographic grouping." Corp C §§5153, 7153, 9153. See also Corp C §§5033-5034, 5151(e), 7151(e), 9151(e).

Community associations. During the period of developer control of community associations, the governing documents may provide that the developer has up to three votes for each subdivision interest owned, while other owners receive only one vote for each interest. 10 Cal Code Regs §2792.18(b). This weighted voting advantage must expire within specified time periods not exceeding 4 years after the issuance of the original subdivision public report for the development, unless otherwise approved by the Department of Real Estate. 10 Cal Code Regs §2792.18(b)(4)(B). See 10 Cal Code Regs §§2792.8(b), 2792.32). After the developer's voting advantage has expired, all lots or units in the subdivision give rise to one vote (and one class) unless the articles or bylaws provide otherwise. See 10 Cal Code Regs §2792.18(b); Corp C §7312(d).

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§10.52 4. Cumulative Voting

Specific authorization required. Directors may be elected by cumulative voting only if the articles or bylaws specifically authorize the practice. Corp C §§5616(a), 7615(a), 9415(a). In cumulative voting, each member has a number of votes equal to the number of directors to be elected multiplied by the number of votes to which the member is entitled. The member may give all votes to one candidate or may distribute the votes among as many candidates as the member wishes. Corp C §§5616(a), 7615(a), 9415(a). Cumulative voting, if authorized, can be invoked *only* for candidates whose names were placed in nomination before the voting began and *only* if at least one member gave notice *at the meeting*, before the voting, of an intention to cumulate votes. If one member gives such notice, all members may cumulate their votes for candidates in nomination. Corp C §§5616(b), 7615(b), 9415(b).

NOTE: Cumulative voting is not allowed for write-in candidates.

Amending or repealing cumulative voting. Once conferred, public benefit and mutual benefit corporations can repeal or amend cumulative voting only by approval of the members. The articles or bylaws may require a supermajority vote of the members or of any class of members for this purpose. Corp C §§5616(a), 7615(a) (no similar provision for religious corporations).

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§10.53 5. Voting Considerations in Absence of Cumulative Voting

Absent cumulative voting, the application of the one-membership-one-vote rule is often misunderstood in the context of director elections. It is not true that each membership may be voted for one, and only one, candidate. Rather, it is customary for each vacancy on the board to be considered a separate "matter" for voting purposes, so that each member may vote for as many candidates as there are vacant positions, but no member may cast more than one vote for any particular candidate. Admittedly, such a system does allow for concerted action to weight votes should a candidate urge his or her supporters to cast a single vote in the candidate's favor and abstain from voting for any other candidate. Because the candidates with the highest number of votes are elected to office, supporters who follow the candidate's instructions will give their candidate a proportionally greater number of votes.

PRACTICE TIP: If a nonprofit corporation intends that only one vote can be cast for each membership held in an election of directors without regard to the number of directors to be elected, such a provision should be clearly stated in the articles or bylaws.

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§10.54 6. Voting Trusts and Voting Trust Agreements

Public benefit corporations. Voting agreements and voting trust agreements among members of public benefit corporations are unenforceable. Corp C §5614.

Mutual benefit corporations. The Code does not specifically authorize or prohibit voting agreements or voting trust agreements for mutual benefit corporations, but it is assumed that such instruments are enforceable because they are referred to in other portions of the Code. See, *e.g.,* Corp C §§7612, 7616(d).

Religious corporations. The Code makes no provision on voting agreements or voting trust agreements for religious corporations.

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G. Permitted Methods of Voting or Consenting to Action

§10.55 1. Voting in Person at Membership Meetings—Public Benefit and Mutual Benefit Corporations

With the exception of the procedures for cumulative voting, the Code does not specify particular procedures to be followed in voting at membership meetings. See §10.52. All that is required is that the election procedures for public benefit and mutual benefit corporations be "reasonable … given the nature, size and operations of the corporation." Corp C §§5520(a), 7520(a) (no similar nomination or voting procedures provision for religious corporations). The chair of the board or the president of the corporation customarily presides at the meeting, at least until a chair for the meeting has been chosen. The corporation's secretary or general counsel usually acts as secretary of the meeting. The degree of formality used in voting may vary with the size of the corporation or the number of members. However, even in small corporations, the secretary should record all motions and votes (including abstentions) and put them in the minutes of the meeting.

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2. Voting by Proxy at Membership Meetings

§10.56 a. Proxy Voting Generally

Requirements. A proxy is a *written* authorization *signed* by a member or the member's attorney-in-fact giving a *designated* person or persons power to vote on the member's behalf. Corp C §5069. To be "signed," the member's name must appear on the authorization by manual signature, typewriting, telegraphic transmission, or some other method, having been placed there by the member or the member's attorney-in-fact. Corp C §5069. No particular form is required for a proxy except that it must be a "written authorization," which includes facsimile, telegraphic, and electronic communications. Corp C §5079; see also Corp C §20. Members of nonprofit corporations enjoy proxy voting rights unless they are limited or withdrawn by the articles or bylaws. Corp C §§5613(a), 7613(a), 9417(a). See form proxy provisions in §§10.64-10.65.

Duration. A proxy is valid for 11 months unless the proxy provides another expiration date (which cannot be more than 3 years after the date the proxy was executed). Corp C §§5613(b), 7613(b), 9417(b).

Revocation. A member may revoke a proxy before its term expires by (1) giving written notice to the corporation, (2) executing a later proxy that is presented to the meeting, or (3) attending the meeting and voting in person. Corp C §§5613(b), 7613(b), 9417(b). The maker's death or incapacity does not revoke a proxy unless the corporation receives written notice of the death or incapacity before the vote is counted. Corp C §§5613(c), 7613(c), 9417(c). For irrevocable proxies in mutual benefit corporations, see §10.61.

NOTE: The rules on proxy use (see Corp C §§5514, 5613, 7514, 7613, 9417) provide little instruction on the content of proxies. Bylaws commonly contain a blanket authorization permitting members "to vote in person or by proxy," without stating any specific requirements.

Changes in proxy rights. The members of public benefit and mutual benefit corporations must approve any article or bylaw amendment repealing, restricting, creating, or expanding proxy rights. Corp C §§5613(e), 7613(f)(1) (no similar provision for religious corporations). However, governing documents frequently require higher approval percentages. See Corp C §§5513, 7513.

Homeowners' associations. Proxy forms for a homeowners' association must specify the length of time the proxy will be valid. 10 Cal Code Regs §2792.17(g).

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§10.57 b. Advantages and Disadvantages of Full Proxy Voting

Economical means to establish quorum. Proxy voting to the full extent authorized by the Code is the traditional method for member input in corporate governance. Unless member approval is solicited by written ballot (see §§10.66-10.71) or obtained by the unanimous written consent of all members (see §10.73), members can take valid action only at a duly held or called meeting at which a quorum is present. Corp C §§5512(a), 7512(a), 9412(a). Proxy rights facilitate establishment of a quorum and permit the members who are unable to attend the meeting in person to have a voice with respect to the issues presented, which is particularly important if it is likely that many members will not be present at the meetings. Proxies also create an economical way for members to vote in a large corporation if they are geographically dispersed with few living near the meeting site.

Difficulties in barring proxy rights. If proxies are prohibited, it may be difficult to transact any business requiring the vote or assent of its members unless the membership is very small, the quorum for membership meetings is fixed at a very low percentage, or votes are conducted by mailed written ballot. However, full proxy rights may be unnecessary or undesirable if the corporation intends to make extensive use of written ballot voting.

PRACTICE TIP: The need for proxies is reduced dramatically if significant issues are voted on by written ballot. See §§10.66-10.71.

Tends to protect incumbents. Because the board routinely solicits proxies at corporate expense and, absent direction from the issuer of the proxy, the proxyholder is given discretion as to how to vote, proxy voting tends to protect incumbent management. With postal rates increasing and apathy being a routine problem in many nonprofit organizations, most members (particularly in larger nonprofit corporations) will not have the interest or commitment to wage an effective counter-proxy-solicitation campaign.

Affects timing of decision-making. Proxies shift the timing of the decision-making process because members tend to make voting decisions during proxy solicitation, largely on the basis of arguments presented by the proxy solicitor rather than waiting for a full debate on the issues at a membership meeting. Andrews, *Procedures for Electing Directors of Nonprofit Corporations Pursuant to the New Nonprofit Corporation Law*, 13 U San Francisco L Rev 857 (1979).

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§10.58 c. Elimination of Proxy Rights

The articles or bylaws can withdraw proxy voting altogether. Corp C §§5613(a), 7613(a), 9417(a) (contrary to rule for business corporations (Corp C §705; *Peoples' Home Sav. Bank v Superior Court* (1894) 104 C 649, 38 P 452)). Before the Nonprofit Corporation Law was enacted, the Corporations Code did not permit a total elimination of proxy voting in the election of directors. *Braude v Automobile Club* (1978) 78 CA3d 178, 144 CR 169. The trial court in *Braude* compelled the defendant to implement new electoral processes that the court considered just and proper, including limiting the use of proxies to conduct ordinary corporate business such as the establishment of a quorum or voting on "normal, uncontested matters." 78 CA3d at 185. Under current law, the trial court's order may be defensible when it seems likely that incumbent management will abuse proxy powers.

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§10.59 d. Limited Proxies

The articles or bylaws may limit or condition proxy rights. Corp C §§5613(a), 7613(a), 9417(a). Common approaches for limiting proxies include matters of form (*e.g.,* requiring a manual signature of the proxy issuer or requiring that the proxy be dated), specifying the class of persons entitled to serve as proxyholders (*e.g.,* requiring proxyholders to be members or designating the corporate secretary as the sole proxyholder), or designating the issues for which proxy votes will be honored (*e.g.,* limiting the use of proxies to director elections).

NOTE: A proxy provision that allows the proxyholder to vote only as directed by the issuing member relegates the use of proxies to an absentee voting system, without the need to comply with the technical requirements of written ballots. See §§10.66-10.71.

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§10.60 e. Proxies Permitted Only for Quorum Purposes

The bylaws may also limit the use of proxies solely to establish a quorum and to vote on procedural matters coming before the meeting, such as the right to vote to adjourn the meeting. Corp C §§5613(a), 7613(a), 9417(a). When a limited proxy provision is in effect, the members who are nominally "present" via proxies are powerless to vote on any other matter presented at the meeting. If the articles or bylaws also provide that certain proposed actions be approved by a majority of all members, by the members, or by supermajority approval, the corporation may be unable to act on substantive matters scheduled for such action by the members.

NOTE: Because a proxy is defined as an instrument authorizing another to *vote* on the issuing member's behalf, a "proxy" that carries no voting rights of any kind is technically not a proxy, but some other form of limited agency. Accordingly, to implement a quorum-only proxy, the article or bylaw should confer on the proxyholder at least the limited right to vote on procedural matters, such as the right to vote to adjourn the meeting or to submit an issue to the members for approval by written ballot.

Quorum and ministerial purposes. The Code acknowledges, by implication, that proxies may be given solely for quorum and ministerial purposes. Once a quorum is present, an action at a members' meeting is approved by "the affirmative vote of the majority of the voting power represented at the meeting, entitled to vote, and voting on [the] matter." Corp C §§5512(a), 7512(a), 9412(a). Therefore, once a quorum is satisfied by the members present in person or by proxy, an action may be taken by the vote of a majority of members who are present and entitled to vote (that is, *not* including those votes represented by a proxy which do not authorize the proxy holder to vote). Thus, a bylaw limiting the use of proxies to satisfy minimum quorum requirements would permit the corporation to conduct many items of routine business on a majority vote of members who are physically present and voting.

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§10.61 f. Irrevocable Proxies—Mutual Benefit Corporations

Subject to statutory limitations, a proxy may be made irrevocable for a mutual benefit corporation (Corp C §7613(d)) for a specified period if so stated in the proxy and if the proxyholder either is, or is the nominee of, one of the following:

- A person who purchased or has agreed to purchase the membership;
- A creditor of the corporation or of the member issuing the proxy if the proxy states that it was given in consideration of the extension or continuation of credit; or
- An employee of the corporation if the proxy was given as required consideration in connection with his or her employment contract.

PRACTICE TIP: Irrevocable proxies are seldom used in homeowners' associations because they are typically issued only to persons who have a financial interest in the issuer's membership.

A proxy given to secure the performance of a duty or to protect a title can be made irrevocable until the occurrence of events that discharge the obligation secured by the proxy. Corp C §7613(d). The transferee of a membership interest who has no knowledge of the irrevocability of a proxy previously given for that interest may revoke the proxy unless the existence of the proxy and the fact of its irrevocability are stated on membership a representing that interest. Corp C §7613(e).

NOTE: The use of irrevocable proxies is prohibited in public benefit and religious corporations. Corp C §§5613(d), 9417(d).

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.62 g. Matters That Must Be Described in Proxy

§10.62 g. Matters That Must Be Described in Proxy

Public benefit corporations. For public benefit corporations, a valid proxy must set forth the general nature of the matter to be voted on for the following matters requiring membership approval (Corp C §5613(f)):

- Voting on the election of directors if the proxy lists all nominees as of the date notice of the election was given to the members (Corp C §5220);
- Removing a director without cause (Corp C §5222);
- Filling certain vacancies on the board (Corp C §5224);
- Changing proxy rights (Corp C §5613(e));
- Amending the articles of incorporation (Corp C §5812);
- Selling or disposing of the corporation's assets (Corp C §5911(a)(2));
- Merging with another corporation (Corp C §§6012, 6015(a)); and
- Dissolving or winding up the corporation (Corp C §6610).

NOTE: A proxy for election of directors in a public benefit corporation is useful only for the particular election for which the proxy is given because of the necessity that the proxy list the nominees at the time the notice of voting is given to members. As for the long list of other matters whose "general nature" must be set forth in a valid proxy, it is not entirely clear whether a member could give an omnibus proxy that merely lists those matters before any of those matters have been noticed for action at a meeting. Although the language of the statute seems not to preclude that approach, the drafter of the statute is reported to not have intended such a result. See 3 Ballantine & Sterling, California Corporation Laws §410.03 (4th ed 1962).

Mutual benefit corporations. For mutual benefit corporations, a valid revocable proxy must set forth the general nature of the matter to be voted on for the following matters requiring membership approval (Corp C §7613(g)):

- Removing a director without cause (Corp C §7222);
- Filling certain vacancies on the board (Corp C §7224);
- Approving a transaction in which a director has a material financial interest (Corp C §7233(a));
- Changing proxy rights (Corp C §7613(f)(1));
- Amending the articles of incorporation (Corp C §7812);
- Selling or disposing of the corporation's assets (Corp C §7911(a)(2));
- Merging with another corporation (Corp C §§8012, 8015(a));
- Dissolving or winding up the corporation (Corp C §8610); and
- Making certain distributions during the winding-up process (Corp C §8719(a)).

NOTE: An irrevocable proxy used in a nonprofit mutual benefit corporation need not describe the general nature of the matters to be voted on.

Religious corporations. Valid proxies in a religious corporation must set forth the general nature of the matter to be voted on for the following matters requiring membership approval (Corp C §9417(e)):

- Amending the articles of incorporation (Corp C §§5812, 9620);
- Selling or disposing of corporate assets (Corp C §9631(a));
- Merging with another corporation (Corp C §§6015(a), 9640(a), (c)); and
- Dissolving or winding up the corporation (Corp C §9680(b)).

Homeowners' associations. In addition to the matters identified in Corp C §7613(g) (see mutual benefit corporations, above), homeowners' associations should also include in proxies the general nature of any vote on any increase in assessments and any amendment to the declaration of restrictions or bylaws.

Identification of proxyholder. The proxy form should clearly identify the designated proxyholder, who may be an individual or a group of persons (such as the board). If more than one person is designated, the form should state how

the designated proxyholders are to decide how the proxy should be voted. Absent a clear indication on how the proxy should be voted, if a proxy designates "the board of directors" as the proxyholder, the proxy should be cast as decided by the vote of a majority of a quorum of the board. See Corp C §§5512, 7512, 9412.

PRACTICE TIP: It is advisable to date proxy forms, although this is not required by statute. A dated proxy presumptively determines its order of execution if the same member has issued a proxy to another person, regardless of the postmark dates on the envelopes in which the proxies were mailed. Corp C §§5613(b), 7613(b) (no similar provision for religious corporations). If a proxy solicitor is concerned that members may be solicited by others, the solicitor ought to date the proxy form as of the date of the meeting at which the proxy will be voted before giving the proxy form to the member for signature.

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§10.63 h. Additional Proxy Requirements—Public Benefit and Mutual Benefit Corporations With 100 or More Members

For public benefit and mutual benefit corporations with 100 or more members, proxies distributed by the corporation or another third party (as distinguished from proxies initiated by a member who wants to be represented at a meeting) to ten or more members must allow the member to choose on the proxy form approval or disapproval of each matter intended to be acted on at the meeting and shall also state, subject to reasonable specified conditions, that the member's choice is binding on the proxyholder. Corp C §§5514(a), 7514(a). See also 10 Cal Code Regs §2792.17(g). This requirement reduces the opportunity for abuse in blind proxy solicitations.

Public benefit corporations; homeowners' associations. In a public benefit corporation's election of directors, the proxy form must list the names of every candidate for election to the board at the time notice of the vote is given to members and may provide a space for the issuing member to indicate a voting preference. Corp C §5613(f). However, in the election of candidates to the governing body of a homeowners' association, it is not mandatory that a candidate be named in the proxy. 10 Cal Code Regs §2792.17(g). A member can also mark any written ballot or proxy form containing the names of candidates with the word "withhold" (or other indication that authority to vote for the election of directors is being withheld), in which event the proxyholder may not cast the vote either for or against a director. Corp C §§5514(b), 7514(b).

PRACTICE TIP: No similar listing requirement applies to mutual benefit or religious corporations. However, listing all nominees is the preferable practice and as a practical matter is the simplest manner to permit a member in a mutual benefit corporation with 100 or more members to indicate approval and disapproval for each nominee.

Actions taken based on faulty proxy subject to challenge. The failure to prepare a proxy form in compliance with these rules does not invalidate a corporate action taken in reliance on the proxy. However, any member may challenge the proxy at a meeting or bring suit in superior court to compel compliance. Corp C §§5514(c), 7514(c).

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.64 i. Form: Proxy Distributed to Ten or More Members of Public Benefit or Mutual Benefit Corporation With 100 or More Members

§10.64 i. Form: Proxy Distributed to Ten or More Members of Public Benefit or Mutual Benefit Corporation With 100 or More Members

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_ _[*NAME OF CORPORATION*]_ _ **PROXY**

I, _ _[*name of member*]_ _, a voting member of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit*]_ _ corporation, revoke any previous proxies and appoint _ _[*name*]_ _ as my proxy _ _[*with full power of substitution*]_ _ to attend the meeting of that corporation's members on _ _[*date*]_ _, and any adjournment or postponement of that meeting, and to vote or otherwise represent _ _[*my membership/each membership which I am entitled to vote*]_ _ as to the following _ _[*matter/matters*]_ _ in the manner I have specified below:

_ _[*Description of proposal*]_ _. As to this matter, my proxy is directed to exercise my vote as follows:

___ Approval **___ Disapproval**

[*Repeat for each additional proposal*]

[*Add one of the following alternatives*]

[*Alternative 1: Directing vote for each nominee]*

With respect to the election of directors, my proxy is directed to exercise my vote as follows with respect to each nominee identified below:

_ _[*Name of first nominee*]_ _ **___ For**
___ Withhold

_ _[*Name of second nominee*]_ _ **___ For**
___ Withhold

[*Repeat for each additional nominee*]

[*Alternative 2: Withholding authority to vote for designated nominee]*

My proxy is directed to exercise my vote as follows with respect to the election of the following nominees as directors: _ _[*names of nominees*]_ _

___ For (except as indicated to the contrary below)

___ Withhold

To withhold authority to vote for any individual nominee, write that nominee's name on the line provided below.

_____

[*Continue*]

**In the election of directors, the proxy holder shall have discretion and authority to cumulate votes and to distribute votes represented by this proxy among the nominees for which I have directed a vote "For" in such proportions as he or she shall determine. If any nominee for which I have directed a vote "For" is unable or unwilling to serve or is otherwise unavailable, the proxy holder _ _[*shall have discretion and authority to vote as he or she shall determine for other nominees and/shall not have the discretion or authority to vote for other nominees but*

shall have the discretion or authority]_ _ **in the event of cumulative voting to distribute such votes in such proportions among other nominees for which I have directed a vote "For" as he or she in his or her sole judgment shall determine.**

_ _[*Date*]_ _ __[*Signature of member*]__

Name: _ _[*Typed name*]_ _

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.65 j. Form: Proxy Distributed to Fewer Than Ten Members or to Members of Nonprofit Corporation With Fewer Than 100 Members

§10.65 j. Form: Proxy Distributed to Fewer Than Ten Members or to Members of Nonprofit Corporation With Fewer Than 100 Members

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_ _[*NAME OF CORPORATION*]_ _ **PROXY**

I, _ _[*name of member*]_ _, a voting member of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation, revoke any previous proxies and appoint _ _[*name*]_ _ as my proxy to attend _ _[*all meetings of that corporation's members/the meeting of that corporation's members on _ _[date]_ _ and any adjournment of that meeting*]_ _ and to vote, execute consents, and otherwise represent my membership in the same manner and with the same effect as if I were personally present.

[*If applicable, add one or more of the following options*]

[*Option 1: Authority limited]*

The authority granted in this proxy is limited to representing my membership to determine a quorum and voting or otherwise representing my membership with respect to _ _[*, and only in favor of,/, and only against,*]_ _ the _ _[*describe proposals, e.g., election of _ _[name of nominee]_ _ to the corporation's board of directors*]_ _.

[*Option 2: No authority to vote on certain matters]*

The proxyholder shall have no authority to vote on or consent to any proposal for _ _[*e.g., merger, consolidation, sale of corporate assets, or dissolution of the corporation*]_ _.

[*Option 3: Matter to be voted on must be described in proxy]*

This proxy is for the purpose of voting or otherwise representing my membership with respect to _ _[*, and only in favor of,/, and only against,*]_ _ the following proposal: _ _[*Specify general nature of matter to be voted on*]_ _.

[*Option 4: Irrevocable proxy for specified term—mutual benefit corporations only]*

This proxy is irrevocable until _ _[*date*]_ _.

[*Option 5: Revocable proxy for specified term]*

If not previously revoked, this proxy shall terminate on _ _[*date*]_ _.

[*Continue*]

_ _[*Date*]_ _ __[*Signature of member*]__

Name: _ _[*Typed name*]_ _

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3. Member Voting by Written Ballot

§10.66 a. Authority to Vote by Written Ballot—Public Benefit and Mutual Benefit Corporations

Any action that could be taken at a regular or special meeting of the members of a public benefit or mutual benefit corporation may be taken by written ballot without a meeting, if approved by the same number or percentage of members required to approve a particular action at a meeting, unless prohibited in the articles or bylaws. Corp C §§5513(a), 7513(a). Specific rules govern the use of written ballots distributed outside a membership meeting to solicit member consents, as listed below.

- **Election of directors by written ballot.** The right to use the written ballot process to conduct an election of directors must be specifically authorized in the articles or bylaws, but election by written ballot is not permitted if the members have cumulative voting rights. Corp C §§5513(a), (e), 7513(a), (e). The written ballot form must list the nominees; therefore, the articles or bylaws may set forth a date for the close of nominations before the printing and distribution of written ballots. Corp C §§5513(f), 7513(f).
- **Withheld ballots.** If an election of directors is authorized and conducted by written ballot and a member returns a ballot marked "withhold" or otherwise indicates that the authority to vote the written ballot in the election is withheld for one or more candidates, the ballot cannot be voted for those candidates. Corp C §§5514(b), 7514(b).
- **Distribution of ballots.** The written ballot form must be distributed to each member entitled to vote on the matter. Corp C §§5513(a), 7513(a). See §10.47 for fixing record dates for written ballots. If the corporation has more than one class of members and the desired vote pertains to an issue that can be approved by the members of a particular class, only members of that class need receive written ballots. See Corp C §5034.
- **Content of ballot.** The written ballot form must describe the proposed action, provide an opportunity to specify approval or disapproval of the proposal, and provide a reasonable time in which to return the ballot to the corporation. Corp C §§5513(a), 7513(a). See also Corp C §§5514(a), 7514(a).
- **Extension of time in which to return ballot.** The Corporations Code does not specifically address whether the corporation can extend the initially prescribed balloting period, but permitting reasonable extensions seems consistent with the law. Written ballot voting is intended to provide a mechanism for obtaining member consents that corresponds, as nearly as possible, to voting at a formal meeting. Because formal meetings can be adjourned for lack of a quorum or other reasons and reconvened later, there seems little reason to prohibit reasonable extensions, particularly if the right to extend the period is clearly noted on the form and in the accompanying solicitation materials and if the materials call for member notification of and decision by the board to extend the balloting period. Given the problems experienced by nonprofit organizations from member apathy, it is difficult to fault voting procedures that seek to maximize member participation.
- **Directive on ballot form for corporation with 100 or more members.** If a written ballot is distributed to 10 or more members of a corporation with 100 or more members, the ballot must provide that, when the member specifies a choice on any matter presented for a vote on the ballot, the vote shall be cast as the issuing member directs, "subject to reasonable specified conditions." Corp C §§5514(a), 7514(a).
- **Solicitation materials to accompany ballot.** The written ballot must be accompanied by solicitation materials indicating (1) the number of responses needed to satisfy the quorum requirement for a valid vote; (2) the percentage of approvals necessary to approve the proposal (unless the only proposal is to elect directors); and (3) the time by which the ballot must be received by the corporation to be counted. Corp C §§5513(c), 7513(c).
- **Delivery of ballot.** The written ballot solicitation must be given to each member personally, by first-class mail, postage prepaid, or by other means of written or electronic communication addressed to each member at his or her address appearing on the corporation's books or given by the member for the purpose of notice. Corp C §§5009, 5511(b), 7513(a). Other rules on giving notice of membership meetings apply to written ballot

solicitations. Corp C §§5513(c), 7513(c). See Corp C §7511(b).

- **Written ballot vote binding.** Once a ballot is returned to the corporation, that vote is binding on the member unless the articles or bylaws permit a member to revoke it. Corp C §§5513(d), 7513(d). This rule depoliticizes the voting process, avoids disputes over the priority of several written ballots received from the same member, and parallels, as closely as possible, the casting of votes by members assembled at a meeting (where a member is rarely permitted to change his or her vote once ballots are cast or a show of hands has been counted).

NOTE: A written ballot cannot be revoked unless otherwise provided in the articles or bylaws. Corp C §§5513(d), 7513(d).

- **Required number of votes.** The proposals specified in the written ballot form are approved only when (Corp C §§5513(b), 7513(b)):
- The total number of responses received within the specified balloting period equals or exceeds the minimum quorum percentage that would have applied to any membership meeting where the proposal could have been presented; and
- The affirmative votes received would have been sufficient to approve the action at such a meeting.
- **Descending quorum.** A descending quorum bylaw (see §10.97) should clearly state whether the descending quorum rule applies to written ballot voting and, if so, how that rule is applied; *e.g.,* that the lower quorum applies during any extension of the initially prescribed balloting period.

For a form of written ballot to amend bylaws that may be modified for other types of votes, see §10.68.

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§10.67 b. Authority to Vote by Written Ballot—Religious Corporations

Solicitation required. Any action that could be taken by the members of a nonprofit religious corporation at a regular or special meeting may be taken by written ballot without a meeting, but the written ballot of each member must be "solicited." Corp C §9413(a) (compare §9413(a) with Corp C §§5513(a) and 7513(a), requiring that written ballots for public benefit and mutual benefit corporations be *distributed*). The solicitation must indicate the time by which the ballot must be returned and the ballots (*i.e.,* the "signed approvals in writing") must set forth the action being approved. Corp C §9413(a)-(b).

Approval requirements. The proposals specified in the written ballot are approved only when (1) the total number of responses received within the specified balloting period equals or exceeds the minimum quorum percentage that would have applied to any membership meeting at which the proposal could have been presented and (2) the affirmative votes received would have been sufficient to approve the action at such a meeting. Corp C §9413(c).

NOTE: A written ballot cannot be revoked. Corp C §9413(d).

Cumulative voting restriction. Directors may be elected by written ballot without a meeting if authorized by the articles or bylaws. However, election by written ballot may not be authorized if the corporation allows cumulative voting (see §§10.52-10.53). Corp C §9413(e).

For a form of written ballot to amend bylaws that may be modified for other types of votes, see §10.68.

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§10.68 c. Form: Written Ballot to Amend Bylaws

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_ _[*NAME OF NONPROFIT CORPORATION*]_ _
ACTION BY WRITTEN BALLOT TO AMEND ASSOCIATION BYLAWS

Under California Corporations Code §_ _[*5513/7513/9413*]_ _, the undersigned member of _ _[*name of nonprofit corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation, hereby acts by written ballot with respect to the matters described below:

AMENDMENT OF BYLAWS

	FOR	**AGAINST**
RESOLVED that the First Amendment to the Bylaws of the Corporation, in the form presented together with this ballot, be adopted.	____	____

_ _[*Date*]_ _ __[*Signature of member*]__
Name: _ _[*Typed name*]_ _

This written ballot must be returned to the corporation at its principal office, at _ _[*address*]_ _ , no later than _ _[*date*]_ _, _ _[*provided that, if responses to the ballot campaign are not forthcoming, the Board of Directors is authorized to extend the balloting period for at least two additional periods of 30 days each. Notice of any extension of the balloting period shall be _ _[posted in the Corporation's principal office/duly noted in the minutes of the Board meeting at which the action is taken and published in the Corporation's next regular communication to the members*]_ _]_ _.

The affirmative vote of _ _[*number*]_ _ percent of the members is required to approve the Amendment of Bylaws. The quorum for this written ballot campaign shall be satisfied when written ballots are received from _ _[*number*]_ _ **percent of the members.**

[*If applicable, add the following option*]

[*Option: If bylaws contain a descending quorum provision and board has authority to extend balloting period]*

During any extended balloting period, the quorum will be satisfied when ballots are received from _ _[*number*]_ _ **percent of the members.**

[*Continue*]

EACH MEMBER MUST PERSONALLY EXECUTE AND RETURN THIS BALLOT FOR THIS BALLOT TO BE COUNTED. PROXY VOTING IS NOT PERMITTED.

Comment: On extension of the balloting period, see §10.66. This form may be modified for other votes by changing the language describing the matters addressed.

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§10.69 d. Confidentiality of Written Ballots

Certain votes must be conducted by secret ballot, such as the election of the governing body of a homeowners' association. See CC §1363.03(b); 10 Cal Code Regs §2792.19. Otherwise, specific member votes need not remain confidential, nor must the corporation refrain from publishing information on the progress of the vote until the balloting period has ended. See Corp C §§5513, 7513. It is difficult to fathom a written ballot procedure that would permit validation of the member's vote without a signature or a control number tying the ballot to a particular member, unless the members mail the written ballots to the corporation in double envelopes with the member's signature and identification appearing only on the outside envelope. (Such a procedure is required for homeowners' associations, as discussed below.)

Neutral tabulation; election inspectors. The board may use the services of a public accountant, bank, trust company, or similar neutral firm to receive and tabulate all written ballots to provide a high degree of confidentiality. The entity selected to tabulate ballots can be designated as inspector of election with powers and duties specified in Corp C §§5615 and 7614 (no similar provision for religious corporations).

Reasonable expectations of members. If the issue of confidentiality and nondisclosure is raised in a court proceeding, the court is likely to examine the reasonable expectations of the members. Voting at meetings is often conducted by a show of hands and it is fairly common for meetings to be adjourned before the close of voting (*e.g.,* if there is a lack of a quorum or if high-percentage voting requirements cannot be met). Thus, confidentiality and the absence of knowledge about the status of an ongoing vote are not guaranteed at membership meetings. However, even though written ballot voting was intended to parallel the process of voting at a formal meeting, the reasonable expectations of members engaging in written ballot voting is that their personal decision will not be known to other members as it would be in a vote conducted by a show of hands. Further, because ballots are solicited over a reasonable period of time, it is not inconsistent with a member's expectations that the status of the balloting be reported in general terms while the vote is proceeding.

PRACTICE TIP: If interim disclosures are to be made as a means of encouraging the return of ballots, the solicitation materials should acknowledge this fact. Similarly, if the vote is to be conducted as a secret ballot with no disclosure of voting information, that policy should be stated in solicitation materials.

Homeowners' associations. Special rules apply to elections conducted by homeowners' associations under the Davis-Stirling Common Interest Development Act (CC §§1350-1378). For example, homeowners' associations must adopt election rules providing each candidate or proponent access to the association's media if any other candidate or proponent has access. In addition, one or three inspectors of election must be fixed, meeting the independence requirements stated in the Act. Secret balloting must be done by mail, with double envelopes; ballot counting and subsequent storage are addressed at length in the Act. See CC §§1363.03-1363.04.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.70 e. Combining Written Ballot Solicitations With Membership Meetings

§10.70 e. Combining Written Ballot Solicitations With Membership Meetings

A written ballot vote is conducted by mail or, if permitted by the articles and bylaws and approved by the board, by electronic transmission. See Corp C §§5513, 7513, 9413; see also Corp C §§20-21. Nevertheless, the corporation may hold a membership meeting to discuss the measures being addressed by the ballot, such as a "candidates' night" meeting to announce and introduce candidates for election to the board. If the written ballot election is scheduled to conclude on the date of the annual membership meeting, a candidates' meeting is often scheduled several days before the annual meeting date so that open issues may be discussed.

Verification. The corporation must verify that a member who tenders a written ballot in person at the meeting has not already voted by mail on the same issue. If the written ballot form prevents easy duplication, perhaps all that is required is for the member to surrender the form previously received in the mail.

PRACTICE TIP 1: If the written ballot form can be duplicated, the bylaws should establish a deadline for receipt of ballots before the annual meeting to ensure that a list of members who have voted will be available for the inspectors of election.

PRACTICE TIP 2: Written ballots received at meetings may also be printed in a different form or on different colored paper so that they can be easily identified and checked against previously received ballots.

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§10.71 f. Members' Lack of Right to Demand Written Ballot Solicitations

No express right to demand ballot voting. Five percent or more of the members may demand that the corporation call a special meeting to consider any legitimate business of the corporation and its members. Corp C §§5510(e), 7510(e), 9411(b). However, members do not have an express right to demand a written ballot vote in lieu of calling a special meeting; the decision to distribute written ballots in lieu of a special meeting rests with the directors. See Corp C §§5513(a), 7513(a), 9413(a).

No right to demand inspectors. Although members and proxyholders are entitled to call for participation of inspectors of election when votes are conducted at a formal membership meeting, only the board may decide whether inspectors of election are to be appointed when a vote is conducted by written ballot. Corp C §§5615(a), 7614(a) (no similar provision for religious corporations). On inspectors of election, see §9.39.

NOTE: These rules provide management an opportunity to influence the outcome of a special meeting called by members. If the issue for which a vote is demanded is placed before the members in written ballot form, each member is ensured receipt of a ballot and the opportunity to vote. If the issue is presented to the members at a special meeting, the date, location, or hour of the meeting may be inconvenient, and members who demanded the meeting must motivate others to attend. Management has the power to choose the procedure it judges most likely to achieve the results it desires.

Judicial enforcement. If the association's governing documents call for a written ballot vote for the election of directors or any other recurring issue and the corporation fails to hold the written ballot vote for 60 days after the designated date, any member (and the Attorney General for public benefit and mutual benefit corporations) may petition the superior court for an order directing that the written ballot vote be conducted. The association must be given notice of the hearing and an opportunity to be heard. Corp C §§5510(c), 7510(c) (no similar provision for religious corporations).

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§10.72 4. Provisions Restricting Manner of Voting Enforceable

Some very large nonprofit corporations, or nonprofit corporations whose members are separated geographically, may wish to adopt bylaws or articles that call for all member voting to be conducted by written ballot. Because members have a statutory right to demand that meetings be held "for any lawful purpose" (see Corp C §§5510(e), 7510(e), 9411(b); §10.78), a written-ballot-only voting procedure will still permit membership meetings to be called to discuss matters relevant to the corporation or to vote on whether issues should be presented to the members for approval by written ballot. Although some commentators question the validity of bylaws purporting to limit members' right to vote, a bylaw requiring that members vote by written ballot on any material issue requiring member approval merely limits the manner in which voting is conducted and does not seek to limit or eliminate member voting rights. Because the bylaw seeks to maximize member voting and does not preclude special meetings to discuss the issues being voted on, it should be valid and enforceable.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.73 5. Action by Unanimous Written Consent of Members

§10.73 5. Action by Unanimous Written Consent of Members

Unless prohibited by the articles or bylaws, any action required or permitted to be taken by the members may be taken without a meeting if all members consent in writing to the action, subject to limitations on voting by written ballot for directors. See §§10.66-10.71. Written consents must be filed with the minutes of the proceedings of the members. Action by written consent has the same force and effect as a unanimous vote of the members. Corp C §§5516, 7516, 9420.

NOTE: Action by written ballot (see §§10.66-10.71) is usually simpler than action by written consent because it does not require the approval of all members. However, for corporations with only a few members, action by written consent makes balloting unnecessary and thus is preferable.

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§10.74 6. Authority of Corporation to Accept or Reject Proxies, Ballots, Consents, and Waivers

Nonprofit organizations use different means to identify their members, including issuance of membership certificates, membership cards, and photo identification passes and, in some smaller organizations, a list of members' signature samples. It is often difficult, however, for nonprofit corporations to verify that a proxy appointment, written ballot, consent, waiver, or other similar document was personally executed by a member.

Name on document corresponds to that of member. To resolve these problems and provide a greater measure of security in corporate transactions, a corporation acting in good faith may accept a proxy appointment, written ballot, consent, or waiver and give it effect as the act of a member if the name signed on the document corresponds to that of a member. Corp C §§5517(a), 7517(a), 9421(a). The corporation and any officer or agent who accepts such a proxy appointment, ballot, consent, or waiver is exempt from liability to the member for the consequences of the acceptance or the rejection. Corporate action based on this acceptance or rejection is valid unless a court of competent jurisdiction holds otherwise. Corp C §§5517(d)-(e), 7517(d)-(e), 9421(d)-(e).

Name on document does not correspond. If the name signed on a proxy appointment, ballot, consent, or waiver does not correspond to the record name of a member, the corporation may nevertheless accept the document and give it effect as the act of the member as long as the corporation is acting in good faith and one of the following circumstances applies (Corp C §§5517, 7517, 9421):

- The member is an entity and the name appearing on the document purports to be that of an officer or agent of the member/entity.
- The name appearing on the document purports to be that of an attorney-in-fact of the member and, if the corporation requests, evidence acceptable to the corporation of the signatory's authority to sign for the member has been presented.
- Two or more persons hold the membership as cotenants or fiduciaries, the name appearing on the document purports to be that of at least one of the coholders, and the person signing appears to be acting on behalf of all coholders of the membership.
- **For mutual benefit corporations,** the signed name purports to be that of an administrator, executor, guardian, or conservator representing the member and, if the corporation requests, evidence acceptable to the corporation of fiduciary status has been presented.
- **For mutual benefit corporations,** the signed name purports to be that of a receiver or trustee in bankruptcy of the member and, if the corporation requests, evidence acceptable to the corporation of the status has been presented.

Rejection. A nonprofit corporation is entitled to reject a proxy appointment, ballot, consent, or waiver if the secretary or other officer or agent authorized to tabulate votes, acting in good faith, has a reasonable basis to doubt the validity of the signature or the signatory's authority to sign for the member. Corp C §§5517(c), 7517(c), 9421(c).

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V. MEMBERSHIP MEETINGS

A. Regular Meetings

§10.75 1. Public Benefit and Mutual Benefit Corporations

Public benefit and mutual benefit corporations with members must hold a regular membership meeting in each year in which directors are scheduled to be elected for the purposes of conducting the election and transacting any other proper business. Corp C §§5510(b), 7510(b). Except for this requirement, the date, time, location, and frequency of membership meetings are as stated or fixed in the bylaws. Corp C §§5510(b), 7510(b). If no location is so stated or fixed, membership meetings are held at the corporation's principal office or, if the board and members agree, meetings may be held by means of electronic transmission or video screen communication. Corp C §§5510(a), (f), 7510(a), (f); see also Corp C §§20-21. A meeting can be called by court order if the corporation is required to hold a meeting but fails to do so. Corp C §§5510(c), 7510(c).

NOTE: Because the requirement to hold an annual meeting is tied to the election of directors at the meeting, corporations whose bylaws call for the election of directors by written ballot need not hold annual meetings.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.76 2. Religious Corporations

§10.76 2. Religious Corporations

In contrast to public benefit and mutual benefit corporations, religious corporations are provided greater flexibility in the procedures for holding member meetings. Both regular and special membership meetings of religious corporations are called, noticed, and held as ordered by the board, using any reasonable method provided in the articles or bylaws. Corp C §§9410(a), 9411(a). The articles and bylaws of religious corporations can alter the statutory requirements for meetings and voting found in Corp C §§9411-9420, with certain exceptions. See Corp C §9410.

Member approvals. On the following matters, member approvals (other than unanimous approvals) are valid only if the general nature of the proposal was stated in the notice of the meeting or in any written waiver of notice (Corp C §9411(e)):

- Amending the bylaws when the bylaws or articles require member approval for amendment (Corp C §9150(b);
- Removal of directors (Corp C §9222);
- Amendment of articles (Corp C §§5812, 9620);
- Disposition of all or substantially all assets (Corp C §9631(a));
- Merger and amendment of a merger agreement (Corp C §§6015(a), 9640(c)); and
- Voluntary dissolution (Corp C §9680(b)).

NOTE: If the corporation's articles or bylaws authorize proxies, the articles or bylaws cannot eliminate the requirements for the form of the proxy found in Corp C §9417(e). Corp C §9410(b); see §10.62. The articles and bylaws also cannot eliminate the availability of an election contest pursuant to Corp C §9418. Finally, the articles and bylaws may not vary the meeting notice provisions of Corp C §9411(e). Corp C §9410(a).

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§10.77 3. Homeowners' Associations

Homeowners' associations must conduct their membership meetings "in accordance with a recognized system of parliamentary procedure or any parliamentary procedures as the association may adopt." CC §1363(d). If the association does not desire to follow a recognized formal procedure, the board should specify meeting procedures in the bylaws or in a board resolution. The bylaws must also provide for regular members' meetings at least once a year. The first meeting must be held within 45 days after 51 percent of the lots or units in the subdivision have been sold, but in no event later than 6 months after the first lot or unit is sold. 10 Cal Code Regs §2792.17(a).

NOTE: Membership meetings must be held in the development, or as close as possible to the subdivision if the governing body determines that a larger meeting room is required than exists within the subdivision. 10 Cal Code Regs §2792.20(b).

Joint neighborhood associations. If two or more nonprofit homeowners' associations have consolidated their functions under a joint neighborhood association, the members of each constituent association are entitled to attend all meetings of the joint association (other than executive sessions). Members of each constituent association must be given a reasonable opportunity to participate in joint association meetings and must have the same rights of access to the joint association's records as they have to the records of their own association. CC §1363(h).

NOTE: The meeting requirements for homeowners' associations in CC §1363(d) are not meant to override the provisions of the California Nonprofit Corporation Law applicable to meetings of homeowners' associations organized as mutual benefit corporations. However, many homeowners' associations are unincorporated associations, and the statutory provisions governing meetings of unincorporated associations are rather limited. See Corp C §18330; see also §§2.4-2.18. The provisions of CC §1363(d) and other provisions of the Davis-Stirling Common Interest Development Act (CC §§1350-1378) often provide the structure lacking in the Corporations Code for unincorporated associations generally. In any event, the Davis-Stirling Act applies to incorporated homeowners' associations, and counsel must harmonize its application with the Nonprofit Corporation Law as necessary.

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§10.78 B. Special Meetings

Special meetings may be called for any lawful purpose by the board, the chair of the board, the president, or (for public benefit and mutual benefit corporations) anyone else specified in the bylaws. Special meetings may also be called for any lawful purpose by 5 percent or more of the members. Corp C §§5510(e), 7510(e), 9411(b). Persons entitled to call a special meeting (other than the board) may do so in a writing delivered to the chair of the board, president, vice president, or secretary. When special meetings are called by anyone other than the board, or when a proper demand for a special meeting is received from 5 percent or more of the members, the corporation must observe special rules on scheduling and noticing the meeting. Corp C §§5511(c), 7511(c), 9411(c). See §10.82.

NOTE: The right of 5 percent of the members to call a special meeting cannot be limited or withdrawn by the articles or bylaws.

Any lawful purpose. Because the members may call a special meeting "for any lawful purpose," the announced purpose of the meeting should be related to matters that would be suitable for member action or approval under the Code. For example, even if a sizable number of the members wish to discuss policies or rules adopted by the board according to the rule-making authority that the board clearly possesses under the organization's governing documents, they should not be permitted to force the corporation to expend the funds and management time required for a member meeting that cannot properly result in an action to countermand the board's exercise of discretion. See §§10.34-10.35.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.79 C. Notice Requirements for Membership Meetings

§10.79 C. Notice Requirements for Membership Meetings

Public benefit and mutual benefit corporations must give members written notice of any regular or special meeting at which membership action is required or permitted. Corp C §§5511(a), 7511(a). The notice must comply with detailed statutory requirements. See Corp C §§5511, 7511; §§10.80-10.91.

Religious corporations are permitted greater latitude in their articles and bylaws to provide methods for noticing membership meetings. See Corp C §§9410(a), 9411(a).

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§10.80 1. Members Entitled to Receive Notice

For discussion of who is entitled to receive notice of a regular or special membership meeting, see §10.45.

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2. Time for Furnishing Notice

§10.81 a. For Regular Member Meetings and Special Meetings Called by the Board

Public benefit and mutual benefit corporations. Whether the bylaws specify a date, time, and location for a regular member meeting, or a regular member meeting is fixed by the board, a public benefit or mutual benefit corporation must give written notice of that meeting either in person, electronically, or by registered, certified, or first-class mail sent to the member's address as it appears on the corporation's books or as given by the member to the corporation for the purpose of notice, not less than 10 or more than 90 days before the date of the meeting. Corp C §§5511(a)-(b), 7511(a)-(b) (no similar provisions for religious corporations). Notices of member meetings must be given at least 20 days in advance when delivered by mail other than first-class, registered, or certified mail. Corp C §§5511(a), 7511(a).

Religious corporations may provide in the articles or bylaws any reasonable method for giving notice of regular or special meetings of members. Corp C §9410(a).

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§10.82 b. For Special Meetings Called by 5 Percent of Members

Public benefit and mutual benefit corporations. An officer (other than the chief financial officer) who receives a demand for a special meeting from 5 percent or more of the members, or from any person (other than a board member) who is entitled to call a special meeting, must give notice of the meeting. The board must set a date for the meeting at least 35 but no more than 90 days after the request is received. If notice of the meeting is not issued within 20 days after receipt of the request, the person or group who made the request may either set a date for and give notice of the meeting or seek a superior court order compelling the corporation to do so. Corp C §§5511(c), 7511(c). See §§10.101-10.107. If a court order is sought (as would be likely if the membership is large and the cost of the mailing substantial), the order may be issued only after the corporation has received notice and has had an opportunity to be heard. Corp C §§5511(c), 7511(c).

Religious corporations. The board must fix a reasonable time and place for a special members' meeting after an appropriate written demand is received. The board must give notice of the date and time of the special meeting as fixed by the board to all members entitled to vote within 20 days after receipt of the demand. Corp C §9411(c).

NOTE: The 20-day period for issuing notice of the meeting gives the corporation an opportunity to verify signatures and otherwise confirm that 5 percent of the members have requested a special meeting. If the special meeting is scheduled within the statutory deadlines, management need not select the particular date, time, or location for the meeting that the faction demanding the meeting desires.

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§10.83 c. For Adjourned Meetings

Public benefit and mutual benefit corporations. Unless otherwise required in the bylaws, public benefit and mutual benefit corporations do not need to give notice of a membership meeting that is adjourned to another time or place if the time and place, and the electronic means by which members may participate, if applicable, are announced at the meeting that was adjourned. No meeting may be adjourned for more than 45 days. If after adjournment a new record date is fixed for the meeting (for example, the meeting was adjourned for more than 45 days), statutory notice requirements once again apply and the members entitled to notice are determined again as of the new record date. Corp C §§5511(d), 7511(d) (no similar provision for religious corporations). See §10.101.

Religious corporations. The Code provides no specific procedures for adjourned meetings of religious corporations. Because the articles or bylaws may provide any reasonable method for holding meetings, it follows that reasonable adjournment procedures are also authorized. See Corp C §9410(a).

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3. Contents of Notice

§10.84 a. General Rule

Public benefit and mutual benefit corporations. Notice of regular meetings of public benefit or mutual benefit corporations need set forth only the place, date, and time of the meeting; the means of electronic transmission or communication, if any, by which members may participate; and a statement of the matters that the board intends to present for membership action. Corp C §§5511(a), 7511(a). Additional business not mentioned in the notice may be transacted at regular meetings, except for certain extraordinary actions that cannot be acted on unless specified in the notice (see §10.85).

PRACTICE TIP: For meetings of corporations with low quorum requirements at which fewer than a third of the members are actually present, the meeting notice should include a statement of the general nature of all matters to be acted on (see §10.96).

Additional notice requirements. Notice of special meetings must state the place, date, and time of the meeting and the general nature of the business to be transacted; no other business may be transacted at the meeting. Notice of any regular or special meeting at which directors are to be elected must include the names of all persons who are nominees when the notice is given. Corp C §§5511(a), 7511(a).

Religious corporations. The board of a religious corporation is free to determine the contents of a notice for both regular and special meetings (Corp C §9411(a)), subject to requirements that certain matters may not be validly acted on by the members unless described in the notice. Corp C §§9410(b), 9411(e); see §10.85.

Homeowners' associations. In addition to the requirements applicable to mutual benefit corporations generally, notice of membership meetings of homeowners' associations must specify the matters that the board intends to present for action by the members. CC §1363(e).

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§10.85 b. Matters That Must Be Specified in Notice

Membership approval is valid for the following matters only if the notice and all waivers of notice of the meeting state the general nature of the proposed action, unless the action was unanimously approved by all members entitled to vote on the matter:

Public benefit corporations (Corp C §5511(f)):

- Removing directors without cause (Corp C §5222);
- Filling vacancies on the board (Corp C §5224);
- Amending the articles (Corp C §5812); and
- Voluntarily electing to wind up and dissolve the corporation (Corp C §6610).

Mutual benefit corporations (Corp C §7511(f)):

- Removing directors without cause (Corp C §7222);
- Filling vacancies on the board (Corp C §7224);
- Approving contracts in which a director has a material financial interest (Corp C §7233);
- Amending the articles (Corp C §7812);
- Voluntarily electing to wind up and dissolve the corporation (Corp C §8610); and
- Approving a distribution plan on winding up that is inconsistent with class liquidation rights specified in the articles or bylaws (Corp C §8719).

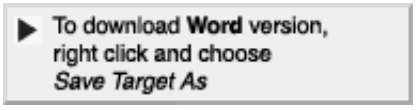
Religious corporations (Corp C §9411(e)):

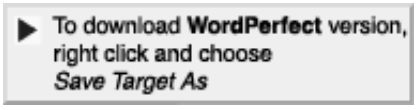
- Adopting, amending, or repealing bylaws (if membership approval is required by law or by the corporation under Corp C §9150(b));
- Removing directors without cause (Corp C §9222);
- Amending the articles (Corp C §§5812, 9620);
- Disposing of corporate assets other than in the usual and regular course of its activities (Corp C §9631(a));
- Adopting or amending a merger agreement (Corp C §§6015(a), 9640(a), (c)); and
- Voluntarily electing to wind up and dissolve the corporation (Corp C §9680(b)).

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.86 c. Form: Notice of Meeting

§10.86 c. Form: Notice of Meeting





_ _[*NAME OF CORPORATION*]_ _

NOTICE OF _ _[*REGULAR/SPECIAL*]_ _ MEMBERSHIP MEETING

Notice is hereby given that a _ _[*regular/special*]_ _ meeting of the members of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation, will be held on _ _[*date*]_ _, at _ _[*time*]_ _ at _ _[*address*]_ _. Only members of record at the close of business on _ _[*record date, see §10.45*]_ _ will be entitled to vote at the meeting.

[*Add one of the following alternatives*]

[*Alternative 1: Regular meetings]*

The following matters, and such other matters as may lawfully be acted on, will be presented to the members for action: _ _[*List and describe in general terms*]_ _.

[*Alternative 2: Special meetings]*

This meeting has been called for the purpose of acting on the following matters, and no other matters may come before the meeting: _ _[*List and describe in general terms*]_ _.

[*Continue*]

[*If applicable, add one or more of the following options*]

[*Option 1: Election of directors]*

The members will elect _ _[*number*]_ _ directors at this meeting. The following persons have been nominated, as of the date of this notice: _ _[*List nominees*]_ _.

[*Option 2: Voting by proxy]*

If you do not expect to be present in person at the meeting and wish your membership to be voted, you may complete the attached proxy form and mail it in the enclosed addressed envelope.

[*Option 3: Voting by proxy in large corporation]*

Whether or not you plan to attend the meeting, please sign and date the enclosed proxy form and mail it promptly in the enclosed addressed envelope. This is important because _ _[*state quorum requirement, e.g., a majority*]_ _ of the members must be represented, either in person or by proxy, to constitute a quorum. If you attend the meeting, you may vote in person even though you mail your proxy form now.

_ _[*Date*]_ _

_ _[*NAME OF CORPORATION*]_ _,
a California nonprofit corporation
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: Member apathy in nonprofit corporations with large membership rolls often jeopardizes the corporation's ability to muster a quorum for member meetings. In this situation, it is useful to explain to members in the notice the quorum requirements and the necessity for a quorum to induce members to mail proxies if only to create the presence of a quorum.

The notice should be signed by the corporate secretary or other person authorized to give notice of membership

meetings. If the notice provides for voting by proxy, a proxy form should be enclosed. See §§10.56-10.65.

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§10.87 4. Service of Notice

Public benefit and mutual benefit corporations. Notice of a meeting must be given either personally, by mail, electronically, or by other means of written communication addressed to the member at the address appearing on the books of the corporation or given by the member for purpose of notice. If a corporation does not have an address for a member, notice may be given either at the corporation's principal office or by publication in a newspaper of general circulation in the county where the principal office is located. Corp C §§5511(b), 7511(b) (no similar provisions for religious corporations). If a notice or report sent to a member at the address appearing on the corporation's books is returned by the United States Postal Service as undeliverable at that address, future notices need not be mailed but are considered to have been properly given if they are held available for the member on written demand at the corporation's principal office for 1 year after the notice date. Corp C §§5511(b), 7511(b).

NOTE: An affidavit of giving of any notice or report, in accordance with statute and executed by the secretary, assistant secretary, or any transfer agent constitutes prima facie evidence of the giving of the notice or report. Corp C §§5511(b), 7511(b).

Mutual benefit corporations. The California Attorney General has opined that mutual benefit corporations may not seek to conserve expenses by giving notice of annual meetings by posting the notice of the meeting at the corporation's principal office and publishing the notice in a newspaper of general circulation in the county where the principal office is located, even if (1) the bylaws authorize this notice, and (2) the members have requested not to be notified either personally or by mail. 82 Ops Cal Atty Gen 229 (1999). The statute permits notice by posting and publication only if the corporation does not have an address for the member. The opinion recognizes, however, that Corp C §7511(g) authorizes a court to find that notices that were not given in conformity with Corp C §7511(b) may still be valid if the notice was given in a fair and reasonable manner. See §10.89.

Religious corporations. The board may serve the notice by any reasonable method. Corp C §§9410(a), 9411(a). Addressing delivery of notices in the articles or bylaws may help avoid the appearance of favoritism should the board's choice of delivery method appear to favor a particular faction.

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§10.88 5. Defective Call or Notice

Action subject to challenge; waiver. If a meeting has been improperly called or noticed, the actions taken at the meeting are defective and subject to challenge. However, any member attending the meeting without objecting to the defective notice waives any challenge to the meeting based on defective notice. See §10.90.

Cure. Alleged defects in the notice of meeting can be cured if (Corp C §§5511(e), 7511(e), 9411(d)):

- A quorum was present in person or by proxy at the meeting; and
- All members entitled to vote but not present in person or, if proxies are allowed, by proxy, waive notice, consent to the holding of the meeting, or approve the minutes of the meeting. See §§10.90-10.91.

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§10.89 6. Court Approval of Defective Notice

Public benefit and mutual benefit corporations. A court may find that notice given by a public benefit or mutual benefit corporation in a "fair and reasonable" manner constitutes valid notice even if it did not comply with statutory notice requirements. Corp C §§5511(g), 7511(g). What the court will find "fair and reasonable" depends on the circumstances, including the nature of the defect in notice and the significance of the action taken at the improperly noticed meeting.

PRACTICE TIP: When a notice of meeting arrives late, but the members have sufficient time to prepare for and attend the meeting, it is more likely that a court will find the notice fair and reasonable, as compared to a notice that fails to alert the members to the general nature of proposed actions that were otherwise required to be described.

Religious corporations. The Code does not specifically address the power of a court to validate a reasonable method of notice for a religious corporation, presumably because the Code's only requirement for notice is that it be reasonable. Corp C §9410(a). However, the absence of a statute for religious corporations analogous to Corp C §§5511(g) and 7511(g) should not be taken as an implication that notice for a religious corporation is not subject to challenge.

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7. Waiver of Notice

§10.90 a. Methods of Waiving Notice

Written notice of waiver. Persons not present in person or by proxy can sign either a waiver of notice of the meeting or a consent to the holding of the meeting, whether before or after the meeting. They may also waive notice by signing a consent or an approval of the minutes of the meeting. Generally, neither the business to be transacted nor the purpose of the meeting need be stated in the waiver or consent. However, for a written waiver of notice to be valid on matters specified in §10.85 (matters that must be stated as agenda items in the notice of meeting), it must contain a general description of those matters. Waivers, consents, and approvals of the minutes must be filed with the corporate records or made a part of the minutes. Corp C §§5511(e)-(f), 7511(e)-(f), 9411(d)-(e).

PRACTICE TIP: These statutory "cure" provisions are of greater practical utility for corporations with smaller memberships than for those with larger memberships; it may be impracticable or impossible to obtain waivers, consents, or approvals except with small memberships.

Waiver by attending meeting without objection. A member's attendance at a meeting also constitutes a waiver of objection to the notice unless at the beginning of the meeting the member objects to the transaction of any business on the ground that the meeting was not properly called. Attendance does not waive the right to object to the consideration of matters required to be included in the notice (see §10.85) that were not so included, if the objection is expressly made any time during the meeting. Corp C §§5511(e), 7511(e), 9411(d).

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§10.91 b. Form: Waiver of Notice and Consent

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

WAIVER OF NOTICE AND CONSENT TO HOLDING A _ _[*REGULAR/SPECIAL*]_ _ MEETING OF MEMBERS OF _ _[*NAME OF CORPORATION*]_ _

The undersigned members of _ _[*name of corporation*]_ _, a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation, desiring to hold a _ _[*regular/special*]_ _ meeting of the members of that corporation at _ _[*place*]_ _, at _ _[*time*]_ _, on _ _[*date*]_ _, waive notice of and consent to the holding of that meeting and agree that any business transacted at that meeting shall be as valid and legal and have the same force and effect as though that meeting were held after notice duly given.

[*If applicable, add the following option*]

[*Option: Subject matter of meeting]*

The business conducted or to be conducted at that meeting included the following matters: _ _[*List and describe in general terms*]_ _.

_ _[*Date*]_ _ __[*Signature of member*]__
Name: _ _[*Typed name*]_ _

[*Repeat for additional members*]

Comment: This form can be used for signature by one or more members. For proposals that must be described in the waiver or consent, see §10.90. Additional matters may be required to be included in a waiver of notice by the articles or bylaws of public benefit and mutual benefit corporations. Corp C §§5511(e), 7511(e) (no similar provision for religious corporations).

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D. Quorum Requirements

§10.92 1. General Rule

A quorum is the portion of the corporation's "voting power" that must be present in person or represented by proxy for a meeting to be considered validly held. Corp C §§5512(a), 7512(a), 9412(a). Similarly, if an action is to be authorized by a written ballot, a quorum is the minimum number of ballots received equating to the voting power that would need to have been present in person or by proxy at a meeting for the action to be valid. Corp C §§5513(b), 7513(b), 9413(c). "Voting power" means the power to vote for the election of directors. Corp C §5078; see §10.38. The memberships of any members, or classes of members, who are ineligible to vote or are disqualified from voting on a particular matter are not counted in confirming whether a quorum is present for purposes of acting on that matter. Corp C §5010. If a quorum exists, the affirmative vote of a majority of the voting power represented, entitled to vote and voting on the particular matter, is ordinarily the act of the members. Corp C §§5512(a), 7512(a), 9412(a). If a meeting is held pursuant to court order, the court may suspend the usual quorum requirements. See §10.103.

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§10.93 2. Public Benefit and Mutual Benefit Corporations

Unless otherwise provided in the bylaws, a quorum for a public benefit or mutual benefit corporation consists of one-third of the corporation's voting power, represented at a meeting in person or by proxy (see §§10.56-10.65) or by written ballot (see §§10.66-10.71). The bylaws may set a different quorum requirement or they may authorize the board to lower the quorum requirements—a common provision for corporations that have difficulty in getting members to attend meetings. The members must approve any bylaw amendment that would increase the quorum requirement. Corp C §§5512(a), 7512(a). If the quorum requirement is set at below one-third, then the only matters that may be voted on at any regular meeting actually attended, in person or by proxy, by members holding less than one-third of the voting power are matters whose general nature was described in the notice. Corp C §§5513(b), 7513(b).

PRACTICE TIP: Corporations whose membership numbers fluctuate greatly should set a percentage of the corporate memberships rather than a flat number as the minimum quorum requirement. Many lawyers recommend a low quorum requirement for nonprofit corporations because it is often difficult to get a large percentage of the membership to attend meetings. For special rules applicable to corporations with low quorum requirements, see §10.96.

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§10.94 3. Religious Corporations

A quorum consists of one-third of the corporation's voting power represented in person, by written ballot, or by proxy. Corp C §9412(a). However, the articles or bylaws may provide any reasonable method for holding meetings (Corp C §9410(a)), which presumably would permit reasonable modification of quorum requirements.

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§10.95 4. Homeowners' Associations

Governing documents prepared by the developer must provide for a quorum percentage of at least 25 percent and no more than 66⅔ percent of the total voting power of the association. The quorum for a vote on regular or special assessments requiring member approval under CC §1366(a) is set by statute at a majority of the members. 10 Cal Code Regs §2792.17(e). Once the developer holds less than 25 percent of the voting power of the homeowners' association, the Department of Real Estate regulations no longer apply and the association's bylaws can be amended to change the quorum requirement for member action, subject only to the mutual benefit corporation rules (see §10.93) and CC §1366(a). Bus & P C §11018.7.

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§10.96 5. Quorum of Less Than One-Third—Public Benefit and Mutual Benefit Corporations

If the bylaws authorize a quorum of less than one-third of the corporation's voting power *and* if the quorum present in person or by proxy at a given meeting is in fact less than one-third, the only matters that can be acted on at that meeting are matters that were specified in the notice of the meeting. Corp C §§5512(b), 7512(b) (no similar provision for religious corporations; see §10.94).

PRACTICE TIP: Counsel should advise low-quorum corporations to always specify in the notice any matters that may come up for action at the meeting.

NOTE: A low initial quorum addresses the chronic problem of satisfying the minimum quorum percentage for valid member actions. The disadvantage of a low quorum is the possibility of dominance by a small faction who could then approve actions favored only by a minority. The corporation can protect itself from this danger by drafting bylaws that call for higher approval percentages for key decisions or actions.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.97 6. Descending Quorum Requirements

§10.97 6. Descending Quorum Requirements

Bylaws may provide for a descending quorum. For example, if the initial quorum for the meeting is fixed at 50 percent and that quorum is not attained, an appropriately drafted bylaw provision can provide that the meeting can be adjourned for lack of a quorum to a subsequent date (but not more than 45 days later for public benefit and mutual benefit corporations (Corp C §§5511(d), 7511(d)) without giving notice of the date and time of the reconvened meeting. The quorum at the reconvened meeting can be any percentage stated in the bylaws that is less than that prescribed for the initial meeting. See Corp C §§5512(a), 7512(a), 9410(a).

PRACTICE TIP: If a corporation desires descending quorum percentages, the bylaws should clearly state whether the lower quorum percentage applicable to the adjourned meeting also applies during any extension of the period for the return of written ballots. For discussion of written ballot voting, see §§10.66-10.71.

Homeowners' associations. Homeowners' associations may use descending quorums but the adjournment cannot be for less than 5 days nor more than 30 days after the date of the original meeting. The quorum at the reconvened meeting can be a percentage stated in the bylaws that is less than that prescribed for the initial meeting, but cannot be less than 25 percent. 10 Cal Code Regs §2792.17(e)(2); see CC §1363.03(b).

PRACTICE TIP: The 5-day delay requirement may be particularly burdensome for rural or resort development associations that have a high percentage of absentee owners. In these situations, it is more desirable that the bylaws provide from the outset for a low quorum percentage for membership meetings.

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§10.98 7. Required Vote for Valid Action When Quorum Present

If a quorum is present at the meeting, "the affirmative vote of the majority of the voting power represented at the meeting, entitled to vote, and voting on any matter shall be the act of the members" unless the Corporations Code or the governing documents prescribe a greater approval percentage. Corp C §§5512(a), 7512(a), 9412(a). In requiring that an affirmative vote requires the majority of the voting power "represented at the meeting," the voting power represented by proxies given for quorum purposes only nevertheless must be included in calculating whether a majority have approved the action. In other words, the statutory requirement blocks member action when the voting power of the members entitled to vote and voting is less than a majority of the total voting power present or represented at the meeting even if the affirmative vote would have constituted a majority of a bare quorum.

PRACTICE TIP: It is unclear for governing documents to describe the minimum affirmative vote for member action as "a majority of a quorum," unless the bylaws clearly and appropriately define this term. Such language is ambiguous because it can be interpreted as permitting the affirmative vote of only one-half plus one of the minimum required quorum to pass a proposal even if the voting power represented at the meeting is far greater than the minimum required quorum.

Public benefit and mutual benefit corporations. Even if the bylaws provide for passage of proposals by a "majority of a quorum," the statutory provisions for determining member action cannot be varied by the bylaws.

Religious corporations. The provisions of Corp C §9410(a), permitting the articles or bylaws to alter the statutory provisions for obtaining member approval, could allow a badly drafted bylaw to trump the statute.

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§10.99 8. Withdrawal of Members Leaving Less Than a Quorum

If a quorum is initially present but a sufficient number of members withdraw from the meeting to leave fewer than the required quorum, the remaining members may continue to transact business as long as any action taken (other than adjournment) is approved by a majority of the number required for a quorum (or any higher approval percentage or approval by specified classes of members as may be prescribed in the Code or the corporation's articles or bylaws). Corp C §§5512(c), 7512(c), 9412(b). For example, in a corporation with a voting power of 100 and a quorum requirement of 51 votes, if 51 or more are initially present but fewer than 51 remain after some members leave, the remaining members may continue to transact business by the affirmative vote of 26 for all matters ordinarily requiring a simple majority vote.

NOTE: If the bylaws of a public benefit or mutual benefit corporation authorize a quorum of less than one-third of the voting power and the meeting is attended by a quorum but less than a third of the members, the members may act only on matters described in the notice of meeting. Corp C §§5512(b), 7512(b) (no similar provision for religious corporations; see Corp C §9410(a)).

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§10.100 9. Adjournment When Quorum Not Obtained

If the minimum specified quorum is not present or represented by proxy at a meeting, the members can take no action other than adjourn the meeting to another time. Adjournment is accomplished by the vote of a majority of the votes represented, either in person or by proxy, even though less than a quorum. If a quorum is still not present at the reconvened meeting, the meeting may be again adjourned in the same manner, from time to time until a quorum is present. Corp C §§5512(d), 7512(d), 9412(c). On descending quorum requirements, see §10.97.

Public benefit and mutual benefit corporations. No meeting may be adjourned for more than 45 days. Corp C §§5511(d), 7511(d) (no similar provision for religious corporations; see Corp C §9410(a)).

On notice of adjourned meetings, see §10.83.

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§10.101 E. Adjournment—Public Benefit and Mutual Benefit Corporations

Without a contrary bylaw provision, notice of the time and place of an adjourned members' meeting of a public benefit or mutual benefit corporation is unnecessary if the time and place of the adjourned meeting, or the means by which members may participate electronically in the adjourned meeting, are announced at the original meeting. No meeting may be adjourned for more than 45 days. Corp C §§5511(d), 7511(d) (no similar provision for religious corporations).

When the meeting is reconvened, the corporation may transact any business that could have been transacted at the original meeting. If after adjournment a new record date for notice or voting is fixed, a notice of the adjourned meeting must be given to each member who would be entitled to vote at the reconvened meeting under the new record dates. Corp C §§5511(d), 7511(d).

On notice requirements, see §10.83.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.102 F. Who Can Attend Membership Meetings

§10.102 F. Who Can Attend Membership Meetings

Members and proxy holders. With the limited exception of certain nonprofit corporations affiliated with public agencies, nonprofit corporations are entitled to restrict attendance to individuals who are members and, if proxy voting is permitted (see §§10.56-10.65), the designated proxyholders of members. Membership meetings are business affairs, not municipal elections, and may be conducted on the same basis as business affairs, including deciding who may be invited to attend. See *Zierath Combination Drill Co. v Croake* (1913) 21 CA 222, 131 P 335. Basic concepts of free association under the United States Constitution should be sufficient to permit a nonprofit corporation to choose to invite only its members to a meeting. *Roberts v United States Jaycees* (1984) 468 US 609, 620, 82 L Ed 2d 462, 104 S Ct 3244.

PRACTICE TIP: Properly drafted notices of member meetings will invite only members, not the general public, and will not encourage members to invite others to accompany them to the meeting. To further preserve the position that a members' meeting is an invitation-only affair, the minutes should note that the attendance of any officers and staff members who are not members was at the invitation of the directors.

Presence of legal counsel. Members who are in a dispute with the corporation often want legal counsel to be present at the meeting. If the attorney is not a designated proxyholder, the corporation should be able to exclude the attorney from the meeting. If a member designates his or her attorney as that member's proxyholder, the board should be entitled to invoke customary parliamentary procedure to limit the attorney's participation to speaking and voting on issues that are presented to the members for approval. Because nonprofit corporations can limit or eliminate proxy voting altogether (see §§10.58-10.59), the articles or bylaws may state that only members may be proxies on behalf of other members.

PRACTICE TIP: If the meeting will include a disciplinary proceeding against a member known to be represented by an attorney, it may be helpful (in the event of subsequent litigation) to permit the member's attorney to attend that portion of the meeting addressing the disciplinary proceeding so that any discipline appears as the result of good faith and a fair and reasonable procedure at which the full circumstances have been considered. Of course, the corporation would be well advised to invite its own counsel to be present as well. See Corp C §§5341, 7341, 9340(d).

CAUTION: If the corporation is known to be represented but its counsel is not present, counsel representing the member is at risk of violating Cal Rules of Prof Cond 2-100, prohibiting communications directly with a party the attorney knows to be represented by another lawyer, when addressing the meeting on the topic of the dispute between the corporation and the member.

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VI. MEETINGS OR BALLOTS ORDERED BY COURT

A. Corporation Fails to Hold Meeting

§10.103 1. Regular Meetings—Public Benefit and Mutual Benefit Corporations

A court may summarily order a public benefit or mutual benefit corporation to hold a members' meeting, or to conduct an election by written ballot, under the following circumstances (see Corp C §§5510(c), 7510(c) (no similar provision for religious corporations)):

- The corporation failed to hold a regular members' meeting within 60 days of the date designated in the bylaws.
- If the bylaws do not designate a date for a meeting, the corporation failed to hold a regular members meeting within 15 months after the formation of the corporation or the last regular meeting.
- The corporation failed to conduct a written ballot vote for 60 days following the date designated in the bylaws for the ballot.

Such an order may be issued on application by any member (or, for public benefit corporations, the Attorney General). When court proceedings are initiated, the corporation is entitled to notice of the proceedings and has the right to be heard. Corp C §§5511(c), 7511(c).

Quorum requirements inapplicable. Ordinary quorum requirements do not apply to meetings held or written ballots conducted under court order. The votes represented in person or by proxy, whatever the number, constitute a quorum for a court-ordered meeting or balloting. The court may also designate the time and place of the meeting, the record date for notice and voting, and the form of notice. Corp C §§5510(d), 7510(d).

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§10.104 2. Special Meetings

Notice of a special members' meeting, if not given by the corporation within 20 days after receipt of a proper request for the meeting (see §10.82), may also be ordered by the court, on notice to the corporation giving it an opportunity to be heard. As is true with court-ordered regular meetings (see §10.103), the court may issue any orders as may be appropriate, including designating the time and place of the meeting, the record date, and the form of notice. Corp C §§5511(c), 7511(c), 9411(c).

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§10.105 B. Corporation Unable to Hold Meeting or Obtain Member Approvals

If it is impracticable or unduly difficult for the corporation to call or conduct a meeting of its members, conduct a written ballot, or otherwise obtain their consent in the manner prescribed by law, the articles, or the bylaws, the superior court "may order that such a meeting be called or that a written ballot or other form of obtaining the vote of members… be authorized, in such a manner as the court finds fair and equitable under the circumstances." Corp C §§5515(a), 7515(a), 9414(a). A petition for court action may be filed by any director, officer, or member (or for public benefit corporations, the Attorney General), but it must be filed in the name of the real party in interest (CCP §367), which is the corporation. See *Greenback Townhomes Homeowners Ass'n v Rizan* (1985) 166 CA3d 843, 212 CR 678.

Court actions. The superior court must provide for a method of notice reasonably designed to give actual notice to all parties entitled to notice of meeting, regardless of whether the method results in actual notice or conforms to otherwise applicable notice requirements. Corp C §§5515(b), 7515(b), 9414(b). In addition, the court may do the following (Corp C §§5515(b)-(c), 7515(b)-(c), 9414(b)-(c)):

- Determine who the members or directors of the corporation are;
- Dispense with any requirement on the holding of and voting at meetings;
- Dispense with any requirement on the number or percentages of votes required to establish a quorum or to approve the action that would otherwise apply under the law, the articles, or the bylaws.

Whenever practicable, the order must limit the subject matter of the meeting, written ballot, or consent to items, including amendment of the articles or bylaws, whose resolution will enable the corporation to manage its affairs without further resort to this judicial procedure, and may authorize obtaining whatever votes are necessary to dissolve, merge, or sell. Corp C §§5515(d), 7515(d), 9414(d).

NOTE: A meeting, vote, or other procedure conducted under court order is as valid for all purposes and has the same force and effect as if the corporation complied with all requirements imposed by statute, articles, and bylaws. Corp C §§5515(e), 7515(e), 9414(e).

Homeowners' associations. Corporations Code §7515 does not expressly extend to actions mandated by, or undertaken pursuant to, the declaration of restrictions of a homeowners' association. The Davis-Stirling Common Interest Development Act (CC §§1350-1378) provides a method of obtaining court-ordered approval of amendments to the declaration under circumstances in which the approval percentage required by the declaration cannot be obtained (CC §1356; see Advising California Common Interest Communities, chap 9 (Cal CEB 2003)), but there is no general authorization for judicial intervention to approve other member actions required by the declaration.

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C. Initiation of Court Proceedings

§10.106 1. Contents of Petition for Initiation of Court Proceedings

Any application for an order to conduct a members' meeting or balloting should aver the basic elements described in the applicable statute, and be accompanied by a declaration of one or more competent witnesses setting forth admissible evidence to support relief, whether by testimony or authenticated documents. The application and declarations should describe the corporation's unsuccessful efforts to comply with the requirement under consideration, or clearly indicate why those efforts would serve no meaningful purpose. In addition, the application should do the following:

- State that the petition is being filed under Corp C §5510(c), §5511(c), §5515, §7510(c), §7511(c), §7515, §9411(c), or §9414.
- Identify the petitioner as a director, officer, member, or delegate (or, for public benefit corporations, the Attorney General), as applicable.
- State that the corporation is a California nonprofit public benefit, mutual benefit, or religious corporation, and state the county of its principal corporate office.
- Identify and attach a copy of the bylaws or other legal provision imposing the requirement in question (*e.g.,* requiring a meeting of the members with a quorum of 50 percent of the membership present or represented).
- In applications under Corp C §§5510(c), 5511(c), 7510(c), 7511(c), and 9411(c), describe with specificity the date of the last regular meeting and the attempts to cause a regular meeting to be held or balloting to be conducted, or the call of a special meeting and the attempts to cause notice to be delivered to the members.
- In applications under Corp C §§5515, 7515, and 9414, describe with specificity why it is impracticable or impossible for the corporation to satisfy this requirement.
- If appropriate, describe adverse consequences or hardships that are likely to occur without judicial assistance.
- Clearly describe the relief sought.

For form of petition in a different but analogous situation (shareholders' petition for court supervision of voluntary winding-up proceeding), see 5 Ballantine & Sterling, California Corporation Laws, App A, Form 14.19 (4th ed 1962).

PRACTICE TIP: Unfortunately, the Corporations Code is essentially silent on the procedure to use in seeking judicial assistance in ordering a members' meeting or balloting. In an effort to shoehorn this type of proceeding into a form of action with which a court may be more familiar, and more willing to process on an expedited basis, some attorneys attempt to combine this proceeding with a petition for a writ of mandate (CCP §§1084-1097) or a temporary restraining order and order to show cause for preliminary injunction (CCP §§526-527). Whether either approach is helpful will likely depend on the experience of the bench in the county where the application is filed, and counsel's relationship with the judges there. Nevertheless, counsel should treat the application as an ex parte matter and seek to present it in chambers in accordance with the rules of the local superior court. Counsel should also be prepared with a scheduling order to describe the method and deadline for serving other parties and to fix a briefing schedule.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.107 2. Hearing and Notice of Hearing

§10.107 2. Hearing and Notice of Hearing

If an application is brought under Corp C §5515, §7515 or §9414, the proponents need not give notice of the filing of an application or any hearing on the petition to members or other interested persons. The law requires only that notice of the court order be given to all parties who would be entitled to notice of a meeting. Corp C §§5515(b), 7515(b), 9414(b). A corporation named as a defendant in an application brought under Corp C §5510(c), §5511(c), §7510(c), §7511(c), or §9411(c) is to be given notice of the application. Because the Code does not provide any details about the method or time for giving notice, such matters will have to be ordered by the court as it deems appropriate.

PRACTICE TIP: The applicant should attempt to obtain on an ex parte basis a preliminary order setting a hearing date and prescribing the manner and dates of service of the application and supporting papers on the corporation. If there is any identifiable opposing action, the order should also include notice of a briefing schedule and of the hearing to interested parties.

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VII. MEMBERS' INSPECTION RIGHTS

§10.108 A. Inspection Rights Generally

Only religious corporations may limit rights. The members of nonprofit corporations enjoy certain inspection rights. Public benefit and mutual benefit corporations cannot limit these rights by contract, the articles, or bylaws, but religious corporations may limit them. See Corp C §§6310-6338, 8310-8338, 9511-9512, 9514.

Form of production. If a corporate record is subject to inspection under the Corporations Code, it must be furnished in written form to the requesting member or his or her agent. Minutes of meetings and other documents subject to inspection must be maintained in written form, in any form "capable of being converted into clearly legible tangible form," or a combination of the two. Corp C §§6320(b), 8320(b), 9510(b). Except for the membership list, nonprofit corporations may make the documents available for inspection by the member rather than furnishing copies of the requested documents. Corp C §§6330(a)(1), 8330(a)(1), 9512.

NOTE: Members of public benefit and mutual benefit corporations may exercise inspection rights in person or through an agent or attorney. The person undertaking the inspection has the right to make copies or extracts of the inspected documents. Corp C §§6311, 8311 (no similar provision for religious corporations).

Membership lists. Subject to the limitations discussed in §10.114, if a member demands inspection of the record of members' names, addresses, and voting rights (collectively the "membership list") for a purpose reasonably related to his or her interests as a member, the member may do either or both of the following (Corp C §§6330, 8330, 9511):

- Inspect and copy the record of all members' names, addresses, and voting rights (collectively, the "membership list"), at any reasonable time, on 5 business days' advance notice to the corporation (stating the purpose of the inspection).
- Obtain the membership list, current as of the most recent record date for which the list was compiled or as of a date specified by the member subsequent to the demand, from the corporate secretary on written demand and payment of a reasonable fee.

NOTE: The rules on the inspection rights of religious corporation members (Corp C §§9511-9512) permit restrictions that would not be possible for public benefit or mutual benefit corporations.

A public benefit or mutual benefit corporation may offer an alternative to the production to the membership list. See §10.110.

Accounting books and records, and minutes. A member of a public benefit or mutual benefit corporation has the right to make a written demand to inspect, copy and make extracts of accounting books and records, and minutes of the meetings of the members, the board and board committees, at any reasonable time. Corp C §§6311, 6333, 8311, 8333. A member of a religious corporation may only inspect, not copy, such records. Corp C §9512.

On annual reports prepared by the board of directors for members, see §§12.43-12.51.

Homeowners' associations. Additional rules govern the inspection rights of members of homeowners' associations. CC §1365.2. See Advising California Common Interest Communities, chap 2 (Cal CEB 2003).

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§10.109 B. Required Records Subject to Member Inspection

Nonprofit corporations must keep the following books and records available for inspection:

- Articles, bylaws, and all their amendments (Corp C §§5160, 7160, 9160);
- Adequate and correct books and records of account (Corp C §§6320(a)(1), 8320(a)(1), 9510(a)(1));
- Minutes of the proceedings of its members, board, and committees of the board (Corp C §§6320(a)(2), 8320(a)(2), 9510(a)(2)); and
- A list of the names and addresses (and any membership classes) of its members (Corp C §§6320(a)(3), 8320(a)(3), 9510(a)(3)).

Mutual benefit corporations whose memberships are subject to restrictions on transfer must keep a statement of those restrictions on file with the secretary of the corporation and make them available for member inspection on the same basis as other corporate records that are open for member inspection. Corp C §7313(b)-(c).

"Books and records of account" undefined. Although the Corporations Code does not define "books and records of account," the term is generally understood to refer to the journals and ledgers in which financial transactions are originally entered and recorded, and the statements compiled from them. Disputes arise when a member tenders a demand to inspect source documents on which books and records of account are based, such as canceled checks and invoices. Similar difficulties arise when a member demands to inspect records that are relevant to only a small or isolated aspect of the corporation's operations, such as documents relevant only to a particular lot of a homeowners' association, or a particular work of art of a museum, and not to the operation of the corporation as a whole. A member's inspection demand for source documents or for isolated documents may be denied. (In contrast, a director has the right to inspect "all books, records and documents of every kind." Corp C §§6334, 8334, 9513.)

"Proceeding" undefined. The Code also fails to define what constitutes a "proceeding" for which minutes must be maintained. For example, if directors routinely meet in advance of a regularly scheduled board meeting in order to develop an agenda for the meeting, the question arises whether minutes must be taken at the prior working session. If no formal action is taken at the working session, if it is not designated as a regular meeting in the bylaws or by board resolution, and is not called as a special meeting, minutes are not needed.

CAUTION: If the corporation denies a lawful inspection demand and the member resorts to his or her judicial rights (see §§10.117-10.120), court-ordered access may be greater than the access required by the initial demand. See Corp C §§6336, 8336.

Homeowners' associations. In contrast, homeowners' associations are subject to open meeting requirements that place strict limits on the ability of directors to meet outside of duly called regular or special meetings. See CC §1363.05.

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§10.110 C. Timing for Inspection

Reasonable time after demand. An inspection of accounting books, records, or minutes of proceedings must take place, following a written demand, at a reasonable time. No specific time limit is placed on the corporation's obligation to respond to a member's demand to inspect any of these items other than a membership list. Corp C §§6333, 8333, 9512.

Timing. Public benefit and mutual benefit corporations must comply with a demand to inspect the membership list on or before the later of 10 business days after the demand is received or the date specified in the demand as the date on which the list is to be compiled. Corp C §§6330(a)(2), 8330(a)(2). Religious corporations have only 5 days after written demand to produce the membership list. Corp C §9511.

NOTE: A member who is not furnished the requested documents has certain remedies through the superior court. See Corp C §§6336, 8336, 9514. See also §§10.117-10.118; Advising California Common Interest Communities, chap 2 (Cal CEB 2003).

Public benefit and mutual benefit corporations. Nonprofit corporations are often concerned that a list furnished for a proper purpose may later be used for other purposes, and they may want to protect their members from undesired intrusions or concerns. Therefore, within 10 business days after receiving a written demand for inspection or for a copy of the membership list, a corporation may deliver to the person making the demand a written offer of an alternative method of achieving the purpose stated in the demand without providing access to the list itself. Corp C §§6330(c), 8330(c) (no similar provision for religious corporations). The usual alternative is to offer to conduct the mailing on the member's behalf if he or she presents the materials in a form ready for mailing and reimburses the corporation for its mailing costs. The member may reject the offer in writing, indicating the reasons the alternative does not meet the proper purpose of the demand. Corp C §§6330(c), 8330(c).

NOTE: In any subsequent action maintained by the member to enforce his or her rights, the corporation has the burden of proving that the offered alternative would reasonably achieve the objectives set forth in the demand. Corp C §§6330(b)(1), 8330(b)(1).

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§10.111 D. What Constitutes Permitted Purpose

Reasonably related to membership interest. A member's inspection rights are conditioned on the member demonstrating that the demand is reasonably related to his or her interests as a member of the corporation. Corp C §§6330, 6333, 8330, 8333, 9511-9512.

NOTE: Presumably, this condition refers to the interests of members generically as opposed to an individual member's interest. In addition, the requirement that the demand be reasonably related to the members' interests implies a need for some logical nexus between the documents sought and the interest to be protected. For example, a demand for accounting books and records addressed to a corporation that made available audited financial statements would seem to advance a members' interest very little unless there were some special reason to doubt the competence of the auditing firm.

Purposes requiring board consent. A membership list is a corporate asset and may not be used for any of the following purposes without the board's consent (Corp C §§6338, 8338):

- For solicitation of money or property, unless the money or property is sought to solicit the vote of members in connection with a director election;
- For any purpose that the demanding member does not reasonably and in good faith believe will benefit the corporation;
- For any commercial purpose; or
- For sale to any person.

Examples. Demands for inspection relating to issues of concern to the members as a whole or to a substantial group of members are likely to be upheld as a proper purpose. Thus, if a group of members band together and demand the right to inspect and copy the mailing list, *e.g.,* to promote candidates for election who support their views, a proper purpose is likely to exist regardless of the board's annoyance with the opposing faction. But if a member's demand stated that the purpose was to distribute literature for a national political candidate, no proper purpose would be stated; indeed, such a purpose could jeopardize the corporation's tax-exempt status. On political activities, see chap 19.

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§10.112 E. Statutory Protections Against Abuse of Inspection Rights

Religious corporations, by limiting members' inspection rights in their articles or bylaws, can protect themselves from abusive inspections. See Corp C §§9511-9512. For further discussion, see §10.106.

Public benefit and mutual benefit corporations, which lack this ability, have options to protect against an abusive exercise of inspection rights by members for improper purposes while protecting members from management's improper refusal of a lawful inspection demand:

- If fewer than the authorized number of members request to inspect the membership list, the corporation may deny access to the list if it reasonably believes that the information will be used for a purpose unrelated to the requesting members' interests in the corporation (Corp C §§6330(b)(1), 8330(b)(1)); and
- If an inspection request is presented by the authorized number of members, the corporation must either comply with the demand or seek a court order setting aside the demand within the time provided by law (Corp C §§6331(a), (e), 8331(a), (e); see §10.111).

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§10.113 1. Protection Against Improper Access by Authorized Number of Members—Public Benefit and Mutual Benefit Corporations

Court petition to set aside demand. If a public benefit or mutual benefit corporation, in good faith and with substantial basis, believes that a membership list demanded by the authorized number of members will be used for a purpose that is not reasonably related to the interests of the requesting members, or if the corporation provides a reasonable inspection alternative, the corporation may petition the superior court for an order setting aside the demand. Corp C §§6331(a), 8331(a). The petition must be filed within 10 days after the corporation received the demand or a written rejection of the corporation's alternative offer (stating the reasons for rejection), whichever is later. Corp C §§6331(b), 8331(b). The 10-day deadline may be extended on a showing of excusable neglect if it is filed within 30 days after tender of the members' demand or after the members reject the corporation's inspection alternative, whichever is later. See Corp C §§6331(c), 8331(c).

Production stayed until hearing. The corporation's petition must be accompanied by an application for a hearing to be held no more than 20 days after the date the petition was filed. Corp C §§6331(b), 8331(b). Once the application is filed, the court must issue a protective order staying production of the list until the hearing on the order to show cause, unless the court finds that there is no reasonable probability that the corporation will make the showing required for issuance of a final order setting aside the members' inspection demand. Corp C §§6331(b), 8331(b).

Protective order staying production until final adjudication. Between the date of the hearing on the order to show cause and the issuance of the court's final order, the court may issue a protective order staying production of the membership list until the final adjudication of the corporation's petition if the court finds that (Corp C §§6331(d), 8331(d)):

- The requesting parties' rights can reasonably be preserved pending issuance of a final order; and
- Either the corporation is likely to make the showing required for issuance of a final order setting aside the members' demand (see Corp C §§6331(f), 8331(f)) or a final order will be issued that specifies an alternative mechanism for achieving the members' proper purposes or imposes conditions on the members' use of the list (see Corp C §§6331(g), 8331(g)).

NOTE: If the corporation fails to file a timely petition, or fails to obtain a protective order, then the corporation must comply with the inspection demand. No further action may be brought by the corporation under Corp C §6331 or §8331. Corp C §§6331(e), 8331(e).

Final order. In its final order, the superior court may set aside the members' demand only if the corporation proves that (1) a reasonable probability exists that the requesting parties will permit use of the membership list for a purpose unrelated to their interests as members, or (2) the method offered by the corporation is a reasonable alternative that can achieve the proper purpose identified in the requesting members' demand and that the corporation intends and is able to effect the offered alternative. Corp C §§6331(f), 8331(f). The court, in its discretion, may order alternative mechanisms for achieving the requesting parties' proper purposes or impose just and proper conditions on the use of the membership list to ensure compliance with the statutory limitations on the use of membership lists. Corp C §§6331(g), 8331(g).

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§10.114 2. Limitations on Access to Membership List to Protect Constitutional Rights—Public Benefit and Mutual Benefit Corporations

Protective order for constitutional rights. The superior court has the authority to limit or restrict the member inspection rights conferred by Corp C §6330 or §8330 when such an order is necessary to protect the rights of a member under the federal or California constitutions. The corporation or any member may file a petition for an order. Corp C §§6332(a), 8332(a) (no similar provision for religious corporations). To the extent possible and if the court finds it appropriate, the protective order must provide for alternative mechanisms by which the persons seeking to exercise their inspection rights may communicate with members for purposes reasonably related to their interests as members. Corp C §§6332(a), 8332(a).

Suspending time for compliance. When a petition for such a protective order is filed, the petitioner may ask the court for a temporary order suspending the running of any time for compliance with the members' inspection rights. Corp C §§6332(b), 8332(b). After notice and hearing, the order may be extended until final adjudication of the petition if it appears that the petitioner may prevail on the merits and it is otherwise equitable to do so. Corp C §§6332(b), 8332(b).

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§10.115 3. Damages From Improper Use

Anyone who uses a corporation's membership list in violation of Corp C §6338(a) or §8338(a) is liable for any damage that the violation causes the corporation. Any profit derived as a result of the unauthorized use of the membership list must be accounted for and paid to the corporation. Corp C §§6338(b), 8338(b).

NOTE: The court may also award exemplary damages if the violation was fraudulent or malicious. Corp C §§6338(b), 8338(b).

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§10.116 4. Corporation's Right to Seek Damages and Injunctive Relief

The corporation is entitled to recover damages, pursue injunctive relief, or both, in addition to other remedies specified by statute, to restrain misuse of its membership list. Corp C §§6331(j), 6338(c), 8331(j), 8338(c). The corporation may also recover reasonable costs and expenses, including reasonable attorney fees. Corp C §§6331(j), 6338(d), 8331(j), 8338(d).

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F. Enforcement of Inspection Rights

§10.117 1. Enforcement of Demand for Membership List—Public Benefit and Mutual Benefit Corporations

If the authorized number of members of a public benefit or mutual benefit corporation demands to inspect or receive a copy of the membership list and the corporation neither complies with the demand nor obtains a protective order staying production of the list, the requesting members may petition the superior court for a writ of mandamus compelling the corporation to comply with the demand. Corp C §§6331(i), 8331(i) (no similar provision for religious corporations); see CCP §1085. The court must issue the peremptory writ unless the corporation offered a reasonable alternative that was not rejected in writing within a reasonable time. See §10.110.

On mandamus procedures generally, see California Administrative Mandamus (3d ed Cal CEB 2003).

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§10.118 2. Enforcement Remedies Available to All Members

If the corporation refuses the lawful inspection demands of any member to inspect the corporation's membership lists, books, records, or minutes, that member may seek enforcement of his or her inspection rights in the superior court of the county where the corporation's principal office is located or where the desired books or records are kept. The court's order may impose just and proper conditions or, for good cause shown, may appoint one or more competent inspectors or independent accountants to audit the corporation's financial statements kept in California and investigate the properties, funds, and affairs of the corporation (and any subsidiary) keeping records in California and to report on them in the manner the court directs. Corp C §§6336(a), 8336(a), 9514(a).

Inspectors and accountants. If the court's order calls for the appointment of inspectors or accountants, the corporation's officers and agents must produce all books and documents in the officers' or agents' custody or power. The court may enforce the order with its contempt authority. Corp C §§6336(b), 8336(b), 9514(b).

Expenses. The applicant ordinarily bears all expenses of the investigation or audit. However, the court may order the expenses paid or shared by the corporation. Corp C §§6336(c), 8336(c), 9514(c).

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.119 3. Criminal and Civil Sanctions for Improper Recordkeeping

§10.119 3. Criminal and Civil Sanctions for Improper Recordkeeping

Directors and officers of the corporation are guilty of a misdemeanor if they do any of the following (Corp C §§6812-6814, 8813-8815, 9690):

- Knowingly concur in making or publishing any materially false report or statement about the corporation's financial condition;
- Willfully or fraudulently exaggerate the corporation's financial condition;
- Act with intent to defraud, destroy, alter, mutilate, or falsify any of the corporation's books, papers, or writings or make or concur in omitting to make any material entry in any book of account, record, or document kept by the corporation; or
- Knowingly present, with intent to deceive, any false, forged, or altered book, paper, voucher, or other instrument to any public officer or board authorized by law to examine the corporation's structure or to investigate its affairs.

Thus, for example, a promoter whose application for a securities permit from the Department of Corporations contains projections or other fiscal information that the promoter knew or should have known was false or misleading may be guilty of a misdemeanor. On directors' and officers' liability, see §§9.103-9.130.

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§10.120 4. Attorney Fees—Public Benefit and Mutual Benefit Corporations

In any action or proceeding to enforce member inspection rights in a public benefit or mutual benefit corporation, the court may award reasonable costs and expenses, including reasonable attorney fees, if it finds that the corporation's failure to comply with a proper demand was unjustified. Corp C §§6323(h), 6331(h), 6337, 8323, 8331(h), 8337; CC §1368(d). See, *e.g.*, *Moran v Oso Valley Greenbelt Ass'n* (2001) 92 CA4th 156, 111 CR2d 636 (although attorney fees are discretionary with trial court, there was no reason to deny them to common interest property owner who sued association for failing to produce minutes for inspection on request when trial court found that association had wrongfully withheld minutes; in dicta, appellate court encouraged trial courts to articulate their reasons for award or denial of fees under Corp C §8337).

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VIII. MEMBERS' OBLIGATIONS

A. Payments to Corporation

§10.121 1. Fees for Joining, Dues, Assessments

Nonprofit corporations may issue memberships for consideration (Corp C §§5311, 7311, 9311; see §10.32) and may levy dues, assessments, and admission fees (Corp C §§5140(g), 7140(g), 9140(g)). Partly paid memberships are permissible. Because memberships and classes of memberships can have different rights, preferences, privileges, restrictions, and conditions if the articles or bylaws so provide (Corp C §§5330, 7330, 9330), a varying dues or assessment structure is possible.

Homeowners' association. A homeowners' association may impose a varying assessment formula to equitably allocate expenses whenever it is reasonable to anticipate that an owner of a lot or unit in the development will receive as much as a 10 percent greater benefit than any other owner in the value of services supplied by the association. 10 Cal Code Regs §2792.16(b).

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§10.122 2. Enforcing Members' Payment Obligations

Admitted to membership or consent. Members are not liable for dues, assessments, or fees merely because the same are authorized in articles or bylaws. No one is liable for any obligation arising from membership unless the person was actually admitted to membership on that person's application or actually consented to the obligation. Corp C §§5350(b), 7350(b), 9350(b). If membership in a homeowners' association is a condition to owning an interest in real property, ownership is considered consent for this purpose. Corp C §7350(c). See also Corp C §7351.

Effect of resignation. A member can avoid liability for dues, assessments, or fees if, on learning of them, the member promptly resigns from membership. Corp C §§5351, 7351, 9351. Resignation alone, however, does not relieve a member from obligations for charges already incurred, services or benefits actually rendered, or amounts that the member agreed to pay by contract or otherwise. Corp C §§5340(b), 7340(b), 9340(b). Further, resignation does not allow a member to avoid contractual obligations arising from ownership of real property. Corp C §§5351, 7351, 9351.

Partly paid memberships. Memberships that are only partly paid and those that are subject to further call are mentioned in the statute (see, *e.g.,* Corp C §§5352(a), 5354, 7352, 7353(a), 9352), but no statutory remedy is provided against members who refuse to honor a call. However, funds in the hands of a fiduciary holding a membership in a representative capacity are liable for any unpaid balance of the purchase price of the membership. Corp C §§5354, 7352 (no similar provision for religious corporations).

PRACTICE TIP: If a nonprofit corporation plans to issue partly paid memberships or memberships subject to further call, the corporation should so authorize in the bylaws. The bylaws should specify the parties' rights and obligations and possible sanctions (such as resale of the membership if a member holding a partly paid membership refuses to respond to further calls). For partly paid memberships, it is recommended that each prospective member sign an application form that spells out the parties' rights.

Pledges. Public benefit and religious corporations do not usually issue partly paid memberships, but contributions are often made in the form of pledges, which may or may not be tied to membership in the corporation. Depending on the terms and specificity of the commitment and its confirmation in writing, a pledge may be an enforceable contractual obligation of the promisor.

Homeowners' associations. Homeowners' associations may impose late charges and interest, and recover all reasonable collection costs (including legal fees) incurred in collecting delinquent assessments, through statutory liens and foreclosure remedies or, in the alternative, the pursuit of a civil action for money damages. CC §§1366-1367.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.123 B. Liability for Corporate Obligations

§10.123 B. Liability for Corporate Obligations

A nonprofit corporation's members are not personally liable for the corporation's debts, liabilities, or obligations. Corp C §§5350(a), 7350(a), 9350(a). In appropriate circumstances, however, the alter-ego doctrine may apply. See also Corp C §§5353, 7354, 9353.

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§10.124 C. Ability of Corporate Creditors to Reach Amounts Owed by Members to Corporation

A corporation's creditors cannot reach unsatisfied obligations owed by the members to the corporation until one or more creditors have obtained a final judgment against the corporation and execution has been returned at least partly unsatisfied (unless these proceedings would be useless). Corp C §§5352(a), 7353(a), 9352(a). Other creditors of the corporation, whether or not their claims have been adjudged, may intervene in any creditor's action to reach and apply unpaid amounts owed to the corporation. Any members who owe amounts to the corporation may be joined in the action. Corp C §§5352(b), 7353(b), 9352(b).

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IX. TERMINATING MEMBERSHIPS

§10.125 A. Resignation

A member may resign from membership at any time, but the articles or bylaws of a mutual benefit corporation may require reasonable notice before a resignation becomes effective. Corp C §§5340(a), 7340(a), 9340(a). For enforceability of resigning members' obligations to the corporation, see §10.122.

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§10.126 B. Expiration of Membership

A membership issued for a specific period of time expires when that period has elapsed unless the membership is renewed. Corp C §§5340(c), 7340(c), 9340(c).

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C. Expulsion, Suspension, or Termination

§10.127 1. Public Benefit and Mutual Benefit Corporations

Good faith and reasonable procedures. Although the bylaws of a public benefit or mutual benefit corporation may provide for any manner of suspending and expelling members (Corp C §§5151(d), 7151(d)), no member may be expelled or suspended and no membership or membership rights may be terminated or suspended except by procedures conducted in good faith and in a fair and reasonable manner (see Corp C §§5341, 7341; see §10.129). Any expulsion, suspension, or termination effected otherwise is void and without effect. Corp C §§5341(a), 7341(a).

Nonstatutory members. Although the statutes cover only statutory members, some may argue that analogous principles also protect the rights of nonstatutory "members." However, the statute provides nonstatutory members no reasonable basis to believe that their status cannot be revoked at the discretion of the corporation. When combined with the likelihood that an honorary status lacks economic or practical necessity, nonstatutory membership should be revocable at will. If in the context of a particular corporation it seems advisable to address this question in advance, the bylaws may provide explicitly that nonstatutory memberships are revocable either at will or on the same terms as statutory memberships.

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Source: Business Law/Advising California Nonprofit Corporations/10 Members and Other Interested Persons/§10.128 a. Grounds for Expulsion, Suspension, or Termination

§10.128 a. Grounds for Expulsion, Suspension, or Termination

An expulsion, suspension, or termination based on substantive grounds that violates the member's contractual or other rights or is otherwise unlawful is not made valid by complying with statutory good faith requirements. Corp C §§5341(f), 7341(f). For example, the Real Estate Commissioner's regulations prevent a property owner in a common-interest subdivision from being permanently expelled from a homeowners' association, regardless of the corporation's scrupulous adherence to statutory procedures. See 10 Cal Code Regs §2792.26.

NOTE: If membership in the corporation is an economic or a practical necessity, as may be true of certain trade or professional organizations, the courts would probably require that the grounds for expulsion or suspension be neither arbitrary nor contrary to public policy.

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§10.129 b. Procedure: Reasonable Requirements

"Fair and reasonable" safe harbor. Any expulsion, suspension, or termination that is not done in good faith and in a fair and reasonable manner is void and without effect. Corp C §§5341(a)-(b), 7341(a)-(b). The Corporations Code sets forth a safe harbor procedure that satisfies the "fair and reasonable" portion of the statutory requirement (Corp C §§5341(c), 7341(c)):

- Provisions in the articles or bylaws set forth the procedure, or copies of such provisions are sent annually to all members as required by the articles or bylaws;
- The procedure provides for 15 days' prior notice of expulsion, suspension, or termination and the reasons for such action; and
- The procedure provides an opportunity for the member to be heard, orally or in writing, at least 5 days before the effective date of the expulsion, suspension, or termination, by a person or body authorized to decide that the proposed action not occur.

Notice. The 15 days' prior notice may be given by any method reasonably calculated to provide actual notice, but any notice given by mail must be sent by first-class or registered mail to the latest address of the member shown on the corporation's records. Corp C §§5341(d), 7341(d).

Other fair and reasonable procedures. A court is not limited to the foregoing safe harbor to find that a procedure is fair and reasonable. Other procedures may be found fair and reasonable under the circumstances. Corp C §§5341(b), 7341(b). Even summary suspension procedures may sometimes be justified. For example, in an organization that reasonably requires membership in another organization as a condition of membership (*e.g.,* a local bar association that requires membership in the State Bar), it may be reasonable for the local organization to rely on actions or findings of the other body. Also, if the corporation's articles or bylaws establish regular dues or assessments that are payable by a certain date and delinquent on another, automatic suspension of delinquent members' voting privileges until payments are made current may be considered fair and reasonable.

Procedures followed in good faith. In reviewing member disciplinary cases, courts focus primarily on whether the organization had disciplinary procedures, the procedures were followed, and the proceeding was conducted in good faith. The court will also examine whether any departures from established procedures denied the disciplined member a fair hearing. See *Williams v Inglewood Bd. of Realtors* (1963) 219 CA2d 479, 33 CR 289. Nonprofit corporations need not comply with specific, formal procedures. See *Pinsker v Pacific Coast Soc'y of Orthodontists* (1974) 12 C3d 541, 116 CR 245 (court refrained from requiring formal court proceedings, and placed responsibility on affected institutions to devise practical methods of providing adequate notice and reasonable opportunity to respond).

On the other hand, a decision that results from substantive unreasonableness, internal irregularities, or procedural unfairness is considered arbitrary. The court is likely to disregard irregularities in procedure that do not harm the plaintiff. *Ezekial v Winkley* (1977) 20 C3d 267, 279, 142 CR 418 (fairness depends largely on nature of tendered issue and whether, *e.g.,* mere written response is adequate or personal appearance by individual and more extensive hearing are required).

PRACTICE TIP: Counsel must consider the necessity and desirability of including detailed disciplinary procedures in the bylaws or in a stand-alone set of enforcement or disciplinary procedures. If detailed and complex disciplinary procedures are in place, the disciplinary body may fail to observe some procedural requirement or formality, giving a disciplined member grounds for appealing the body's decision or contesting the action in court. The contrary view—namely, that providing internal procedures is beneficial—is supported by court decisions such as *Palmer v Regents of Univ. of Cal.* (2003) 107 CA4th 899, 132 CR2d 567, and *Westlake Community Hosp. v Superior Court* (1976) 17 C3d 465, 131 CR 90, which have held that when a private association or public entity establishes mechanisms to handle internal grievances of employees or members, the failure to exhaust those internal remedies precludes any subsequent private civil action with respect to the same grievance.

Organizations that are small in size, social in nature, and involve no substantial membership fee or other investment generally rely on the minimum procedures in the Nonprofit Corporation Law. However, more specific procedures may be necessary and appropriate for larger organizations in which the members have contractual or property rights. If detailed procedures are adopted, counsel should prepare standardized notice and other forms to provide more assurance of uniform and consistent application and a clear record of procedural compliance.

Homeowners' associations. Whenever the board of a homeowners' association (CC §1351) meets to consider disciplinary action against a member, the member must be given notice of the meeting by personal delivery or first-class mail at least 10 days before the meeting. The notice must contain at least the time and place of the meeting, the nature of the alleged violation for which the discipline is being considered, and a statement that the member has the right to attend the meeting and address the board in executive session, if the member desires. See also CC §1363.05. If the board decides that disciplinary action is warranted, the board must also inform the member of the disciplinary action, by personal delivery or first-class mail, within 15 days following the action. If these procedural requirements are not met, the disciplinary action is invalid. CC §1363(h).

PRACTICE TIP: Homeowners' associations must try to resolve most disputes over enforcement of the organization's articles, bylaws, rules, and declaration of covenants and restrictions through some form of alternative dispute resolution procedure as a prerequisite to filing a civil action for declaratory relief or injunctive relief. See Advising California Common Interest Communities, chap 7 (Cal CEB 2003).

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§10.130 c. Members' Remedies

Court action within 1 year; equitable relief. A member must commence a court action challenging expulsion, suspension, or termination of membership, including any claim of defective notice, within 1 year after the date of the expulsion, suspension, or termination. Corp C §§5341(e), 7341(e). The court may order any relief that it finds equitable under the circumstances, including reinstatement or monetary damages. Corp C §§5341(e), 7341(e). See, *e.g., Westlake Community Hosp. v Superior Court* (1976) 17 C3d 465, 131 CR 90; *Cason v Glass Bottle Blowers Ass'n* (1951) 37 C2d 134, 231 P2d 6.

Grounds for setting aside vote. The court may not set aside a vote of the members solely because a person was wrongfully excluded from the vote or the meeting by virtue of the challenged expulsion, suspension, or termination. To set aside such a vote, the court must find not only that the expulsion, suspension, or termination was wrongful, but also that it was in bad faith and for the purpose, and had the effect, of excluding the member from the vote or from the meeting where the vote took place so as to affect the outcome of the vote. Corp C §§5341(e), 7341(e).

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§10.131 2. Terminating Membership—Religious Corporations

Membership in a religious corporation may be terminated as provided in the corporation's articles or bylaws. Corp C §9340(d). The bylaws may provide for the manner of admission, withdrawal, suspension, and expulsion of members. Corp C §9151(d). Although there are no statutory due process requirements for a termination or for court action by a terminated member, case law may provide some protection. See *Curran v Mt. Diablo Council of Boy Scouts of Am.* (1983) 147 CA3d 712, 195 CR 325 (procedural fairness requires adequate notice and reasonable opportunity to respond to charges).

NOTE: Although membership in a religious corporation may be issued for consideration (Corp C §9311), members may not transfer membership (other than certain transfers of memberships in a limited equity housing cooperative) for value (Corp C §9320). Thus, religious corporations may not repurchase or redeem their memberships for value.

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§10.132 3. Terminating Class of Memberships or All Memberships—Public Benefit Corporations

A public benefit corporation may terminate all memberships or any class of memberships by amending its articles or bylaws, but certain statutory requirements (in addition to those ordinarily applicable to amendments; see §§6.34-6.36) must be met. Corp C §5342(a). Provisions applicable to expulsion, suspension, or termination of individual members (Corp C §5341) do not apply to such amendments (Corp C §5342(g)).

The amendment must be approved by the members after written notice not less than 45 nor more than 90 days before the date set for voting on the amendment. The notice must describe the amendment's effect on the corporation and the members (except that this notice is not required if all members entitled to vote receive a written notice before the vote setting forth the effect of the amendment on the corporation and its members and if all sign a written waiver of notice). Corp C §5342(b)-(c). If requested by a member, the corporation, at its option, must either (1) supply an up-to-date list of the members' names, addresses, and voting rights prepared by the corporation, as provided in Corp C §6330(a)(2), or (2) allow the member to inspect and copy the corporation's record of the members' names, addresses, and voting rights, as provided in Corp C §6330(a)(1). The corporation must provide either the list or an opportunity to inspect and copy it, as soon as reasonably possible to allow the member the time to communicate with other members about the proposed amendment. Corp C §5342(e). The articles or bylaws may impose additional requirements. Corp C §5342(d). The amendment, if validly adopted, terminates the rights that the affected persons have as members. Corp C §5342(f).

NOTE: Although membership in a public benefit corporation may be issued for consideration (Corp C §5311), members may not transfer membership (other than certain transfers of memberships in a limited equity housing cooperative) for value (Corp C §5320(b)). Thus, public benefit corporations may not repurchase or redeem their memberships for value.

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§10.133 D. Redemption of Memberships—Mutual Benefit Corporations

A mutual benefit corporation may provide in its articles that one or more classes of memberships are redeemable, in whole or in part, at the option of the corporation or of the member holding the membership. Corp C §7332(a).

PRACTICE TIP: Such a provision in the articles should delineate not only the right of redemption but also the terms and conditions of exercising the right, such as the events that give rise to the right of redemption, the time or time periods applicable, and the consideration or procedure for setting the consideration.

Limitations on redemption. The corporation may not redeem or repurchase memberships if doing so would constitute a distribution to members that would render the corporation unable to meet its obligations or its liabilities as they mature, or if it would violate any additional restrictions in the articles or bylaws on redemptions. Corp C §7332(a).

Sinking funds; agreements. Mutual benefit corporations may create sinking funds, or enter into agreements, to repurchase or redeem memberships. Corp C §7332(b). Any distributions made from the sinking fund or under the redemption agreement are subject to those limitations.

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X. TRANSFERRING MEMBERSHIPS

§10.134 A. Public Benefit and Religious Corporations

Transferable unless restricted. Memberships and membership rights in public benefit corporations and religious corporations are transferable unless the articles or bylaws provide otherwise, but they cannot be transferred for value. Corp C §§5320(a)-(b), 9320(a). Thus, transfer by inter vivos gift is permitted unless the articles or bylaws provide to the contrary.

PRACTICE TIP: Membership rights ordinarily cease on the member's death or dissolution unless the articles or bylaws provide otherwise. Corp C §§5320(a)(2), 9320(b). If desired, the articles or bylaws should specifically authorize transferability at death, by will, or otherwise.

Transferability as fundraising factor. The right of transfer can be an important fundraising factor in certain types of public benefit corporations. For example, members who make large contributions to a civic opera are often given preferential seating locations. The desirability and prestige of the seating location, when coupled with the right of transfer, may encourage members to continue making substantial contributions.

When members are entities. Transfer rights may also be important if the member is an entity rather than an individual. For example, a public benefit corporation, such as a hospital, may establish a subsidiary nonprofit corporation for a specific purpose, such as research. The parent corporation may be unwilling to fund its subsidiary unless it has the right to transfer its memberships to, *e.g.,* a successor.

NOTE: These transfer restrictions do not limit the transfer, purchase, or sale of a membership in a limited equity housing cooperative (typically formed as a public benefit corporation) if the transaction is consistent with CC §817(b)(1)(C) (restricting amount of appreciation of such interests). Corp C §5320(c).

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§10.135 B. Mutual Benefit Corporations

Nontransferable absent contrary article or bylaw. Generally, memberships and membership rights in a mutual benefit corporation are nontransferable, and membership rights ordinarily cease on the member's death or dissolution. Corp C §7320(a)-(b). However, the articles or bylaws may allow transfer of all memberships (or of memberships in any class or classes), including transfer on a member's death, dissolution, merger, or reorganization, with or without restriction or limitation. Alternatively, the articles or bylaws may authorize the board to provide for membership transfers. Corp C §7320(b).

Effect of subsequent restriction on transfer. If transfer rights are provided, no subsequent restriction on those rights is binding on any memberships issued before the restriction was adopted "unless the holders of such memberships voted in favor of the restriction." Corp C §7320(c).

NOTE: It is unclear whether a membership whose holder voted against a subsequent restriction, which was nonetheless validly approved by the members, would be subject to the restriction. Because the statute speaks of "holders" and "memberships" in the plural, it likely means that all memberships or all memberships of a particular group are bound by a subsequent restriction if it was validly approved by the required vote of the affected members or group of members.

If the articles or bylaws grant transfer rights subject to board approval, or if they grant transfer rights but authorize the board to adopt restrictions on transfers as it deems appropriate in the circumstances, membership approval is not required because the member would be on notice that the transferability of the membership is at the board's discretion. The Corporations Code does not specifically require that transfer restrictions be reasonable, but the wording of Corp C §7320(c) appears broad enough to permit a court to conclude that a member is not bound by unreasonable or punitive restrictions subsequently imposed by board resolution.

Restricted transferability membership certificates. Membership certificates that are subject to restrictions on transferability must state that a copy of the restrictions is on file with the corporate secretary and is available for inspection by the members. Corp C §7313(b)(2). If no certificates are issued, or if memberships may be transferred only with the corporation's consent, then the corporation must give the transferee notice, within a reasonable time after the corporation is first notified of the proposed transfer and before the membership is transferred, of the information that would have been provided to the transferee by the required legends. Corp C §7313(c).

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§10.136 XI. MEMBERS' DERIVATIVE SUITS

Public benefit and mutual benefit corporations. Derivative suits are actions brought by one or more members to enforce the corporation's rights against third parties that the corporation has unjustifiably failed to enforce. See Corp C §§5710, 7710.

The right being enforced is that of the corporation. Derivative actions are distinct from actions by members to enforce their own rights, such as a cause of action against the corporation for unlawful expulsion, suspension, or termination (see §§10.127-10.131) and from actions by or concerning the corporation in which members have a statutory right to intervene, such as an action for involuntary dissolution (see chap 20).

The plaintiff must have been a member at the time the relevant transaction occurred or (for mutual benefit corporations) a subsequent member whose membership devolved by operation of law from a holder who was a member when the transaction occurred. Corp C §§5710(b)(1), 7710(b)(1). The complaint must allege with particularity either the plaintiff's efforts to obtain action by the board or the reasons for not making such efforts. Corp C §§5710(b)(2), 7710(b)(2). Plaintiffs may be required to post a bond. Corp C §§5710(a), (c), 7710(a), (c).

For discussion of procedural requirements, see 3 Ballantine & Sterling, California Corporation Laws §413 (4th ed 1962).

Religious corporations. The Code contains no comparable derivative action provision for religious corporations. However, current and former members are authorized to bring actions in the name of the corporation to remedy a breach of trust under which any of the religious corporation's assets are held. The provisions of Corp C §5710 apply to this type of action. Corp C §9142(a)(1). See §10.134.

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XII. DISTRIBUTIONS TO MEMBERS

§10.137 A. Definitions

"Distribution" means "the distribution of any corporate gains, profits, or dividends to any member as such." Corp C §5049. See *People ex rel Groman v Sinai Temple* (1971) 20 CA3d 614, 99 CR 603 (nonprofit cemetery corporation's benefits furnished to members not "dividend," "gain," or "profit"); thus, the definition excludes payments that are not distributions of the corporation's "gains, profits, or dividends." "Member" includes both statutory members (as defined in Corp C §5056; see §10.3) and any persons who, although not statutory members, are called or referred to as members by the corporation, as authorized by Corp C §§5332(a), 7333(a), and 9332(a). Corp C §5049. However, payments made to members or associated persons in some capacity other than as members, *e.g.,* as beneficiaries of a corporate program or as employees, are not distributions.

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§10.138 B. Distributions on Dissolution

For discussion of the rules governing distributions to members on winding up and dissolving the corporation, see §20.83.

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C. Restrictions on Distributions; Persons Liable for Violations

§10.139 1. Public Benefit Corporations Prohibited From Making Distributions

Distributions barred. Public benefit corporations are prohibited from making any distributions. Corp C §5410. Subject to the general rules governing a director's standard of care (Corp C §5231), directors who approve unlawful distributions are jointly and severally liable to the corporation (Corp C §5237(a)(1)-(2)).

Suit against recipient of unlawful distribution. A creditor, a director, the Attorney General, or, subject to the requirements of a derivative suit (see §10.136), a member, may bring an action in the corporation's name against the recipient of an unlawful distribution. Corp C §5420(a)-(b). The recipient may implead all other persons liable and, if the conduct of the person sued was not fraudulent, may compel contribution from such persons in the same or in an independent action. Corp C §5420(c).

Damages. The court may award damages in the amount of the wrongful distribution plus interest. In addition, the court may award punitive damages for the benefit of the corporation against any director, officer, member, or other person who with intent to defraud the corporation caused, received, or aided and abetted in making the distribution. Corp C §5420(b).

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§10.140 2. Mutual Benefit Corporations May Make Distributions in Certain Situations

When permitted. A mutual benefit corporation may make no distributions except on dissolution or the purchase or redemption of outstanding memberships. Corp C §7411. All distributions are prohibited if the corporation is unable (or if the transaction is likely to render it unable) to meet its obligations. Corp C §§7412-7413.

Suit against recipient of unlawful distribution. An action to enforce the liability of a recipient of an unlawful distribution may be brought in the corporation's name by any creditor whose debt or claim arose before the distribution occurred and who did not consent to it, whether or not the claim has been adjudged. Corp C §7420(a)-(c)(1). If the corporation is a subsidiary of a head organization and has an obligation to pay its assets to the head organization on dissolution (Corp C §7413), the head organization may bring suit in the name of the subsidiary against recipients of a distribution violating that obligation (Corp C §7420(c)(2)).

NOTE: The statute does not mention the corporation or its members as persons who may bring suit. However, the clear implication is that the corporation would have standing to sue because the statue states that the recipients of an illegal distribution are liable "to the corporation." Corp C §7420(a). See 3 Ballantine & Sterling, California Corporation Laws §408.03[2][a][ii] (4th ed 1962).

Liability requires knowledge that distribution improper. A person sued for receiving an unlawful distribution may implead all other persons who are liable and, if the conduct of the person sued was not fraudulent, may compel contribution in either the main action or an independent action. Corp C §7420(d). However, recipients are liable only if they had knowledge of facts indicating the impropriety of the distribution. Corp C §7420(a)-(b).

NOTE: The Nonprofit Mutual Benefit Corporation Law (Corp C §§7110-8910) is silent on punitive damages.

Director liability. Subject to the general rules on a director's standard of care (Corp C §7231), directors who approve unlawful distributions are jointly and severally liable to the corporation and to creditors who are entitled to sue recipients of the distribution. Corp C §7236(a).

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§10.141 3. Religious Corporations Prohibited From Making Distributions

Distributions barred. Religious corporations are prohibited from making any distributions. Corp C §5410 (made applicable to religious corporations by Corp C §9610(a)).

Suit against recipient of unlawful distribution. A creditor, a director, or the "authorized number of members" (Corp C §5036; see §10.37) may bring an action in the corporation's name against the recipient of an unlawful distribution. Corp C §9610(b). The recipient may implead all other persons liable and, if the conduct of the person sued was not fraudulent, may compel contribution in either the main action or an independent action. Corp C §5420(c) (made applicable to religious corporations by Corp C §9610(a)).

Damages. The court may award damages in the amount of the wrongful distribution plus interest. Corp C §5420(a) (made applicable to religious corporations by Corp C §9610(a)). In addition, the court may award punitive damages for the benefit of the corporation against any director, officer, member, or other person who caused, received, or aided and abetted in making the distribution with intent to defraud the corporation. Corp C §9610(b).

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§10.142 4. Suit Against Directors Who Approved Unlawful Distribution

Suit against directors. The same persons authorized to sue recipients of unlawful distributions are also empowered to sue the directors who approved the unlawful distribution. Thus, the directors may be sued by any creditor or director, the Attorney General, or, in a derivative suit (see §10.136), a member.

Damages. The damages recoverable from a director in an action brought under Corp C §5237, §7236, or §9245 are (see Corp C §§5237(d), 7236(d), 9245(c)):

- The amount of the illegal distribution;
- The fair market value of the distributed property at the time of the illegal distribution, if the illegal distribution consisted of property, plus interest from the date of the distribution at the legal rate on judgments until paid, plus all reasonably incurred costs of appraisal or other valuation, if any, of that property; or
- The loss suffered by the corporation as a result of the illegal loan or guaranty.

NOTE: In an action for the benefit of creditors of a mutual benefit corporation, the directors' liability is no more than the liability of the corporation to the nonconsenting creditors at the time of the distribution. Corp C §7236(d).

Impleader; subrogation. A director who is sued may implead all other directors who are liable and may compel contribution, either in the same action or in an independent action. Corp C §§5237(e), 7236(e), 9245(d). A director who is held liable for an unlawful distribution is subrogated to the corporation's rights against the recipients of the distribution and, if sued, may cross-complain against the recipients or bring an independent action against them based on the subrogation rights. Corp C §§5237(f), 7236(f), 9245(e).

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11

Property Tax Exemption for Nonprofit Organizations

William C. Choi

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Source: Business Law/Advising California Nonprofit Corporations/11 Property Tax Exemption for Nonprofit Organizations/§11.1 I. SCOPE OF CHAPTER

§11.1 I. SCOPE OF CHAPTER

This chapter covers the following property tax exemptions that are applicable to most tax-exempt organizations:

- Welfare exemption (see §§11.3-11.60).
- Church and religious exemption (see §§11.61-11.67).
- Museum, library, and educational exemption (see §§11.68-11.77).

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§11.2 II. OVERVIEW

Property taxable unless exempt. All property in California is taxable unless exempt under the laws of the United States or the California Constitution. Cal Const art XIII, §1; Rev & T C §201. Unless an exemption applies, property taxes are imposed on both real and tangible personal property at the rate of 1 percent of the assessed value plus the amount necessary to fund certain voter-approved obligations. Cal Const art XIIIA, §1 (real property tax rate); Cal Const art XIII, §2 (personal property rate may not exceed real property tax rate). The tax base is fixed on January 1 (referred to as the "lien date") of each year for the taxable year beginning the following July 1. Rev & T C §§401.3, 405, 2192. The tax base of real property is generally limited to its fair market value at the time of its acquisition adjusted by up to 2 percent per year for inflation. Cal Const art XIIIA, §2; Rev & T C §110.1. In contrast, the tax base of tangible personal property is its fair market value on January 1 of each year. Cal Const art XIII, §1; Rev & T C §110.

Exemptions from property tax. Numerous exemptions are contained in Cal Const art XIII, §§3-5 and Rev & T C §§201.1-241. Most exemptions apply either to property of a specific type or to property owned or used by certain types of individuals or organizations.

No exemption from special assessments. It should be noted that only taxes, as opposed to special assessments, are entitled to exemption. A tax is a levy on all property without regard to special benefits; a levy made only on land on the basis of benefits received is a special assessment. *Trumbo v Crestline Lake Arrowhead Water Agency* (1967) 250 CA2d 320, 322, 58 CR 538. "[E]xemptions of private property from taxation do not extend to special assessments, levied upon the basis of equivalent benefit, unless specifically so provided." *Cedars of Lebanon Hosp. v County of Los Angeles* (1950) 35 C2d 729, 747, 221 P2d 31.

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III. WELFARE EXEMPTION

§11.3 A. Background

Under Cal Const art XIII, §4(b), the legislature may exempt from taxation "[p]roperty used exclusively for religious, hospital, or charitable purposes and 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) no part of whose net earnings inures to the benefit of any private shareholder or individual." This provision was adopted by the voters as a constitutional amendment in 1944.

Under Rev & T C §214(a), "[p]roperty used exclusively for religious, hospital, scientific, or charitable purposes owned and operated by community chests, funds, foundations, limited liability companies, or corporations organized and operated for religious, hospital, scientific, or charitable purposes is exempt from taxation." The state legislature enacted this provision in 1945. In doing so, the legislature added a fourth purpose, *scientific*, to the three enumerated in the constitution and set forth numerous qualifying conditions.

Sections 11.4-11.53 of this chapter discuss the requirements for the welfare exemption; on the claims process for the welfare exemption, see §§11.54-11.60. For more detailed discussion, see State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption* (guide for nonprofit organizations that wish to file for property tax exemption through the welfare exemption), available on the BOE's website at http://www.boe.ca.gov/proptaxes/pubcont.htm. See also State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 (rev Oct. 2004).

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§11.4 B. Requirements for Exemption

California Constitution art XIII, §4(b) and Rev & T C §214(a) essentially impose three requirements to qualify for the welfare exemption:

(1) The entity seeking the exemption must be a qualifying organization (see §§11.5-11.13);

(2) The property must be both owned and operated by a qualifying organization (see §§11.14-11.18); and

(3) The property must be used exclusively for qualifying purposes (see §§11.19-11.53).

In addition, the interest must be recorded on the lien date in the office of the recorder of the county where the property is located. An entity's failure to establish the fact of recordation to the assessor constitutes a waiver of the exemption. Rev & T C §261(a).

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§11.5 1. Qualifying Organization

A qualifying organization must have qualifying purposes. See §11.6. A qualifying organization also may not be organized or operated for profit. See §11.7. Its earnings must not inure to the benefit of private shareholders or individuals. See §11.8. The organization documents must irrevocably dedicate the property to qualifying purposes. See §11.9. The organization itself also must be exempt from income taxation. See §11.12. Under certain circumstances, a limited liability company may be a qualifying organization. See §11.13.

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§11.6 a. Religious, Hospital, Scientific, or Charitable Purpose

The organization seeking the exemption must be one that is organized and operated for religious, hospital, scientific, or charitable purposes. Rev & T C §214(a). This chapter discusses the four types of qualifying purposes—religious, hospital, scientific, and charitable—in the context of what it means to use property for those purposes. See §§11.20-11.33. Charitable purposes include education purposes as defined in Rev & T C §214(j). See §11.28.

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§11.7 b. Not Organized or Operated for Profit; Safe Harbor for Hospitals

The organization may not be organized or operated for profit. Rev & T C §214(a)(1). California corporations must be organized under the Nonprofit Corporation Law (Corp C §§5000-10841). Foreign corporations must qualify under similar laws of their jurisdiction. Articles of incorporation, declarations of trust, or other organizational documents must indicate that the organization is not organized or operated for profit. The organization may use property to generate profit as long as the profit does not inure to the benefit of any private shareholder or individual (see §11.8) and the property is used in the actual operation of the exempt activity (see §§11.42-11.50). *Greek Theatre Ass'n v County of Los Angeles* (1978) 76 CA3d 768, 142 CR 919.

Safe harbor for hospitals. A safe harbor applies to a hospital if its operating revenues do not exceed 10 percent of its operating expenses for any year. Rev & T C §214(a)(1). A hospital exceeding the safe harbor may still qualify if it can show need for, *e.g.*, expansion or debt retirement. *Rideout Hosp. Found., Inc. v County of Yuba* (1992) 8 CA4th 214, 10 CR2d 141.

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§11.8 c. No Benefit to Private Individual

No private inurement. No part of the net earnings of the organization may inure to the benefit of any private shareholder or individual. Cal Const art XIII, §4(b); Rev & T C §214(a)(2). A similar provision prohibits use of the organization's property for the benefit of any private person. Rev & T C §214(a)(4). See §11.52. For example, compensation to insiders is scrutinized to ensure that it is not excessive. The BOE is required, as a basis for comparison, to use the amount paid for like services and salaries in comparable public or private institutions. Rev & T C §254.6(b)(1). Similarly, business transactions between the organization and an insider may be scrutinized to ensure that the terms are fair to the organization.

PRACTICE TIP: These provisions closely track the inurement/private benefit prohibition under IRC §501(c)(3). Thus, an organization that is careful to structure transactions on an arm's-length basis to avoid federal inurement/private benefit violations should be fine from a property tax perspective. For example, in *Scripps Clinic & Research Found. v County of San Diego* (1997) 53 CA4th 402, 415, 61 CR2d 756, the court found that a scientific research organization's licensing of its research to Johnson & Johnson on arm's-length, fair market terms and conditions did not result in a prohibited private benefit to Johnson & Johnson. Similarly, in *Greek Theatre Ass'n v County of Los Angeles* (1978) 76 CA3d 768, 783, 142 CR 919, the court held that the use of professional entertainers did not result in a private benefit to those entertainers when the record showed that they were paid at a fair market or below fair market rate.

Hospitals. If a qualifying organization enters into a contractual arrangement with a third party with payments based on a percentage of net earnings, the inurement issue is likely to come into play. However, when a hospital issued a promissory note with a stated interest rate, but payable only out of the net earnings of the hospital, the court held that inurement did not result. *St. Francis Mem. Hosp. v City & County of San Francisco* (1955) 137 CA2d 321, 290 P2d 275.

Cemeteries. In *Westminster Mem. Park v County of Orange* (1960) 54 C2d 488, 6 CR 775, a case involving the nonprofit cemetery exemption under Cal Const art XIII, §3(g), the California Supreme Court held that a "percentage of grave sales" contract entered into by the original landowners with the cemetery corporation did not result in the inurement of net earnings to the individuals.

CAUTION: In the context of the federal income tax exemption for cemeteries under IRC §501(c)(13), the federal courts have held that a "percentage of grave sales" contract results in the inurement of net earnings to individuals. See, *e.g., Restland Mem. Park v U.S.* (5th Cir 1975) 509 F2d 187; *Knollwood Mem. Gardens* (1966) 46 TC 764.

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Source: Business Law/Advising California Nonprofit Corporations/11 Property Tax Exemption for Nonprofit Organizations/§11.9 d. Acceptable Dissolution Clause and Statement of Irrevocable Dedication

§11.9 d. Acceptable Dissolution Clause and Statement of Irrevocable Dedication

To qualify for the welfare exemption, the property must be irrevocably dedicated to qualifying purposes, and, on the organization's liquidation, dissolution, or abandonment, the property must not inure to the benefit of any private person except a fund, foundation, or corporation organized and operated for a qualifying purpose. Rev & T C §214(a)(6). To meet these requirements, articles of incorporation or similar organizational documents must contain a statement that (Rev & T C §214.01; 18 Cal Code Regs §143(b)):

- The organization's property is irrevocably dedicated *only* to religious, hospital, scientific, or charitable purposes, and
- On dissolution, the organization's property is to be distributed *only* to a nonprofit entity organized and operated for religious, hospital, scientific, or charitable purposes. Rev & T C §214.01.

CAUTION: A dedication or dissolution clause that provides that the property is to be used for an "educational *or* charitable" purpose would not qualify since not all educational purposes are charitable purposes within the meaning of Rev & T C §214.

PRACTICE TIP: Practitioners seeking the welfare exemption for property owned by foreign (non-California) corporations should pay particular attention to whether the articles contain acceptable dedication and dissolution clauses, because the articles may not have been drafted with this issue in mind.

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§11.10 (1) BOE Irrevocable Dedication Clauses

The Board of Equalization (BOE) has promulgated the following examples of acceptable irrevocable dedication clauses (18 Cal Code Regs §143(c)(4)):

> Example No. 1: The property owned by this organization is irrevocably dedicated to charitable, scientific, hospital, or religious purposes.
>
> Example No. 2: The property owned by this organization is irrevocably dedicated to charitable and educational purposes meeting the requirements of Revenue and Taxation Code section 214.
>
> Example No. 3: The property owned by this organization is irrevocably dedicated to educational purposes as defined in Revenue and Taxation Code section 214, subdivision (j).
>
> Example No. 4: The property located in California owned by this organization is irrevocably dedicated to charitable, scientific, hospital, or religious purposes.
>
> Example No. 5: The property owned by this organization is irrevocably dedicated to charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code.
>
> Example No. 6: The property of this corporation is irrevocably dedicated to charitable purposes and no part of the net income or assets of this corporation shall ever inure to the benefit of any director, officer, or member thereof or to the benefit of any private person.

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§11.11 (2) Sample BOE Dissolution Clauses

The BOE also has promulgated these examples of acceptable dissolution clauses (18 Cal Code Regs §143(d)(3)):

Example No. 1: Upon the liquidation, dissolution or abandonment of this organization, its assets, remaining after payment or provision of payment of all debts and liabilities of this organization, shall be distributed to an organization organized and operated for a charitable, scientific, hospital, or religious purpose meeting the requirements of Revenue and Taxation Code section 214.

Example No 2: Upon the liquidation, dissolution or abandonment of this organization, the proceeds or assets related to property located in California, remaining after payment or provision of payment of all debts and liabilities of this organization, shall be distributed to an organization organized and operated for a charitable, scientific, hospital, or religious purpose meeting the requirements of Revenue and Taxation Code section 214.

Example No 3: Upon the liquidation, dissolution or abandonment of this organization, its assets, remaining after payment or provision of payment of all debts and liabilities of this organization, shall be distributed to an organization organized and operated exclusively for charitable and educational purposes meeting the requirements of Revenue and Taxation Code section 214.

Example No. 4: Upon the liquidation, dissolution or abandonment of this organization, its assets, remaining after payment or provision of payment of all debts and liabilities of this organization, shall be distributed to an organization organized and operated exclusively for educational purposes meeting the requirements of Revenue and Taxation Code section 214, subdivision (j).

Example No. 5: Upon the dissolution or winding up of the corporation, its assets remaining after payment, or provision for payment, of all debts and liabilities of this corporation shall be distributed to a nonprofit fund, foundation or corporation which is organized and operated exclusively for charitable purposes and which has established its tax exempt status under section 501(c)(3) of the Internal Revenue Code.

Example No. 6: Upon the dissolution or winding up of the organization, its assets remaining after payment or provision of payment of all debts and liabilities of this organization, shall be distributed to a nonprofit organization which is organized and operated exclusively for charitable purposes.

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§11.12 e. Must Be Exempt Organization

The organization must be qualified as an exempt organization under Rev & T C §23701d or IRC §501(c)(3). Rev & T C §214.8. This requirement was added by the legislature in 1973 to establish a clear baseline standard for property owners and assessors alike to look to in determining who might qualify for the welfare exemption. The legislature, however, recognized that the standards for exemption under IRC §501(c)(3) and Rev & T C §23701d are not identical to the standards established for the welfare exemption. Accordingly, Rev & T C §214.8 explicitly provides that it is not intended to enlarge the welfare exemption. Thus, recognition under IRC §501(c)(3) or Rev & T C §23701d is a necessary, but not sufficient, basis for qualification for the welfare exemption.

PRACTICE TIP: Organizations desiring to house property in a title-holding company under IRC §501(c)(2) or §501(c)(25) (which correspond to Rev & T C §23701h or §23701x) should consider the property tax implications before proceeding. Only IRC §501(c)(3) or Rev & T C §23701d organizations can qualify for the welfare exemption.

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§11.13 f. Limited Liability Companies May Qualify

Many nonprofits have expressed an interest in putting certain real and personal property into a limited liability company (LLC) with the goal of isolating the potential liabilities attributable to such property from the organization's other assets. For federal tax purposes, an LLC, the single member of which is an IRC §501(c)(3) organization, is treated as a division of such an organization. Treas Reg §301.7701-3(b). Thus, an organization putting property into an LLC is not required to obtain a separate tax exemption for the LLC or file tax returns for it.

Such federal treatment is not available to LLCs for California welfare exemption purposes. However, an LLC may be able to qualify for the California welfare exemption. Among other requirements, all the members of the LLC must be organizations that qualify for the welfare exemption. Rev & T C §214(a); BOE Property Tax Rule 136.

PRACTICE TIP: Although an LLC may qualify for the California welfare exemption, note that it does not qualify for the state franchise tax exemption. Thus, Rev & T C §§17941 and 17942 continue to impose the minimum franchise tax and the "LLC fee," respectively. An LLC may avoid these taxes by qualifying for exemption as a title holding company under Rev & T C §23701h or §23701x (see Rev & T C §17941(d)). A question exists regarding whether an LLC that otherwise qualifies for the welfare exemption (*e.g.*, when the single member is an IRC §501(c)(3) organization) would be disqualified by virtue of obtaining title-holding company status under state law. In an April 20, 2009 letter, BOE tax counsel opined that an LLC, the sole purpose of which is to hold title to real property on behalf of its qualifying member, may qualify for the welfare exemption provided that the requirements under BOE Property Tax Rule 136 are met. The opinion, however, is silent on whether such an LLC which has obtained the franchise tax and LLC fee exemption under Rev & T C §23701h or §23701x would still qualify. See BOE Staff Opinion Letter (Apr. 20, 2009), available on the BOE website at http://www.boe.ca.gov/proptaxes/pdf/880_0148.pdf.

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§11.14 2. Property Owned and Operated by Qualifying Organization

Property must be both owned and operated by a qualifying organization. Rev & T C §214(a). Note, however, that the owner and operator need not be the same legal entity. As long as each qualifies for the exemption, the owner and operator may be two different entities. *Christ the Good Shepherd Lutheran Church v Mathiesen* (1978) 81 CA3d 355, 146 CR 321. But if the property is leased, the lessee must be a qualifying organization, must use the property for qualifying purposes, and must separately file a claim for exemption. See §§11.15-11.18. Although such property may be leased at fair market value, leases that are intentionally profit-making or commercial in nature do not qualify.

NOTE: BOE staff at one time took the position that property (1) acquired by a qualifying organization specifically to lease to another qualifying organization, or (2) for which the rent charged was greater than 10 percent over and above all operating costs, was intentionally profit-making or commercial in nature. Property Taxes Law Guide, Annos 880.0125 (Feb. 9, 1979). This Annotation, however, was "deleted" by the BOE in 2006. Although the Annotation no longer represents the position of BOE staff, some county assessors appear to continue to be influenced by the Annotation when challenging fair market value leases of property by one qualifying organization to another.

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§11.15 a. Property Operated by Nonqualifying Organization

Property owned by a qualifying organization but leased to a for-profit organization does not qualify for the exemption under Rev & T C §214(a). Thus, for example, commercial real property donated to a qualifying organization would not qualify for the exemption if the property is leased to for-profit organizations.

EXAMPLE: Qualifying organization purchases an office building that is intended to be used by the organization for its exempt activities. Initially, however, portions of the building will be leased to both qualifying and nonqualifying entities. Each year the qualifying organization-owner and each of the qualifying organization-lessees must file the application for welfare exemption with respect to the portion of the building used for qualifying purposes. No exemption will be permitted for the portion of the building used by nonqualifying entities.

PRACTICE TIP: Qualifying organizations receiving a bequest of property must ensure that a change in ownership with respect to the property was reported to the county assessor at the time of the donor's death. It is not uncommon for the administration of complicated estates and trusts to take up to 5 years or longer before the property is distributed to the qualifying organization. An unreported change in ownership (which would have resulted in a higher assessed value and, therefore, higher taxes) could result in the qualifying organization receiving property that is subject to several years of unpaid property taxes.

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§11.16 b. Property Owned by Nonqualifying Organization

Welfare exemption for personal property. If the operator of the property is a qualifying organization, but the owner of the property is not a qualifying organization, the exemption for the real property is denied. Rev & T C §214(a). The qualifying operator, however, is entitled to the welfare exemption on all personal property owned by it and used for exempt purposes.

EXAMPLE: Qualifying organization has a 40-year lease of the land from a nonqualifying person, owns the building on the land and uses the land and building for charitable purposes. The assessed value of the land would not be exempt because it is owned by a nonqualifying person. See §11.17. However, the value of the building and personal property owned and used by the qualifying organization for qualifying purposes would be exempt. *J. Paul Getty Museum v County of Los Angeles* (1983) 148 CA3d 600, 195 CR 916.

Other exemptions. Although a qualifying operator of the real property could not qualify for the welfare exemption if the owner does not qualify, the operator may be able to obtain one of the other exemptions available under Cal Const art XIII, §3(d), (f), for certain free libraries, free museums, public schools, colleges, and churches. Unlike the welfare exemption, these exemptions look solely to the use of the property and not ownership. See §§11.62-11.75.

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§11.17 c. Long-Term Leases

A long-term lease of real property that might imbue the lessee with ownership characteristics in other contexts—*e.g.,* creation of a 35-year leasehold interest that is treated as a change in ownership for property tax reassessment purposes under Rev & T C §61(c)(1)—does not result in the lessee being treated as the "owner" for welfare exemption purposes. If property reverts to the nonqualifying owner after the lease term, the reversion violates the irrevocable dedication requirement of Rev & T C §214(a)(6). See §11.9. Also, the requirement that the interest of the claimant be recorded with the county as of the lien date, *i.e.,* January 1 of each year, is not met in the case of long-term leases. Rev & T C §261(a). An exception to the foregoing rule applies when a qualifying organization holds a taxable possessory interest. See §11.18.

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§11.18 d. Possessory Interests

In certain cases, the leasehold interest on otherwise exempt property (*i.e.,* property owned by the federal, state, or local government) may be separately valued and assessed for property tax purposes. Rev & T C §107. See Ehrman & Flavin, *Taxing California Property* (4th ed 2008). In these cases, if the possessory interest is held by a qualifying organization and used for qualifying purposes, that possessory interest may be entitled to the welfare exemption. Rev & T C §261(c); *Greek Theatre Ass'n v County of Los Angeles* (1978) 76 CA3d 768, 142 CR 919 (holder of taxable possessory interest in outdoor theater in city park eligible for exemption); *Tri-Cities Children's Ctr., Inc. v Board of Supervisors* (1985) 166 CA3d 589, 212 CR 541 (organization operating nursery school on local school district property eligible for exemption).

PRACTICE TIP: Qualifying organizations leasing property from the government should make sure to obtain a welfare exemption for the value of the possessory interest. In lieu of the recordation requirement under Rev & T C §261(a), the claimant organization is required to file with the county assessor a copy of the document giving rise to the possessory interest. Rev & T C §261(c).

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§11.19 3. Exclusive Use for Qualifying Purposes

Exempt property must be used for specified qualifying purposes. See §§11.20-11.33. The use must be exclusive. See §§11.34-11.38. The property must be in use on the January 1 lien date or under construction. See §§11.39-11.41. The property must be used for actual operation of the exempt activity and reasonably necessary to accomplishment of the qualifying purpose. See §§11.42-11.50. Specified uses are expressly not permitted. See §§11.52-11.53.

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§11.20 a. Qualifying Purposes

Neither Cal Const art XIII, §4(b), nor Rev & T C §214(a) specifically define the four qualifying purposes—religious, hospital, scientific, and charitable. As a result, the courts have defined these terms for welfare exemption purposes. See §§11.21-11.33.

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§11.21 (1) Religious

Religious purpose defined. A religious purpose is broadly defined to include almost any belief, cult, or system, irrespective of whether it involves belief in a Supreme Being. "Religion simply includes: (1) a belief, not necessarily referring to supernatural powers; (2) a cult, involving a gregarious association openly expressing the belief; (3) a system of moral practice directly resulting from an adherence to the belief; and (4) an organization within the cult designed to observe the tenets of the belief. The content of the belief is of no moment." *Fellowship of Humanity v County of Alameda* (1957) 153 CA2d 673, 693, 315 P2d 394; see *Friedman v S. Cal. Permanente Med. Group* (2002) 102 CA4th 39, 47, 125 CR2d 663.

Church exemption. Moreover, a religious organization that does not qualify for the welfare exemption because it does not own the property in question (see §11.14) may be able to qualify for the church exemption. The benefit of the church exemption is that property used, but not owned, by a church may qualify for the exemption. See §§11.62-11.66.

Church property also may qualify for the religious exemption. See §11.67.

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§11.22 (2) Hospital

"Hospital" defined. A hospital is defined as a service organization that serves patients, doctors, and the public; a place where the patient, whether poor or rich, can be treated under ideal conditions; and where rooms, special diets, and X-ray, laboratory, surgery, and a "multitude of other services and equipment" are available. *Cedars of Lebanon Hosp. v County of Los Angeles* (1950) 35 C2d 729, 735, 221 P2d 31. Certain outpatient clinics and hospital support organizations also may qualify as hospitals. See §§11.23-11.24.

Health care organization as charitable organization. When a health care organization cannot qualify for the welfare exemption as a hospital, as an outpatient clinic, or as a hospital support organization, it can seek to qualify as a charitable organization. A health care organization seeking exemption in this manner, however, must be prepared to provide the BOE or assessor with a schedule or list of donations and grants received, services or programs provided to the public on a sliding fee schedule or at no charge, the number of patients who were provided services at full cost versus reduced or no cost, and the organization's charity care policies. State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267, p 5 (rev Oct. 2004).

Whether a health care organization must provide substantial services for free or below fair market value to qualify as a "charitable" organization is open to debate. In *Lundberg v County of Alameda* (1956) 46 C2d 644, 649, 298 P2d 1, the court held that the term "charity" includes a purpose to relieve others from disease, suffering, or constraint. See §11.26. Under trust law, charitable purposes include the promotion of health. Restatement (Second) of Trusts §§368, 372 (1959). There does not appear to be an additional requirement that the goods or services be provided for free or below fair market value to qualify in order for the activity to qualify as "charitable." This issue has not yet been tested in the courts.

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§11.23 (a) Outpatient Clinics

Outpatient clinics. Revenue and Taxation Code §214.9 expands the definition of "hospital" to include certain outpatient clinics. Section 214.9 provides that the following outpatient clinics qualify as hospitals:

- Clinics that furnish or provide psychiatric services for emotionally disturbed children; and
- Clinics that are nonprofit multispecialty clinics described in Health & S C §1206(*l*).

NOTE: The definition of "hospital" does not include portions of an outpatient clinic that may be leased or rented to a physician for an office for the general practice of medicine.

Nonprofit multispecialty clinics. Health and Safety Code §1206(*l*) enumerates a number of conditions a clinic must meet to qualify as a nonprofit multispecialty clinic. Among these are the requirement that the clinic be operated by a nonprofit corporation qualifying for exemption under IRC §501(c)(3), and which has at least 40 physicians representing ten or more board-certified specialties. The only decision addressing multispecialty clinics is a BOE decision, *Matter of St. Jude Hosp. Yorba Linda, dba St. Jude Heritage Health Found*. (May 7, 1997, Appeal No. 97-005), discussed in State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 35 (rev Oct. 2004). There, the five-member Board ruled that a single, integrated clinic operating at different sites did not need to meet the requirements of Health & S C §1206(*l*) on a site-by-site basis.

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§11.24 (b) Hospital Support Organizations

Revenue and Taxation Code §214.11 provides that property owned and operated by a nonprofit organization shall be deemed used for a hospital purpose if it is used exclusively to meet the needs of a hospital that qualifies for the exemption under Rev & T C §214. There is some disagreement between the BOE and assessors on the one hand and nonprofit organizations on the other about what this provision means. The general position taken by the BOE and assessors is that Rev & T C §214.11 applies to nonprofit organizations providing nonmedical support services to a hospital, such as purchasing, food services, laundry, collections, and waste disposal. See State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption*. Nonprofit organizations, on the other hand, believe that nonprofit corporations that own and operate stand-alone facilities such as chemical laboratories, dialysis or magnetic resonance imaging (MRI) facilities, or skilled nursing facilities also should qualify under Rev & T C §214.11. More often than not, these organizations are a part of an integrated health care system that includes hospitals.

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§11.25 (3) Scientific

Scientific organizations. A scientific organization, in addition to meeting all other requirements for a qualifying organization, must be chartered by Congress, unless the scientific purpose is medical research. Moreover, the organization's objectives must be "the encouragement or conduct of scientific investigation, research, and discovery for the benefit of the community at large." Rev & T C §214(a)(7).

NOTE: The BOE takes the position that real property owned by a qualifying scientific research organization may be exempt only if it is also used for religious, hospital, or charitable purposes. Noting that Cal Const art XIII, §4(b), does not include a scientific purpose and that the scientific purpose was added by the legislature when it enacted Rev & T C §214, the BOE believes that the legislature was authorized to expand on the property tax exemptions provided by the California Constitution only with respect to personal property and not real property, citing Cal Const art XIII, §2. See State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 10 (rev Oct. 2004). See also Ehrman & Flavin, *Taxing California Property* (4th ed 2008) (confirming view that legislative authority to exempt real property must derive from California Constitution).

Educational-charitable institutions. Finally, it might be possible for scientific research organizations that are not chartered by the Congress and do not have the purpose of medical research to qualify for the welfare exemption as an educational-charitable institution. It is well established that an educational activity that provides a broad community benefit may qualify as a charitable purpose. See §§11.26-11.28. Thus, a nonprofit scientific research organization that routinely publishes the results of research in a nonmedical, scientific field for the benefit of the public potentially could qualify for the welfare exemption as a charitable organization.

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§11.26 (4) Charitable

A charitable purpose is broadly defined by a community benefit test developed in the context of educational activities and can be considered a "catch-all" category for the welfare exemption. See §11.27. The legislature has further defined charitable purposes to include specified educational purposes and activities. See §§11.28-11.29. Not all educational activities, however, are considered charitable activities for purposes of the welfare exemption. See §11.30. Noneducational activities also may qualify under the community benefit test. See §§11.31-11.33.

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§11.27 (a) Community Benefit Test

"Charity" defined. The term "charity" has been defined as "a gift to be applied consistently with existing laws, for the benefit of an indefinite number of persons—either by bringing their hearts under the influence of education, or religion, by relieving their bodies from disease, suffering, or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works, or otherwise lessening the burdens of government." *Lundberg v County of Alameda* (1956) 46 C2d 644, 649, 298 P2d 1, quoting *Estate of Halm* (1925) 196 C 778, 781, 239 P 307. In *Stockton Civic Theatre v Board of Supervisors* (1967) 66 C2d 13, 22, 56 CR 658, the court added that "charitable activity must benefit the community as a whole or an unascertainable and indefinite portion thereof." The court further established that the term "charitable" should be broadly construed in favor of the welfare exemption. 66 C2d at 18. See *J. Paul Getty Museum v County of Los Angeles* (1983) 148 CA3d 600, 606, 195 CR 916.

NOTE: The BOE takes the position that an organization's ability to attract charitable contributions from the public is an "important criteria by which its charitable purpose can be demonstrated." Recognizing, however, that neither Cal Const art XIII, §4(b), nor Rev & T C §214 establishes this criteria as a necessary element of the welfare exemption, the BOE points out the "absence of donations, by itself, will not result in a determination that a charitable purpose does not exist if it can be shown that the organization is providing a benefit or gift to the community." State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 5 (rev Oct. 2004).

Community benefit. The organizations in *Lundberg* (nonprofit schools of less than collegiate grade) and *Stockton Civic Theatre* (community theater group) were both recognized by the California Supreme Court as educational organizations that met the requirements for charity. More recently, in *Greek Theatre Ass'n v County of Los Angeles* (1978) 76 CA3d 768, 142 CR 919, the court ruled that the professional presentation of operas, concerts, and other performances was a charitable-educational activity that benefited the community as a whole. In *J. Paul Getty Museum v County of Los Angeles, supra,* the court held that providing a cultural, educational, and recreational resource to southern Californians by displaying Greek and Roman antiquities, renaissance paintings, and 17th and 18th century decorative arts benefited the community as a whole.

NOTE: The BOE legal staff's historic interpretation of the "community benefit" test has been to define the relevant community that must be benefited as the State of California. In practice, that has meant that the qualifying organization must benefit some Californians in order to satisfy the "community benefit" test, and an organization could not qualify for the welfare exemption if "substantially all" its activities benefit persons outside of California. Taxpayers, however, have argued for a broader definition of "community" to include out-of-state and international activities. Among other arguments, taxpayers have pointed out that the current narrow interpretation of "community" violates the Commerce Clause of the United States Constitution because it discriminates against out-of-state commerce by giving a tax benefit only to in-state activities.

Community benefit limited by state boundaries. The elected members of the BOE directed BOE staff to review their policy regarding the community benefit test for the welfare exemption. At a July 17, 2007, meeting, the members heard discussions regarding the feasibility of expanding the test to include nonprofit organizations that own property in California but whose charitable activities solely benefit persons outside of California. After several additional hearings, including those in which testimony from interested parties was heard the Board voted at a March 19, 2008, meeting to retain the current definition of the term "community." For further discussion of this issue, see Letter to Assessors No. 2008/034 (May 2, 2008), available on the BOE website at http://www.boe.ca.gov/proptaxes/2008.htm.

Charging of fees not determinative. It is well settled that neither financial nor other limitations determine whether a benefit is conferred on the general community. Thus, a court rejected the assertion that the high cost of transportation to the island and the applicable fees created a recreational park for the elite rather than a gift to the community. *Santa Catalina Island Conservancy v County of Los Angeles* (1981) 126 CA3d 221, 241, 178 CR 708. A charitable purpose

may exist despite the fact that an organization charges for the use of its property, provided that the those costs are used solely to help defray the costs of operation of the exempt activity and the property is used in connection with an exempt purpose. *Peninsula Covenant Church v County of San Mateo* (1979) 94 CA3d 382, 398, 156 CR 431.

Factors. Two dependent factors inform the court's determination: the nature of the use of property, and the degree to which the activity is open to the community as a whole. If the activity is one that is deemed particularly necessary to the welfare of the community (or is a service that the government otherwise would be compelled to provide for the community, such as a hospital or elementary school), that activity may be considered a charitable purpose even though only a small number of people are directly benefited. However, if the activity serves educational or humanitarian goals and is open to all or virtually all of the community, that activity may be exempt even though it is not a necessary activity in the same sense as the institution's primary purpose. 94 CA3d 382, 399. Thus, if an institution serves an interest historically regarded as being closely tied to the public welfare, the courts may require no more than indirect public benefit, such as possible tax savings. In contrast, if the institution's purpose has received relatively little recognition in judicial decisions and governmental programs, the courts will require a more direct and demonstrable benefit to the community at large. *Clubs of Cal. for Fair Competition v Kroger* (1992) 7 CA4th 709, 715, 9 CR2d 247.

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Source: Business Law/Advising California Nonprofit Corporations/11 Property Tax Exemption for Nonprofit Organizations/§11.28 (b) Qualifying Educational Activities

§11.28 (b) Qualifying Educational Activities

Under Rev & T C §214(j), charitable purposes include educational purposes and activities that:

- Benefit the community as a whole, or an unascertainable and indefinite portion of the community;
- Include the study of relevant information, the dissemination of that information to interested members of the general public, and the participation of such interested members of the general public; and
- Are not primarily for the benefit of the organization's shareholders.

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Source: Business Law/Advising California Nonprofit Corporations/11 Property Tax Exemption for Nonprofit Organizations/§11.29 (c) Property Used for Educational Broadcasting

§11.29 (c) Property Used for Educational Broadcasting

An educational television station owned by a qualified organization that receives at least 25 percent of its operating expenses as contributions from the general public or dues from members may qualify for the welfare exemption. Rev & T C §§214(d), 225.5(a). Property used exclusively for noncommercial educational FM broadcast stations also qualifies. Rev & T C §225.5(b). On personal property used in producing educational television programs, see Rev & T C §215.5.

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§11.30 (d) Nonqualifying Educational Activities

No benefit to community as a whole. Cases denying exemption to property used by certain educational organizations have turned on the community benefit doctrine, *i.e.*, the courts ruled in those cases that the course of study offered by the organization did not benefit the community as a whole. For example, in *California College of Mortuary Science v County of Los Angeles* (1972) 23 CA3d 702, 100 CR 558, the appellate court ruled that an accredited junior college for morticians and funeral directors did not benefit the community as a whole, but benefited only the funeral service industry. Similarly, in *Alcoser v County of San Diego* (1980) 111 CA3d 907, 169 CR 91, the court ruled that a construction industry vocational training school operated under a trust created by a labor union and construction industry employers did not benefit the community as a whole, because the school gave priority to union members and to persons recommended by the employers, and sought to obtain jobs for graduates exclusively with those employers.

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§11.31 (e) Homes for the Aged

Homes for the aged may qualify for the welfare exemption, even if the occupants are not financially needy. However, the home must serve the occupants' needs, the alleviation of which constitutes a worthy social value. See *Fredericka Home for the Aged v County of San Diego* (1950) 35 C2d 789, 221 P2d 68; *Fifield Manor v County of Los Angeles* (1961) 188 CA2d 1, 10 CR 242. But see *Martin Luther Homes v County of Los Angeles* (1970) 12 CA3d 205, 90 CR 524 (housing for aged not exempt when rent was not adjusted according to need, neither life care contracts nor medical, hospital, or dental facilities were provided, and units were not specially equipped for the aged).

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§11.32 (f) Preservation of Nature

Property used exclusively to preserve native plants or animals, biotic communities, geological or geographical formations of scientific or educational interest, and open-space land used solely for recreation and enjoyment of scenic beauty, if they are open to the general public (subject to reasonable restrictions because of the needs of the land), are deemed to be within the exemption under Cal Const art XIII, §4(b), and Rev & T C §214. Rev & T C §214.02. The property must be owned and operated by a scientific or charitable fund, foundation, or corporation, the primary interest of which is to preserve those natural areas and that meets all the requirements of Rev & T C §214. Rev & T C §214.02.

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§11.33 (g) Other Qualifying Activities

The decisions discussed in §11.27 established the community benefit test in the context of educational activities. The California Supreme Court has noted, however, that "the word 'charitable' encompasses a wide range of activities beneficial to the community." *Stockton Civic Theatre v Board of Supervisors* (1967) 66 C2d 13, 20, 56 CR 658. Thus, the community benefit test has been used in other contexts to find other activities within the definition of "charity."

Preservation of island for recreational purposes. In *Santa Catalina Island Conservancy v County of Los Angeles* (1981) 126 CA3d 221, 242, 178 CR 708, the court held that the use of the island for recreational purposes for the benefit of hundreds of thousands of visitors each year constituted a benefit to the community as a whole or to an unascertainable and indefinite portion thereof. Moreover, the preservation of the plant, animal, and other natural features of the island provided a benefit to society as a whole. 126 CA3d at 242. Thus, the property qualified for the welfare exemption under Rev & T C §214.02. See §11.32.

Museums. In *J. Paul Getty Museum v County of Los Angeles* (1983) 148 CA3d 600, 607, 195 CR 916, the court held that by displaying its art work and generally carrying on the work of a museum, the Getty Museum "provides a cultural, educational and recreational resource to all the people of Southern California."

NOTE: The exemption sought by the Getty Museum was on the main museum building which was under construction during the tax year in issue. Buildings under construction may be exempt under the welfare exemption (see §11.41) but are not exempt under the museum exemption (see §§11.68-11.71).

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§11.34 b. Property Used Exclusively for Qualifying Purposes

Under Rev & T C §214(a), exempt property must be used exclusively for qualifying purposes. "Exclusive use" has been defined to include use "incidental to and reasonably necessary for" the qualifying purpose. See §§11.35-11.37. "Occasional use" for nonqualifying purposes also may be permitted. See §11.38. Property used exclusively to meet the needs of a hospital is considered used exclusively for hospital purposes. See §11.24.

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§11.35 (1) "Exclusive Use" Defined: Incidental and Reasonably Necessary Standard

In *Cedars of Lebanon Hosp. v County of Los Angeles* (1950) 35 C2d 729, 221 P2d 31, decided shortly after the enactment of the welfare exemption, various hospitals applied for and obtained the welfare exemption with respect to most of the hospital property. The assessor, however, refused to grant an exemption on some 5-10 percent of the property on the ground that that portion was being used for nonexempt purposes, such as property used for a nurses training school, housing for certain essential employees of the hospital, a tennis court for the employees, and a hospital thrift shop. After establishing that the language of Rev & T C §214 must be strictly, but reasonably, construed, the court concluded that the phrase "property used exclusively for hospital purposes" should be held to include "any property which is used exclusively for any facility which is incidental to and reasonably necessary for the accomplishment of hospital purposes; or, in other words, for any facility which is reasonably necessary for the fulfillment of a generally recognized function of a complete modern hospital." 35 C2d at 736. Using this standard, the court held that the property used for training nurses, the housing of essential staff, and the tennis courts used primarily by hospital staff were exempt "hospital" property. The hospital thrift shop, however, was deemed an independent undertaking to raise revenue and, thus, was not "incidental to and reasonably necessary for" the accomplishment of hospital purposes. 35 C2d at 745.

Following the "incidental to and reasonably necessary for" standard set by *Cedars of Lebanon,* courts have held that property with certain types of uses qualified for the exemption while property with other uses did not. See §§11.36-11.37. For discussion of fundraising activities, see §§11.44-11.50.

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§11.36 (a) Cases Finding Property to Be Exempt Under Incidental and Reasonably Necessary Standard

The following property has been determined to be exempt:

- YMCA dormitory rooms rented to young men were incidental to its charitable purpose of promoting the welfare of young men and boys. *YMCA v County of Los Angeles* (1950) 35 C2d 760, 221 P2d 47.
- Living quarters for priests and lay brothers whose presence on the property was essential to the carrying on of the organization's religious and charitable activities constituted incidental and necessary facilities. *Serra Retreat v County of Los Angeles* (1950) 35 C2d 755, 221 P2d 59.
- The use of part of a large land conservancy for public hiking, fishing, motor tours, and hunting did not affect its exempt status when these activities were reasonably necessary and incidental to the organization's exempt purpose of preserving hundreds of diverse plant, animal, and biotic communities, and the conservancy was actively engaged in their protection. *Santa Catalina Island Conservancy v County of Los Angeles* (1981) 126 CA3d 221, 178 CR 708.
- A bar maintained within a theater and open only to persons admitted to performances was reasonably necessary for the fulfillment of a generally recognized function of a complete modern theater and, therefore, exempt. *Greek Theatre Ass'n v County of Los Angeles* (1978) 76 CA3d 768, 780, 142 CR 919.

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§11.37 (b) Cases Finding Property to be Nonexempt Under Incidental and Reasonably Necessary Standard

The following property has been determined to be nonexempt:

- Portions of YMCA property devoted to a restaurant, a barbershop, a valet shop, and a gym store, all of which were open to the public as well as to YMCA members, were largely commercial in nature, and not incidental and reasonably necessary for the accomplishment of exempt purposes. *YMCA v County of Los Angeles* (1950) 35 C2d 760, 773, 221 P2d 47.
- A swimming pool, tennis courts, locker rooms, and sauna owned by a church did not qualify as property used for religious purposes when the use was primarily recreational and the primary users of these facilities were nonmembers. *Peninsula Covenant Church v County of San Mateo* (1979) 94 CA3d 382, 394, 156 CR 431.

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§11.38 (2) "Occasional Use" for Nonqualifying Purposes

Some incidental use permitted. The courts further liberalized the "exclusive use" test by holding that qualifying property could be used on an "occasional" basis for uses that are not within the exempt purpose and activity. In *Fellowship of Humanity v County of Alameda* (1957) 153 CA2d 673, 699, 315 P2d 394, the court held that if the primary use of the property is for qualifying purposes, then it would be "extremely liberal in holding that some incidental use does not take it out of the exemption." Accordingly, the court found that occasional use of church property for social activities did not disqualify the property from the church exemption. See §§11.62-11.66. Similarly, in *Peninsula Covenant Church v County of San Mateo* (1979) 94 CA3d 382, 393, 156 CR 431, although the court found that the church-owned recreational facilities were primarily used by nonmembers and, thus, not exempt, the church's community center building qualified for the welfare exemption because it was primarily used by members.

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§11.39 c. Property in Use on January 1 Lien Date

Property must actually be in use for qualifying purposes on the January 1 lien date to qualify for the welfare exemption. See §11.40. Property under construction may qualify as property in use. See §11.41.

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§11.40 (1) Unused Property

Vacant lots, unused buildings, or even an unused portion of a building do not qualify for the exemption. See *First Baptist Church v County of Los Angeles* (1952) 113 CA2d 392, 248 P2d 101 (lot with cornerstone for new building did not qualify for church exemption). This restriction does not mean that property must be in continuous use throughout the year to qualify for the exemption. In *San Francisco Boys' Club v County of Mendocino* (1967) 254 CA2d 548, 553, 62 CR 294, for example, the court held that property used as a boys' camp only during the summer months qualified. This restriction also does not mean that unimproved property will never qualify for the welfare exemption. Unimproved property can be used for a charitable purpose. For example, if held as a park or a nature trail, it might qualify if all of the other requirements of the welfare exemption are met. Rev & T C §214.02. See §§11.32, 11.43.

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§11.41 (2) Property Under Construction

California Constitution art XIII, §5, provides an exemption for "buildings under construction, land required for their convenient use, and equipment in them if the intended use would qualify the property for exemption." This provision is implemented by Rev & T C §§214.1-214.2.

Section 214.1 provides that property used exclusively for religious, hospital, or charitable purposes include "facilities in the course of construction" together with the land on which the facilities are located. Section 214.2(a) provides that "facilities in the course of construction" includes the demolition or razing of a building with the intent to replace the building with a facility to be used for qualifying purposes.

NOTE: The BOE notes that "facilities in the course of construction" must have "activity connected with the construction or rehabilitation of a new or existing building or improvement that results in physical changes visible to any person inspecting the site where the building or improvement is located." State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 27 (rev Oct. 2004), citing *National Charity League v County of Los Angeles* (1958) 164 CA2d 241, 330 P2d 666.

The requirement that a tax assessment must be made within 4 years after July 1 of the assessment year in which the property escaped taxation or was under-assessed (Rev & T C §532) does not apply to property to which the welfare exemption was granted while the property was in the course of construction if (1) the construction is later abandoned or (2) on completion of construction, the property or a portion of the property is used for other than religious, hospital, or charitable purposes (Rev & T C §532.2). The assessor will assess as escaped property that portion of the property not used for religious, hospital, or charitable purposes. Rev & T C §532.2(b). Construction is not deemed to be abandoned if it is delayed due to reasonable causes and circumstances beyond the organization's control that occur despite the exercise of ordinary care and the absence of willful neglect. Rev & T C §214.2(b).

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§11.42 d. Property Used for Actual Operation of Exempt Activity and Reasonably Necessary to Accomplishment of Exempt Purpose

The property must be used for the actual operation of the exempt activity and must not exceed the amount of property reasonably necessary to the accomplishment of the exempt purpose. Rev & T C §214(a)(3). The "actual operation" requirement generally overlaps the "use" requirements discussed above, *i.e.,* that the property must be used exclusively for qualifying purposes and that it be in actual qualifying use on the lien date. See §11.43. Property used in certain fundraising activities, however, may not qualify. See §§11.44-11.48.

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§11.43 (1) In General

Actual operation requirement liberally construed. As discussed in §§11.34-11.41, courts generally have been liberal in finding that property is used for qualifying purposes if it is incidental to and reasonably necessary for the carrying on of the exempt purpose. Thus, in *San Francisco Boys' Club v County of Mendocino* (1967) 254 CA2d 548, 553, 62 CR 294, nearly 2000 acres of land used for roads and trails that were not a part of the main campground were nevertheless deemed necessary for the exempt purpose and used in the actual operation of the camp. In *Santa Catalina Island Conservancy v County of Los Angeles* (1981) 126 CA3d 221, 245, 178 CR 708, 42,000 acres maintained by the organization for conservation/preservation purposes were deemed property used for the actual operation of the organization. The decision was based in part on Rev & T C §214.02, which specifically provides that land owned and operated by a qualifying organization exclusively for nature preservation purposes qualifies for the welfare exemption. See §11.32.

Reasonably necessary standard. Similarly, in determining whether the property used by the organization exceeds what is reasonably necessary to accomplish the exempt purpose, the courts generally have respected the determination of the organization. In *Christward Ministry v County of San Diego* (1969) 271 CA2d 805, 811, 76 CR 854, the court suggested that even land used as a "buffer zone" to protect participants on a religious retreat facility from the "outside world" reasonably could be used to accomplish the exempt purpose.

EXAMPLE: These issues were raised in an unpublished opinion of the California Court of Appeals, Second Appellate District, in *Soka Univ. of America v County of Los Angeles and State Bd. of Equalization* (July 9, 2008, B193955; not certified for publication) 2008 Cal App Unpub Lexis 5526. In reversing the trial court's granting of summary judgment in favor of Soka University on this issue, the court found that the evidence presented no facts concerning whether each of the various parcels of property used by the university was used for the actual operation of the exempt activity, and whether each parcel of property did not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose. "Merely describing the activities conducted on a parcel of property—to give two examples, 'nature classes and activities; open space and community access' or 'Master's Program; ESL Program; botanical reserve; nature classes and activities; campus walks; open space and community access'—provides no evidence of whether the parcel was used exclusively for educational purposes, and does not address the key issue of whether each parcel of property did 'not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose.' " 2008 Cal App Unpub Lexis 5526, *41.

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§11.44 (2) Fundraising Activities

Commercial activities not exempt. The "exclusive use" and "actual operation" requirements of Rev & T C §214(a)(3) have resulted in the courts taking the position that property used in fundraising activities that are commercial in nature and in competition with business enterprises do not qualify for the exemption. See, *e.g., Cedars of Lebanon Hosp. v County of Los Angeles* (1950) 35 C2d 729, 745, 221 P2d 31 (portion of hospital property used for thrift shop denied exemption); *YMCA v County of Los Angeles* (1950) 35 C2d 760, 773, 221 P2d 47 (portion of YMCA property used for barbershop, tailor shop and restaurant denied exemption because uses competed with similar businesses and were commercial in nature).

Competition with taxable businesses. The BOE has applied the commerciality doctrine in *Matter of the Monterey Bay Aquarium Found*. (July 26, 1988, Appeal No. 87-07) and *Matter of the Crystal Cathedral of the Reformed Church in America* (Feb. 29, 1984) (discussed in State Board of Equalization, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 53 (rev Oct. 2004)) to deny the exemption with respect to portions of those organizations' property. In the *Monterey Bay Aquarium* case, a portion of the aquarium was used for a restaurant and a bookstore. The BOE held that such uses did not qualify for the exemption because they unfairly competed against taxable business enterprises. Similarly, the BOE held that the Crystal Cathedral's systematic renting of certain of its properties for secular concerts and corporate events resulted in unfair competition with taxable organizations renting similar venues.

In another case, in an advisory opinion issued by the BOE legal staff in connection with fundraising activities on the San Diego Aircraft Carrier Museum (*USS Midway*), staff counsel opined that when the museum actively marketed itself for corporate events and 135 such events took place in one calendar year, the parts of the museum used for those events did not qualify for the welfare exemption. See BOE Letter to Chief Assessor of San Diego County (Dec. 1, 2006), available at http://www.boe.ca.gov/proptaxes/pdf/880_0099.pdf.

PRACTICE TIP: Care should be taken to delineate the areas where nonqualifying activities take place. In the *USS Midway* case, for example, only areas used for the nonqualifying activities were deemed taxable. Common areas, such as the parking lot, elevators, and restrooms, also were deemed taxable because those areas necessarily were used for the corporate events and, thus not exclusively used for qualifying purposes.

Occasional fundraising activities may be permitted. In determining whether property used for fundraising activities is used for the actual operation of the exempt activity, however, the legislature has provided that consideration shall not be given to property used only on an occasional basis for fundraising purposes, provided that the proceeds derived from the fundraising activities are (Rev & T C §214(a)(3)(A)):

- Not unrelated business taxable income (UBTI) as defined in IRC §512; and
- Used to further the exempt activity of the organization.

For further discussion, see §§11.45-11.48.

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§11.45 (a) Occasional Fundraising Activities

Occasional use. For fundraising activities, "occasional use" is defined as the "use of the property on an irregular or intermittent basis by the qualifying owner or any other qualifying organization… that is incidental to the primary activities of the owner or the other organization." Rev & T C §214(a)(3)(B)(i). The BOE provides examples of qualifying and nonqualifying fundraising activities in State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 51 (rev Oct. 2004). See §§11.46-11.47.

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§11.46 (i) Examples of Occasional Fundraising Activities

The following are examples of occasional fundraising activities:

- A qualifying organization annually operates a fireworks stand on its property for one week before the Fourth of July.
- A qualifying organization conducts a dance on its property quarterly, hiring an orchestra to provide the music and charging admission.
- A qualifying organization that provides scholarships to disadvantaged youths uses a portion of its property, a large multi-purpose room, for its annual fundraising dinner, that includes a silent auction of items solicited from local businesses and individuals. The organization also uses this room for its annual winter book sale, which features both new and used books solicited from individuals and businesses. The organization also allows another qualified organization to use this room for its annual fundraising dinner/dance and for its annual fundraising drive, which involves the setup of a large phone bank staffed by volunteers soliciting pledges of contributions.
- A qualifying organization operates an art museum on its property that is used quarterly for early evening wine and cheese receptions, each of which is co-sponsored by a large firm that recruits its employees to attend. All the proceeds go to the museum. The organization allows the museum to be used by three other qualified organizations for their annual fundraising receptions, which pay a use fee that merely covers the costs of using the facility.
- A large national charitable organization raises millions of dollars by conducting marches throughout the world. Full-time permanent staff in its California office organize the marches that are conducted within the state. These marches take place on a regular basis; at any given time there may be many marches conducted at various locations throughout the state. A small portion of the proceeds of the marches is used by the organization for the administration of its fundraising activities, and the balance of the proceeds is contributed to other charitable organizations. Even though this organization regularly carries on fundraising activities, the property used to administer the marches qualifies for the welfare exemption.

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§11.47 (ii) Examples of Nonqualifying Fundraising Activities

The following are examples of nonqualifying fundraising activities:

- A qualifying organization uses its parking lot every weekend from May through September for fundraising purposes. Members of the organization cook barbecue dinners for sale to the public from 11 a.m. to 6 p.m. An ad is placed in the local newspaper that indicates the price of each meal is $6.00. A phone number is listed so persons can order the meals for takeout, or for their added convenience, free delivery is provided to homes and businesses. Signs advertising the barbecue dinner sales are placed along streets and at the off ramp of the nearby freeway. This activity would disqualify the property used for the fundraising activity, since its use is continuous rather than occasional. See BOE Letter to San Luis Obispo County Assessor (Jan. 27, 1998), available at http://www.boe.ca.gov/proptaxes/pdf/240_0005.pdf. BOE counsel suggests fundraising events held "few times a year clearly would be occasional, however, weekly or monthly would not be occasional."
- A qualifying organization operates a museum that contains a theater auditorium designed and equipped for showing education films in connection with its program of public education in the arts and sciences. The theater operates daily during the hours the museum is open to the public. The organization permits another nonprofit organization to operate the theater as an ordinary motion picture theater for public entertainment during evening hours every weekend. Again, this activity would disqualify the property used for the fundraising activity, since its use is continuous rather than occasional.
- A qualifying organization has parking area property located near the municipal auditorium that generally features cultural and community events on a weekly basis. The organization uses its property in the evenings and during weekends as a commercial parking business when those events are being held. This is not a qualifying activity because it competes with other, similar businesses that are commercial in nature.
- A qualifying organization allows another qualifying organization to use its large multipurpose room the first Saturday of every month for a computer fair, which is co-sponsored by a computer business that systematically and consistently advertises the event. Computers are displayed and sold, with $50 from every computer sold going to the charitable organization. This is not a qualifying fundraising activity since the for-profit company is not a qualifying organization, the use of the property is not occasional, and some of the proceeds will benefit the for-profit company.

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§11.48 (b) Fundraising Activities With Proceeds Taxable as Unrelated Business Taxable Income (UBTI)

To the extent the proceeds of the fundraising activities are taxable as unrelated business taxable income (UBTI) under IRC §512, the property used for these fundraising activities does not qualify for the exemption. Rev & T C §214(a)(3)(A). Briefly, UBTI is the income derived by an exempt organization from a trade or business that is regularly carried on and is unrelated to the activities or purposes of the exempt organization. IRC §512(a)(1). Various exceptions to the rule exist, including income from a trade or business that is carried on by an IRC §501(c)(3) organization primarily for the convenience of its members, patients, officers, or employees. IRC §513.

The methodology for determining the exempt and nonexempt portions of the relevant property is set forth in Rev & T C §214.05. See §§11.49-11.50.

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§11.49 (i) Partial Exemption Allowed

Revenue and Taxation Code §214.05(a) starts with the premise that the property in question is exempt. The statute then sets forth three circumstances in which only a partial exemption would be allowed (Rev & T C §214.05(b)):

(1) If a reasonably ascertainable portion of the property generates both exempt and nonexempt income, then only a partial exemption would be permitted for the value of such reasonably ascertainable portion of the property based on the ratio of exempt income to total income. For example, a hospital pharmacy that sells both drugs and gift items is located in a reasonably ascertainable portion of the hospital. Assuming that 75 percent of its income is tax-exempt and 25 percent is unrelated business taxable income (UBTI), 75 percent of the value of that portion of the property would be exempt.

(2) If a reasonably ascertainable portion of the property is used for both exempt purposes that produce no income and for purposes that produce UBTI, then the amount of the portion of the property subject to the exemption is determined by dividing the amount of time the property is used for the exempt purpose by the total time the property is used.

(3) If the activities described above cannot be attributed to a reasonably ascertainable portion of the property, then only a partial exemption is allowed for the entire property based on the formulas described above, *i.e.,* allocation based on the proportion of tax-exempt income or time used for the exempt purpose.

The statute does not set forth a specific method by which the formulas are to be applied; thus, it is up to the organization to develop a methodology that is reasonable and consistently applied. If more than 75 percent of the income of the organization is not related to the use of particular property, then a similar allocation must be made based on the ratio of exempt income to total income from activities in this state. Rev & T C §214.05(c).

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§11.50 (ii) Information Required

Any qualifying organization that has unrelated business taxable income (UBTI) under IRC §512 must provide information to the assessor, as a part of its annual claim for exemption, that would enable the assessor to determine the exempt versus nonexempt portion of the property. The organization should include with the information sent to the assessor the relevant federal tax returns for the preceding year, information about the activities which produce the UBTI, and the information necessary to make the required allocations of income or time. Rev & T C §214.05(d).

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§11.51 (3) Use of Property for Meetings Conducted by Other Exempt Organizations

In determining whether property is used for the actual operation of the exempt activity, consideration is not given to use of the property for meetings conducted by another exempt organization if the meetings are incidental to the other organization's primary activities, are not fundraising meetings or activities, and are held no more than once per week. Rev & T C §214(a)(3)(D).

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§11.52 e. Prohibition on Property Used to Benefit Private Person

The property may not be used or operated to benefit any private person. Rev & T C §214(a)(4). This prohibition is similar to the inurement prohibition under Rev & T C §214(a)(2), discussed in §11.8. However, unlike the inurement prohibition, this provision prohibits the use of the qualifying organization's property rather than inurement of the organization's earnings. Thus, even an organization with no net earnings could lose its welfare exemption on property so used by a private person.

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§11.53 f. Prohibition on Property Used for Fraternal, Lodge, or Social Club Purposes

Property used for fraternal, lodge, or social club purposes is specifically declared to be taxable except when that use is clearly incidental to a primary religious, hospital, scientific, or charitable purpose. Rev & T C §214(a)(5). Thus, property that is owned and used primarily by a social club or a fraternal society does not qualify for exemption. Moreover, such organizations typically qualify for federal tax exemption under IRC §501(c)(7), (8), and (10), rather than IRC §501(c)(3), and thus would not meet the threshold organizational requirement of Rev & T C §214.8. See §11.12. Conversely, occasional meetings of a social club at a church would not disqualify the church property from the welfare exemption.

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§11.54 C. Welfare Exemption Claim Process

The welfare exemption is unique in that it is co-administered by the Board of Equalization (BOE) and the county assessors.

BOE role. An organization seeking the welfare exemption must first obtain an organizational clearance certificate from the BOE. The BOE determines whether the organization itself is eligible for the exemption (that is, whether the organization is organized and operated exclusively for one or more of the qualifying purposes).

NOTE: Questions concerning the eligibility requirements for exemption and how to obtain an organizational clearance certificate (see §11.55) should be addressed to the BOE. State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption*.

County assessor's role. An organization seeking the welfare exemption must then file a claim by the prescribed date containing the required information on the prescribed form with the county assessor. See §§11.55-11.58. The county assessor will review the claim to determine whether the organization's specific property qualifies for the exemption based on the property's use (that is, whether the property is exclusively used for one or more of the qualifying purposes). The county assessor may grant or deny the claim. See §11.59. Denial of a claim may be challenged by administrative process and ultimately by judicial review. See §11.60.

NOTE: Questions concerning whether a particular property use qualifies for exemption and how to file a claim for the welfare exemption should be addressed to the county assessor's office where the property is located. State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption*.

For further discussion, see Letter to Assessors No. 2003/070 (Nov. 14, 2003), available on the BOE website at http://www.boe.ca.gov/proptaxes/ltacont.htm.

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§11.55 1. Organizational Clearance Certificate Filed With BOE

Filing claim. An organization that intends to claim a welfare exemption must file a claim for an organizational clearance certificate with the BOE. Rev & T C §254.6(a). The claim is made by filing Form BOE-277, Claim for Organizational Clearance Certificate—Welfare Exemption, available at http://www.boe.ca.gov. (Limited liability companies instead file BOE-277-LLC, Claim for Organizational Clearance Certificate—Welfare Exemption—Limited Liability Company.) The claim must be accompanied by certified copies of the organization's financial statements and articles of incorporation, including amendments, and a copy of a valid, unrevoked letter or ruling from the Franchise Tax Board or IRS stating that the organization qualifies as an exempt organization. Rev & T C §254.6(c).

In addition, the organization must provide detailed information identifying its activities. Documentation to help the BOE determine whether to issue the certificate includes brochures, pamphlets, the website address, and copies of newspapers articles. State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption*.

NOTE: The county assessor may not approve a welfare exemption claim until the BOE has issued an Organization Clearance Certificate under Rev & T C §254.6. 18 Cal Code Regs §143(e)(4).

BOE response. The BOE staff will review each claim to determine whether the organization meets the requirements of Rev & T C §214, based on specified criteria. Rev & T C §254.6(b). After review, the BOE will issue notice of the staff's finding as to eligibility on Form BOE-277-F, Welfare or Veterans' Organization Exemption, Organizational Clearance Certificate Finding Sheet.

Claim is ineligible. If the BOE staff determines that the claimant is not eligible, the BOE will also send the claimant Form BOE-277-F1, Welfare or Veterans' Organization Exemption, Organizational Clearance Certificate—Preliminary Notice, and the claimant has 30 days to provide additional information or to request a 30-day extension to provide additional information. If the BOE staff determines that the claimant remains ineligible, the BOE will issue a final notice of ineligibility on Form BOE-277-F2, Welfare or Veterans' Organization Exemption, Organizational Clearance Certificate —Final Notice. The claimant may file an appeal with the BOE within 60 days of the date of mailing of the final notice. Rev & T C §254.6(d).

Claim is eligible. If the BOE ultimately determines that the organization is eligible for the exemption, which the BOE will issue Form BOE-277-OCC, Organizational Clearance Certificate for Welfare or Veterans' Organization Exemption. At any time thereafter, the BOE may conduct an audit or verification of an organization to determine whether the organization meets the requirements of Rev & T C §214.

Revocation and appeal. Once granted, an organizational clearance certificate will remain valid until the BOE staff determines that the organization no longer meets those requirements and revokes the certificate. In making that determination, the BOE may review information submitted by the organization on Form BOE-277-P, Periodic Filing for Organizational Clearance Certificate—Welfare or Veterans' Organization Exemption, that the BOE staff mails to each organization once every 3 years. The organization may appeal the revocation to the BOE within 60 days of the date of mailing of the notice of revocation. The BOE will hold a hearing unless the BOE staff and the claimant agree to submit the matter to the BOE for a decision without a hearing. Rev & T C §254.6(e).

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§11.56 2. Filing of Claim With County Assessor

First filing. A nonprofit organization filing (1) its first claim for property tax exemption, (2) for the first time in a particular county, or (3) after not having filed for 1 or more years must file Form BOE-267, Welfare Exemption (First Filing) with the county assessor in the county where the property is located. Form BOE-267 seeks basic organizational information (*e.g.,* name and corporate identification number); information on whether the organization has filed a claim for an organizational clearance certificate and been granted a certificate, as discussed in §11.55; and information on each property (*e.g.*, description and use) for which exemption is sought.

PRACTICE TIP: If the organization has property in different counties, a separate form must be filed with each county assessor.

Annual filing. Once an organization has received the exemption, it is required to make an annual filing on Form BOE-267A, Claim for Welfare Exemption (Annual Filing) with the county assessor. Form BOE-267A is a one-page form that asks a series of "yes-no" questions primarily to ascertain whether the organization, its operation, or the nature of the activities on the property has changed since the prior filing. If the organization's articles of incorporation have been amended, it must submit a copy of the amendment certified by the Secretary of State to the BOE. If the organization moved to a new location or acquired new property during the year, it is required to file that portion of Form BOE-267 that deals with the nature and use of the property.

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§11.57 a. Filing Date

General rule. A welfare exemption claim generally must be filed with the county assessor between the January 1 lien date and February 15 each year. Rev & T C §255(a).

NOTE: Filing a late claim may result in a loss of as much as $250 in cancellation or loss of any refund due. See §11.58.

After denial of church/religious exemption. When an application for the church or religious exemption (see §§11.61-11.67) is denied, the claimant is given 15 days from the date of notification of the denial to file a welfare exemption claim. Rev & T C §255(c).

PRACTICE TIP: In the case of an initial filing when previously taxable property is purchased by a qualifying organization (for qualifying uses), the claim for exemption should be filed as soon as possible.

When the purchase occurs after the lien date (January 1) but before the start of the fiscal year for property tax purposes (July 1), the property will be entitled to the exemption for the upcoming fiscal year if the claim is filed within 90 days from the first day of the month following the month in which the property was acquired. Any tax assessed will be canceled or, if paid, refunded. Rev & T C §271(a)(1)-(2). When the purchase occurs after the start of the fiscal year (July 1), the tax assessed will be canceled or refunded in proportion to the number of days for which the property was qualified for the exemption during the fiscal year over 365 days. Rev & T C §271(a)(3). If the claim is filed after January 1 of the year following the year of purchase, only 85 percent of any tax or penalty or interest that otherwise would be entitled to relief will be canceled or refunded. With respect to the disallowed 15 percent, however, the maximum amount of disallowance is limited to $250. Rev & T C §271(b)-(d).

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§11.58 b. Effect of Late Filing

Waiver and relief. Generally, if a claimant fails to follow the required procedure, the exemption is deemed waived for that year. Rev & T C §260. However, relief is provided by Rev & T C §270(a) when a claim for the welfare, church, museum/library, or educational institution exemption is not filed by February 15.

- If the claim is filed on or before January 1 of the following year, 90 percent of any tax, penalty, or interest may be canceled or refunded. Rev & T C §270(a)(1).
- If the claim is filed after January 1 of the following year, 85 percent of any tax, penalty, or interest may be canceled or refunded. Rev & T C §270(a)(2).

With respect to the "disallowed" 10 or 15 percent, all but $250 also will be canceled or refunded. Rev & T C §270(b).

PRACTICE TIP: Although as a matter of practice, assessors automatically refund taxes paid for periods for which an exemption subsequently is granted, counsel should calendar the date for each payment and file a claim for refund if the refund is not received within the 4-year limitation period.

No statute of limitations applies to claims involving a cancellation of taxes. Thus, theoretically, the claim can be filed at any time and the claimant would risk a loss in exemption of at most $250. However, as a practical matter, the failure to file a claim would result in the assessor issuing an assessment against the property. On payment of the assessment, generally a statue of limitations of 4 years from the date of payment applies to claims for refund depending on the circumstances. Rev & T C §5097(a)(2)-(3). A different statute of limitations may apply in the event an application for a reduction in an assessment or an application for equalization of an assessment has been filed pursuant to Rev & T C §1603. See Rev & T C §5097(a)(3).

NOTE: The amount of the cancellation or refund of tax on a claim for exemption may be reduced if the exemption claim (see §11.54) is not filed by the specified date (see §11.57).

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§11.59 3. Review of Claim

Field review. The welfare exemption claim is filed with the county assessor in the county in which the property is located, as discussed in §11.56. After verifying that all information has been submitted and the claim has been properly signed, the assessor conducts a field review (with respect to first-time claims only). The purpose of the review, in effect, is to verify the accuracy of the representations made in the claim. As part of this process, the assessor generates a Form BOE-267-FIR, Welfare Exemption Assessor's Field Inspector Report, including a recommendation for approval or denial. State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 2, §267 at 104 (rev Oct. 2004).

NOTE: The Field Inspection Report and other records related to the assessor's determination of eligibility are public records open to public inspection. Govt C §§6250-6276.48; Rev & T C §408.2(a).

Assessor's determination. On the basis of the field review, the assessor conducts a review of the claim and the findings/recommendations of the field inspector. The assessor is directed to consider issues related to the use of the property in the actual operation of the exempt activity and amount of property needed for the exempt purpose (see §11.42). The assessor may initiate an audit or verification of the operations of the owner or operator of the property to determine that both the owner and operator are eligible. Rev & T C §254.5(b)(1)-(2). On the basis of its review, the assessor makes a determination as to whether the property meets the requirements for exemption. Rev & T C §254.5(c)(1).

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§11.60 4. Challenging Denial of Claim

When a claim for exemption is denied by the assessor, a notice is sent to the claimant indicating that the claim has been denied. See Rev & T C §254.5(c)(2). For this purpose, the assessor may use Form BOE-267-F, Welfare or Veterans' Organization Exemption, Assessor's Finding on Qualification of Property Use.

Payment of tax; claim for refund. While informal discussions with the assessor regarding a denial may take place, there is no prepayment remedy for a denial. Should the assessor deny the claim for exemption, the claimant must pay the tax and file a claim for refund. Generally, a statue of limitations of up to 4 years from the date of payment applies to claims for refund. Rev & T C §5097(a)(2)-(3). See §11.58.

Court action. On denial of the claim for refund, the claimant may bring an action in superior court for the refund of tax paid under Rev & T C §§5140-5142. The action must be filed in superior court within 6 months after the date of rejection of the claim for refund. Rev & T C §5141(a).

NOTE: The procedural rules, including the applicable statute of limitations, must be carefully followed. For example, the claim for refund must state all applicable grounds for the refund because court relief can only be granted on grounds specified in the refund claim. Rev & T C §5142(a).

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IV. CHURCH AND RELIGIOUS EXEMPTIONS

§11.61 A. Welfare, Church, and Religious Exemptions Compared

Three exemptions—the welfare exemption, the church exemption, and the religious exemption—may apply to exempt property used for religious purposes. See State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption.*

(1) Church exemption. Most religious organizations qualify their property for exemption under the church exemption. See §§11.61-11.67. This exemption is limited to religious organizations using the property for worship only. See §11.64. Thus, activities eligible for this exemption are limited to traditional ceremonial functions.

NOTE: Of the three exemptions, a singular advantage of the church exemption is that it is the only one available to leased property.

(2) Religious exemption. Churches that use their properties for religious worship and operating schools of less than collegiate grade may be eligible for a full or partial religious exemption. See §11.67. The school must be owned and operated by the church. See State Board of Equalization, Pub. 149, *Property Tax Welfare Exemption.*

NOTE: The religious exemption is generally more desirable for church-owned property because of its one-time filing provision.

PRACTICE TIP: Churches that lease property to schools that are operated on their properties must file for the welfare exemption for those portions of the properties used by the schools. In addition, the school must also file for the welfare exemption as the operator of the property.

(3) Welfare exemption. The welfare exemption covers the greatest number of uses. See §§11.3-11.53. It must be claimed for uses of the property beyond the scope of religious worship and schools, or if the property also is used regularly by a charitable organization.

NOTE: If an application for the church or religious exemption (see §§11.62-11.67) is denied, the claimant has 15 days from the date of notification of the denial to file a welfare exemption claim. Rev & T C §255(c).

For additional information, see State Board of Equalization Pub. 48, *Property Tax Exemptions for Religious Organizations*.

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§11.62 B. Church Exemption

Property used exclusively by a church is specifically exempt under the California Constitution. The exemption applies to "[b]uildings, land on which they are situated, and equipment used exclusively for religious worship." Cal Const art XIII, §3(f). The legislature incorporated this provision by reference in Rev & T C §206. Requirements for exemption are discussed in §§11.63-11.65. Administrative issues involved in claiming the exemption are discussed in §11.66. Church property also may qualify for the religious exemption. See §11.67.

NOTE: The exempt property includes church parking lots (Cal Const art XIII, §4(d); Rev & T C §206.1) and "buildings under construction, land required for their convenient use, and equipment in them if the intended use would qualify the property for exemption" (Cal Const art XIII, §5).

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§11.63 1. Requirements for Exemption

The church exemption under Cal Const art XIII, §3(f), essentially requires that the property be used for religious worship (see §11.64) and that it be used "exclusively" for that purpose (see §11.65). Unlike the welfare exemption (see §11.15), the church exemption does not require that the property be owned by a qualifying organization.

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§11.64 a. Religious Worship

In order for a religious use of property to further qualify as a church use (thus avoiding the ownership requirement of the welfare exemption), the property must be used for religious worship. As discussed in the context of religious uses qualifying for the welfare exemption (see §11.21), the court in *Fellowship of Humanity v County of Alameda* (1957) 153 CA2d 673, 693, 315 P2d 394, broadly defined "religion" to include almost any belief, cult, or system, irrespective of whether it involves belief in a Supreme Being. That court further defined "religious worship" as "any lawful means of formally observing the tenets of the cult."

Ancillary services. The BOE believes that the "formal observance" of the religion refers to "traditional ceremonial functions: such as regularly scheduled services with attendance and participation of the complete congregation. However, other ancillary services which are sacramental in nature (*e.g.,* baptisms, confirmation, Bar Mitzvahs, weddings, funerals and other comparable ceremonies) meet the definition although the presence of the entire congregation is not required." State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 2, §267 at 2 (rev Oct. 2004).

Nonqualifying examples. The BOE provides the following examples of property used for religious purposes that may not qualify for the church exemption:

- Church administration for two or more churches.
- Licensed nursery schools.
- Schools of less than collegiate grade, for social halls and community centers.
- Retreats or summer camps.
- Convents and monasteries.
- Reading rooms at locations other than church premises.

These types of properties may, however, qualify for the welfare exemption if the applicable requirements are met.

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§11.65 b. Exclusive Use Requirement

"Incidental to and reasonably necessary for" standard. As discussed in the context of the welfare exemption, the requirement that property be used "exclusively" for exempt purposes has been defined to include use that is "incidental to and reasonably necessary for" the accomplishment of the exempt purpose. The discussion and examples of what constituted a qualifying or nonqualifying use in the welfare exemption context apply in the church context as well. Indeed, many of the cases cited in the welfare exemption discussion are cases involving the church exemption. See §§11.34-11.38.

Occasional use permitted. Briefly, incidental or occasional uses of church property by nonchurch members or organizations will not disqualify the property from the church exemption. Thus, when church property is occasionally used by a boy or girl scout troop, the use would not be disqualifying. On the other hand, if the property were leased to a nonchurch organization on a regular basis, the property would not qualify for the church exemption. See, *e.g., Peninsula Covenant Church v County of San Mateo* (1979) 94 CA3d 382, 394, 156 CR 431, in which church-owned recreational facilities primarily used by nonmembers did not qualify for the welfare exemption. See also *Matter of the Crystal Cathedral of the Reformed Church in America* (Feb. 29, 1984), in which the BOE decided that portions of church property systematically rented for commercial purposes did not qualify for the exemption. (The *Crystal Cathedral* decision is discussed in State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 1, §267 at 53 (rev Oct. 2004).) However, if the lessee is an organization qualifying for the welfare exemption, and uses the property for qualifying purposes, then the welfare exemption would be available on the property, provided that both parties file for the exemption.

NOTE: In determining what constitutes an "incidental" use, it should be remembered that the courts are likely to be "extremely liberal in holding that some incidental use does not" disqualify the property from exemption. *Fellowship of Humanity v County of Alameda* (1957) 153 CA2d 673, 699, 315 P2d 394.

Church property and fundraising. Similarly, in the context of church property used for fundraising purposes, incidental uses of church property that are supportive of the primary use for religious worship and primarily involve church members are likely to be considered qualifying uses. For example, according to the BOE, meals provided for a fee before or after church services for those in attendance and annual festivals conducted by the church which include worship services are considered qualifying uses. State Board of Equalization, Assessors' Handbook, *Welfare, Church, and Religious Exemptions,* pt 2, §267 at 5 (rev Oct. 2004).

Nonqualifying fundraising uses. The BOE provides the following examples of nonqualifying fundraising uses:

- The regular operation of a thrift shop.
- Use of the property for regularly conducted fundraising barbecues that are publicized and open to the public.
- Lease of church property on a regular basis to nonqualifying organizations for the purpose of generating rental income.

Cell towers. The BOE has advised that leasing space for cell towers (typically affixed to the roof of the church building) constitutes a nonqualifying fundraising use. See BOE Letter to Assessors No. 2008/054 (Sept. 16, 2008), available on the BOE website at http://www.boe.ca.gov/proptaxes/2008.htm. The assessor is required to determine the percentage of the total property used for the nonqualifying purpose and reduce the percentage of the property available for the exemption accordingly.

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§11.66 2. Administrative Issues

The procedures for filing for the exemption, handling by the assessor, and challenging adverse decisions are essentially the same as the procedures discussed above for the welfare exemption claim. (There is no separate entity qualification process with the church exemption.) See §§11.54-11.60. Aside from filing for the exemption on a different form (churches file on Form BOE-262-AH, Church Exemption), the primary distinction is with respect to leased property.

Lessor's exemption claim. Because churches need not own property used in religious worship to qualify for the church exemption, a specific Form BOE-263, Lessor's Exemption Claim, must be filed by the owner in the case of leased premises. Such claim must include an affidavit prepared by the church/lessee attesting to the fact that the property is used exclusively for religious worship. Any resulting reduction in property taxes on the property must inure to the benefit of the church. Thus, either through the lease or through a separate transaction, the church must receive a reduction in rent proportional to the tax reduction obtained by the lessor. Rev & T C §206.2.

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§11.67 C. Religious Exemption

Exclusively used for religious purposes. Under Cal Const art XIII, §4(b), the provision that forms the basis for the welfare exemption, property used exclusively for religious purposes is exempt from taxation. See §11.21. The legislature amplified this provision in Rev & T C §207.

Section 207 provides that the exemption applies to "[p]roperty owned and operated by a church and used for religious worship, preschool purposes, nursery school purposes, kindergarten purposes, school purposes of less than collegiate grade, or for purposes of both schools of collegiate grade and schools less than collegiate grade but excluding property used solely for purposes of schools of collegiate grade." The exemption essentially applies to property owned and operated by a church that:

- Conducts its worship services on the property; or
- Conducts its worship services and also operates its own preschool, nursery school, or schools at or below the collegiate level.

NOTE: The legislative intent in enacting this section was to provide a streamlined process for property tax exemption for churches operating schools on church property. Before the effective date of this section, churches in such situations were required to file a church exemption for the property used for religious worship and a welfare exemption for property used for school purposes.

The details of the ownership and use requirements, as well as the administrative provisions, mirror those discussed above in the context of the welfare and church exemptions. The exemption is secured by filing Form BOE-267-S, Religious Exemption Claim. See also BOE Letter to County Assessors 2009/055 (Nov. 20, 2009), explaining the simplification of filing requirements for churches that jointly use property with public schools, effective January 1, 2010. The letter is available at http://www.boe.ca.gov/proptaxes/pdf/lta09055.pdf For discussion of the church exemption, see §§11.62-11.66.

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V. MUSEUMS, LIBRARIES, AND EDUCATIONAL INSTITUTIONS

§11.68 A. Museum/Library Exemption

California Constitution art XIII, §3(d), exempts from property taxation "[p]roperty used for libraries and museums that are free and open to the public." This exemption is incorporated by reference in Rev & T C §202(a).

Interplay with welfare exemption. Unlike the welfare exemption (see §§11.14-11.18), the exemption for free public libraries and museums has no ownership test. The exemption depends entirely on use. It is applied on a property-by-property basis. There is no exception for use during a construction period, as there is under the welfare exemption (see §11.41). Provided that the requirements of both exemptions are satisfied, a property could qualify for exemption under both the welfare exemption and the free museum/library exemption. Thus, property ultimately intended to qualify under the museum/library exemption may be eligible for the welfare exemption during the period of construction. See §11.41.

Requirements for exemption are discussed in §11.69. The exemption for leased property may be claimed by either the lessor or the lessee. See §11.70. The party claiming the exemption must comply with the exemption application requirements, including filing of an affidavit, as described in §11.71.

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§11.69 1. "Museum" and "Library" Defined

"Property used 'for a museum' must be used primarily to house and display objects of lasting value. This does not preclude other uses, but requires the use as a museum to be primary." *Fellowship of Friends, Inc. v County of Yuba* (1991) 235 CA3d 1190, 1196, 1 CR2d 284. In *Fellowship of Friends*, the exemption was denied to a religious organization that housed an art collection in a building used primarily for other purposes and only open to the public two days each week by appointment only.

NOTE: According to a 1987 opinion of the BOE staff, the museum or library, in addition to being free, must be accessible to the general public on a regular, publicized basis in order to qualify for the exemption. See BOE Staff Opinion Letter (May 7, 1987), available on the BOE website at http://www.boe.ca.gov/proptaxes/pdf/445_0065.pdf However, a BOE staff opinion from 1996 appears to de-emphasize the publicity requirement. See BOE Staff Opinion Letter (May 30, 1996), available at http://www.boe.ca.gov/proptaxes/pdf/445_0030.pdf.

A similar approach was taken in *Yttrup Homes v County of Sacramento* (1977) 73 CA3d 279, 140 CR 680, in which the court upheld the library exemption for a privately owned property that was used for administrative purposes by a city-county library.

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§11.70 2. Exemption for Leased Property

Lessee must receive benefit of exemption. Because use is the sole requirement, it is possible that the exemption will apply when the property is owned by an individual or a for-profit entity. The legislature, realizing this, provided that any reduction in property taxes on leased property used for free libraries and museums must inure to the benefit of the lessee institution. Thus, either through the lease or through a separate transaction, the library or museum must receive a reduction in rent proportional to the tax reduction obtained by the lessor. Rev & T C §202.2. If the lessor does not claim the exemption, the legislature further provided that the lessee may file a claim for refund under Rev & T C §5096 with respect to taxes paid by the lessor on the property. The lessee is deemed to be the person who paid the tax, and the refund will be made directly to the lessee. Rev & T C §202.2. Generally, the claim for refund must be filed within 4 years from the date of payment. Rev & T C §5097(a)(2)-(3). See §11.58.

Thus, to the extent that the free library/museum exemption is applicable, either the lessee or the lessor may claim the exemption with respect to real and tangible personal property. If the lessor claims the exemption, the lessor must pass on the savings to the qualifying lessee in the form of reduced rents. If the lessor has paid the tax, the lessee may file a claim for refund for the taxes paid and obtain the refund directly.

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§11.71 3. Administrative Issues

In use by lien date. The exemption is only available for property that was in use as a free library/museum as of the lien date. *Yttrup Homes v County of Sacramento* (1977) 73 CA3d 279, 140 CR 680. The exemption must be claimed annually by February 15 by filing a form prescribed by the BOE with the county assessor. Rev & T C §255(a). The effect of late filing is discussed in §11.58. Unlike the welfare exemption (see §11.59), there is no statutory requirement for review by the BOE.

Form. The exemption for free libraries/museums is secured by submitting Form BOE-268-B, Exemption for Property Used by a Free Library or Free Museum. The form contains an affidavit, the terms of which are specified by statute, regarding the use of the property.

- For property used as a free public library, the affidavit states the extent to which the property is open to the public, whether or not any admission or user charge is made for the use of library books, periodicals, or facilities and the extent (if any) to which sales or business activities are conducted on the premises. Rev & T C 259.8.
- For property used as a free museum, the affidavit states whether or not any admission or user charge is made to those viewing the museum contents and the extent (if any) to which sales or business activities are conducted on the premises. Rev & T C §259.9.

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§11.72 B. Educational Institution Exemption

Nonprofit educational institutions. The "educational institution" exemption is generally available to public schools of all grade levels and to nonprofit private schools of higher education (*i.e.,* collegiate grade). Property used exclusively for school purposes of less than collegiate grade or used exclusively for nursery school purposes may qualify for the welfare exemption if it otherwise meets all the requirements of Rev & T C §214. Rev & T C §214(b)-(c). There is no property tax exemption for for-profit educational institutions.

- All property used exclusively for California's public schools, community colleges, state colleges, and state universities (including the University of California system) is exempt from taxation. Cal Const art XIII, §3(d); Rev & T C §202(a)(3).

NOTE: No exemption is available for property under construction that is intended to be used for public education.

- Buildings, land, equipment, and securities used exclusively for educational purposes by a nonprofit "educational institution of collegiate grade" are exempt from taxation. An "educational institution of collegiate grade" is generally an entity incorporated as a college that requires a 4-year high school degree (or its equivalent) for admission and confers upon graduates a professional or academic degree. Cal Const art XIII, §3(e); Rev & T C §203(b).

NOTE: This exemption extends to buildings under construction, land required for the convenient use of those buildings, and equipment contained in those buildings if it is intended that the property will qualify for the exemption on completion of construction. Cal Const art XIII, §5.

The requirement of exclusive use is discussed in §§11.73-11.75. For leased property, the exemption may be claimed by either the lessor or the lessee. See §11.76. Administrative issues are discussed in §11.77.

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§11.73 1. Exclusive Use Requirement

"Exclusive use" defined. The educational institution exemption under both Rev & T C §§202(a)(3) and 203(b) is tied solely to *use* of the property by a qualifying organization exclusively for educational purposes. *Mann v County of Alameda* (1978) 85 CA3d 505, 509, 149 CR 552. Property is "used exclusively" for educational purposes if it is "reasonably necessary for the fulfillment of a generally recognized function of a complete modern college." *Church Divinity Sch. v County of Alameda* (1957) 152 CA2d 496, 502, 314 P2d 209. The property, however, does not have to be absolutely indispensable to the college's operation. "The term 'educational' is a comprehensive one embracing mental, moral and physical education." *Board of Trustees of Leland Stanford Jr. Univ. v County of Santa Clara* (1978) 86 CA3d 79, 84, 150 CR 109.

NOTE: The phrase "used exclusively" has been construed consistently with the interpretations reached for purposes of determining application of the welfare exemption. *English v County of Alameda* (1977) 70 CA3d 226, 243, 138 CR 634. See §§11.74-11.75.

Nevertheless, for both public schools of collegiate grade and private nonprofit colleges, property tax generally will be imposed to the extent that the subject property is primarily devoted to bookstore use that generates unrelated business taxable income (see IRC §512). Rev & T C §§202(c), 203(d).

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§11.74 a. Incidental Use for Noneducational Purposes

Incidental uses permitted. Certain incidental use of the property for other than educational purposes will not destroy the exemption, so long as such incidental use is "directly connected with, essential to, and in furtherance of the primary use." See *Honeywell Info. Sys., Inc. v County of Sonoma* (1974) 44 CA3d 23, 28, 118 CR 422 (county's use of 3.56 percent of available time on computer system for parochial schools and private business in exchange for fees was *not* reasonably necessary to further primary purpose of public schools; exemption completely denied for leased equipment). But see *Oates v County of Sacramento* (1978) 78 CA3d 745, 751, 143 CR 337 (use by private parties of 3 percent of computer time for a fee was de minimis when school superintendent leased 32,960 square feet, computer was housed in an area of 2880 square feet, and superintendent used 1050 square feet for other nonschool uses; leased property was exempt from taxation). See also *Board of Trustees of Leland Stanford Jr. Univ. v County of Santa Clara* (1978) 86 CA3d 79, 85, 150 CR 109 (use of university golf course by alumni and general public more than 50 percent of the time did not destroy "exclusive use" of property for educational purposes; 90 percent of the "outside uses" were alumni, and a university has a special relationship to its alumni).

Apportionment. When property is used for both exempt and nonexempt purposes, the courts may permit apportionment of the property taxes. See *Oates v County of Sacramento* (1978) 78 CA3d 745, 751, 143 CR 337 (when approximately 85 percent of privately owned property was used for exempt educational purposes, only the 15-percent portion was subject to property tax). See also *Cedars of Lebanon Hosp. v County of Los Angeles* (1950) 35 C2d 729, 745, 221 P2d 31 (welfare exemption granted to extent of exempt use; nonexempt use of portion of property did not destroy entire exemption). But see *Honeywell Info. Sys., Inc. v County of Sonoma* (1974) 44 CA3d 23, 28, 118 CR 422 (nonexempt use of available time on computer system destroyed property tax exemption; no apportionment made).

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§11.75 b. Residential Use of Property

Short-term leases. When a college owns the land and the buildings, and individuals have short-term leasehold interests in the buildings for use related to the college's educational purposes, the courts have determined that assessors may not levy the tax on either the college, as the property owner, or on the individual's possessory interest. See *Church Divinity Sch. v County of Alameda* (1957) 152 CA2d 496, 502, 314 P2d 209 (parking lot, free faculty housing, and married student rental housing owned by colleges were all "reasonably necessary for the fulfillment of a generally recognized function of a complete modern college"; thus, tax on such properties could not be levied against the colleges); *English v County of Alameda* (1977) 70 CA3d 226, 242, 138 CR 634 (possessory interests in college-owned property were not taxable); *Mann v County of Alameda* (1978) 85 CA3d 505, 509, 149 CR 552 (students' leasehold interests in family housing owned by University of California were not taxable).

Long-term leases. In contrast, when a college owns the land but an individual has a long-term leasehold on the land and owns the residence built on the land, the educational institution exemption does not apply. *Connolly v County of Orange* (1992) 1 C4th 1105, 4 CR2d 857. The court observed that "[t]his presents a case of property substantially owned and enjoyed by a private person, while the title remains in the college." 1 C4th at 1128, quoting *Yale Univ. v Town of New Haven* (Conn 1899) 42 A 87, 94.

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§11.76 2. Exemption for Leased Property

Lessee must receive benefit of exemption. Generally, the duty of paying the property tax, and the benefit of any tax exemption, lies with the person holding legal title to the property. However, the property tax exemption for educational institutions is tied to the *use* of the property for a particular exempt purpose, not ownership. The property may be used by a qualifying institution for an exempt purpose, but legal title to the property may be held by another. In the case of leased property, the legislature has provided that the benefit of the exemption must accrue to the lessee institution.

Lessor. Thus, if exempt property is the subject of a lease, and the lease provides that the value of the exemption has been taken into account in establishing the lease terms, the lessor may claim the exemption by filing Form BOE-263, Lessor's Exemption Claim, and submitting an affidavit by the lessee institution which complies with the provisions of Rev & T C §259.8 (public library) or §259.9 (free museum). See §11.71. If the lease does not specifically account for the value of the tax exemption, the lessor must grant the lessee institution a reduction in future rental payments, or, if payments have already been made under the lease, a refund in an amount equal to the reduction in taxes. Rev & T C §202.2.

Lessee. If for whatever reason the lessor does not claim the exemption, the lessee institution will be deemed to be the person who paid the tax. The lessee may file a claim for refund with respect to taxes paid by the lessor. Rev & T C §202.2.

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§11.77 3. Administrative Issues

In use by lien date. The educational institution exemption must be claimed annually by February 15 by filing the form prescribed by the BOE with the county assessor. Rev & T C §255(a). Note, however, the public school exemption is only available for property that was in use as a public school as of the lien date. *Yttrup Homes v County of Sacramento* (1977) 73 CA3d 279, 140 CR 680. The effect of late filing is discussed in §11.58. Unlike the welfare exemption (see §11.59), there is no statutory requirement for review by the BOE.

Forms. The exemption for nonprofit private colleges is secured by submitting Form BOE-264-AH, College Exemption. The exemption for property used exclusively by a public school is obtained by filing Form BOE-268-A, Exemption for Property Used Exclusively by a Public School. Each of these forms contains an affidavit, the terms of which are specified by statute, regarding the use of the property. See also BOE Letter to County Assessors 2009/055 (Nov. 20, 2009), explaining the simplification of filing requirements for eligible nonprofit organizations that jointly use property with public schools, effective January 1, 2010. The letter is available at http://www.boe.ca.gov/proptaxes/pdf/lta09055.pdf

Property used by private nonprofit college. For property used by a private nonprofit college, the affidavit states (1) that the educational institution is of collegiate grade and is not conducted for profit, (2) that the grounds for which exemption is claimed are those within which its buildings are located, and (3) that the property for which exemption is claimed is used exclusively for the purposes of education. Rev & T C §258.

Property used by public school. For property used by a public school, the affidavit states (1) the property owner's name and the name of the school within the public school system that is using the property exclusively for public school purposes, and (2) the terms of the agreement by which the public school obtained the use of the property (if written, a copy of the agreement must accompany the affidavit). Rev & T C §259.10.

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12

Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection

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§12.1 I. SCOPE OF CHAPTER

This chapter reviews the tax filings required of tax-exempt organizations. It incorporates changes to the IRS Form 990 filing procedure and requirements resulting from the form's redesign, effective for the 2008 tax year (generally filed in 2009) and later tax years. See §§12.2-12.30. Filings with the Franchise Tax Board and the Board of Equalization are covered in §§12.31-12.34.

The chapter also reviews the recordkeeping (see §§12.35-12.42) and reporting requirements (see §§12.43-12.69) for most types of nonprofit corporations. (Some specialized nonprofit corporations, such as nonprofit small business development corporations, are beyond the scope of this book.) Inspection rights by the public, members, directors, and the Attorney General are discussed in §§12.74-12.89.

The chapter covers best practices for voluntary reporting under the Anti-Terrorist Financing Guidelines and for crisis management (see §§12.70-12.73). The chapter also addresses the application of the Brown Act open meeting requirements to nonprofit corporations. See §§12.90-12.98.

Requirements for notice of a future event (such as a meeting) or a proposed action are discussed in chaps 9-10. State securities laws on nonprofit corporations that sell securities are covered in chap 10. Laws imposed by municipalities in regulating nonprofit fundraising activities are discussed in chap 14. The extensive reporting requirements for dissolution and winding up are covered in chap 20.

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II. REQUIRED TAX FILINGS

A. Reports and Returns to Internal Revenue Service

§12.2 1. Information That Must Be Furnished to IRS

The information generally required to be furnished by an organization exempt under IRC §501(a) includes the following (Treas Reg §1.6033-2(a)):

NOTE: The redesigned IRS Form 990 incorporates the information below into the core form and/or one or more applicable schedules. See §§12.3-12.21.

- Gross income, which includes tax-exempt income but does not include contributions, gifts, grants, or similar amounts received. Whether an item constitutes a contribution, gift, grant, or similar amount depends on the surrounding facts and circumstances. Treas Reg §1.6033-2(a)(2)(ii)(a). Gross income for the year is computed by subtracting the cost of goods sold from all receipts other than gross contributions, gifts, grants, nonincludable dues, and assessments from members and affiliates. Treas Reg §1.6033-2(a)(2)(ii)(a).
- Information on dues and assessments not included in gross income, from members and affiliates for the year.
- Expenses incurred within the year attributable to gross income.
- Its disbursements (including the prior year's accumulations) made within the year relating to its exempt purposes.
- Its assets, liabilities, and net worth as of the beginning and end of the year.
- The total of contributions, gifts, grants, and similar amounts received by the organization during the taxable year, and the names and addresses of everyone who contributed, bequeathed, or devised $5000 or more (in money or other property) during that taxable year.

  NOTE: Private foundations must also furnish to the IRS the names and addresses of all persons who became "substantial contributors" before the taxable year. Treas Reg §1.6033-2(f). A "substantial contributor" is defined as anyone contributing an aggregate amount of more than $5000 if that amount is greater than 2 percent of the total contributions and bequests received by the foundation. For a trust, a "substantial contributor" includes the creator of the trust and includes all descendants, without limitation. IRC §507(d)(2).

- The names and addresses of all officers, directors, or trustees of the organization (or anyone having responsibilities or powers similar to those of officers, directors, or trustees) and, for a private foundation, the names and addresses of all foundation managers, as described in IRC §4946(b)(1). The reference to persons having responsibilities and powers similar to those of officers, directors, or trustees covers those individuals who function as officers, directors, or trustees of the organization, regardless of title, as well as the key employees of the organization. TD 9423, 2008-43 Int Rev Bull 966.

  NOTE: The redesigned IRS Form 990 expanded the definition of "key employee" to include not only persons having responsibilities or powers similar to those of officers, directors, or trustees, but also persons who manage a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization. "Key employees" are defined as those earning compensation over $150,000 per year. Treas Reg 1.6033-2T(a)(2)(ii)(g); TD 9423, 2008-43 Int Rev Bull 966; Instructions for Form 990. See §§12.5, 12.17.

- Fees paid to attorneys. If the entity is engaged in a trade or business and pays more than $600 per year to an attorney or a corporate or noncorporate law firm, the organization must file IRS Form 1099, disclosing those payments. IRC §6045(f).
- Information detailing compensation to directors, trustees, and certain independent contractors. The redesigned IRS Form 990 requires that compensation reported as paid to officers and other employees be consistent with

Form W-2 (box 5) and that compensation reported as paid to directors, individual trustees, and independent contractors be consistent with Form 1099-MISC (box 7). Temporary regulations require an organization to report compensation it has paid during the calendar year ending with or within the organization's annual accounting period, or during such other period as specified by the form or form instructions. A fiscal year organization will continue to be required to use fiscal year accounting when reporting aggregate compensation as an expense item (Part IX). However, an organization will not be required to reconcile compensation for individuals reported in Part VII with compensation for such individuals included in its Part IX statement of expenses. Temp Treas Reg §1.6033-2T(a)(2)(ii)(h); TD 9423, 2008-43 Int Rev Bull 966.

- For a private foundation liable for tax under IRC §§4940-4948, the information required by IRS Form 4720.
- Its lobbying expenditures, grassroots expenditures, exempt-purpose expenditures, lobbying nontaxable amount, and grassroots nontaxable amount for the taxable year and for prior taxable years that are base years (within the meaning of Treas Reg §1.501(h)-3(c)(7)), if the organization has an election under IRC §501(h) in effect for the taxable year. An organization that is a member of an affiliated group of organizations (see Treas Reg §56.4911-10(b)) must report this information on the basis of the expenditures of all members of the group during the taxable year of the group that ends with or within the member's taxable year and for prior taxable years of the group that are base years (within the meaning of Treas Reg §56.4911-9(b)).

NOTE: For additional information that must be furnished by members of an affiliated group of organizations and by controlling members in a limited affiliate group, see respectively Treas Reg §§56.4911-9(d) and 56.4911-10(f)(1). See also Treas Reg §1.6033-2(a)(2)(ii).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.3 2. The Redesigned IRS Form 990

§12.3 2. The Redesigned IRS Form 990

New Form 990. On December 20, 2007, the IRS released a redesigned IRS Form 990 for the 2008 tax year (to be filed in 2009 and later years). The redesigned Form 990 incorporates responses to legislative and nonprofit sector changes since the form's last revision in 1979. The new form, which seeks to improve transparency and compliance and reduce burden, consists of a core form applicable to all Form 990 filers and numerous schedules to be completed as needed. Internal Revenue Service, Background Paper, *Forms 990, Moving From the Old to the New*, August 19, 2008.

Variations. Variations or alternatives to the basic Form 990 include:

- IRS Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. This form may be filed by most organizations with gross receipts and total assets below certain amounts. See §12.22.
- IRS Form 990-PF, Private Foundation Annual Return. See §12.24.
- IRS Form 990-T, Exempt Organization Business Income Tax Return. Organizations with gross income of $1000 from unrelated business income must file this form. It is also used to pay the IRC §6033(e)(2) proxy tax. See §12.23.
- IRS Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations. See §12.25.
- IRS 990-N, Electronic Notice (e-Postcard). See §12.29.

2008 tax year. A nonprofit corporation that obtains federal tax-exempt status must file annual returns on IRS Form 990. IRC §6033. For the 2008 tax year (filed in 2009), the Form 990 must be filed by an organization exempt from income tax under IRC §501(a) (including an organization that has not applied for recognition of exemption) if its gross receipts are greater than or equal to $1,000,000 and its total assets are greater than or equal to $2,500,000 at the end of the tax year. This includes organizations described in §501(c)(3) (other than private foundations) and organizations described in other 501(c) subsections (other than black lung benefit trusts). See Instructions for Form 990, p 2.

2009 tax year. For the 2009 tax year (generally filed in 2010), an organization described above must file Form 990 if its gross receipts are greater than or equal to $500,000 and its total assets are greater than or equal to $1.25 million at the end of the tax year. For the 2010 tax year and later years, an organization described above must file the Form 990 if its gross receipts are greater than or equal to $200,000 and its total assets are greater than or equal to $500,000 at the end of the tax year. See Instructions for Form 990, p 3. See §12.23.

Exceptions from filing requirement. Certain organizations are excused from Form 990 filing requirement, including the following (IRC §6033(a)(3); Treas Reg §1.6033-2(g); Rev Proc 96-10, 1996-1 Cum Bull 577; Rev Proc 95-48, 1995-2 Cum Bull 418; Rev Proc 94-17, 1994-1 Cum Bull 579; Rev Proc 83-23, 1983-1 Cum Bull 687):

- Churches, their integrated auxiliaries (see Treas Reg §1.6033-2(h)), and conventions or associations of churches.
- Organizations (other than private foundations) that normally have gross receipts below $25,000 (although Treas Reg §1.6033-2(g)(1)(iii), (g)(3), refers to a test of $5000). However, the redesigned IRS Form 990 requires all supporting organizations described in IRC §509(a)(3) to file Form 990 (or Form 990-EZ, if applicable), even if their gross receipts are normally less than $25,000. See Instructions for Form 990.
- Foreign organizations that are not private foundations, with annual gross receipts from United States sources of no more than $25,000 and with no significant activity in the United States (Rev Proc 94-17, 1994-1 Cum Bull 579).
- United States possession organizations (any organization created or organized in a possession of the United States) that are not private foundations, with annual gross receipts from United States sources of no more than $25,000 and with no significant activity in the United States (Rev Proc 2003-21, 2003-1 Cum Bull 448); and
- Governmental units and affiliates of governmental units.

Some religious corporations need not file annual information returns with the IRS. IRC §6033(a)(3)(A); Treas Reg §1.6033-2(g)(1).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.4 a. IRS Form 990--Core Form

§12.4 a. IRS Form 990—Core Form

The redesigned IRS Form 990 consists of an 11-page core form, to be completed by each Form 990 filer. In addition, an organization may be required, depending on its type and activities, to complete one or more schedules. The redesigned Form 990 provides both general instructions and specific instructions for the core form and specific instructions for each schedule.

The Form 990 general instructions include a glossary of important terms and an appendix of special instructions (see §12.5). See Form 990; Instructions for Form 990; Internal Revenue Service Background Paper, *Forms 990: Moving From the Old to the New* (Aug. 19, 2008).

- Part I requests the organization's identifying information and requires a summary of the organization's key financial, compensation, governance, and operational information.
- Part II contains signature lines and related information for the organization's officer, and paid preparer (if applicable), who sign the form.
- Part III requires information relating to the organization's program services and exempt purpose achievements. This part, which is similar to the previous Form 990, Part III, requires an organization to describe its mission, program services and accomplishments, and any changes to its program services. The new Form 990, Part III, additionally requires certain information on direct revenue and expense information regarding its largest program services.
- Part IV provides a comprehensive list of all "trigger questions" to help an organization determine which schedules it must complete. As discussed below, whether or not an organization is or is not required to file a particular schedule may depend on whether it files Form 990, Form 990-EZ, or Form 990-PF.
- Part V requests information on employment taxes, information returns, backup withholding, unrelated business income tax, foreign bank accounts, prohibited tax shelter transactions, substantiation of contributions, donor-advised funds, and special requirements applicable to organizations described in IRC §501(c)(7) or (c)(12), and IRC §4947(a)(1) non-exempt charitable trusts. Through this part, the IRS intends to alert organizations to potential federal tax compliance and filing obligations beyond Form 990.
- Part VI requires information regarding an organization's governing body, management, policies, and disclosure practices. It requests information on certain relationships between or among governing and management officials, and information regarding how the organization makes certain important information available to its constituents.
- Part VII, Section A, requires an organization to report, for each person listed (other than a key employee or a former director or trustee of the organization), compensation and other payments totaling more than $100,000 annually paid by the organization and its related organizations to the person. For key employees, the redesigned Form 990 requires an organization to report compensation and other payments totaling more than $150,000 annually paid by the organization and its related organizations to the person. For former directors and trustees, the redesigned Form 990 requires an organization to report compensation and other payments totaling more than $10,000 annually paid by the organization and its related organizations to the person solely on account of the person's past services as a director or trustee of the organization. As amended by temporary regulations, Treas Reg §1.6033-2T(a)(2)(ii)(g) gives the Commissioner discretion to revise the threshold amount for reporting by form and instruction. TD 9423, 2008-43 Int Rev Bull 966. Part VII, Section B, requires a list of the organization's top five highest paid independent contractors that received more than $100,000 from the organization. See §12.2.

NOTE: The redesigned Form 990 requires that compensation reported as paid to officers and other employees be consistent with IRS Form W-2 (box 5) and that compensation reported as paid to directors, individual trustees, and independent contractors be consistent with Form 1099-MISC (box 7).

- Part VIII requires reporting of revenue in three categories: (1) contributions, gifts, grants, and other similar amounts; (2) program service revenue; and (3) other revenue. All organizations must complete Part VIII, Column

(A), Total Revenue, to report their gross receipts for all sources of revenue. Organizations other than IRC §527 organizations must complete Columns (B) through (D) to report related or exempt function revenue, unrelated business revenue, and revenue excluded from tax under IRC §§512-514.

- Part IX requires information regarding an organization's functional expenses. All organizations must report total expenses. Similar to the old Form 990, IRC §501(c)(3) and IRC §501(c)(4) organizations, and IRC §4947(a)(1) nonexempt charitable trusts, must provide a breakdown of functional expenses. These organizations must classify most of their listed expenses as either program service expenses, management and general expenses, or fundraising expenses. The new Part IX also incorporates changes to the types of expenses that are to be reported, particularly with respect to grants paid, fees paid to nonemployees, information technology, payments to government officials, payments to affiliates, and insurance.
- All organizations must complete Part X to report assets, liabilities, and net assets or fund balances. Part X bears similarities to the old Form 990, Part IV. However, the new form's Part X provides for separate reporting of program-related investments and intangible assets, and combines the reporting of all land, buildings, and equipment on a single line. Part X also separates secured mortgages and notes payable from unsecured notes and loans payable.
- Finally, **Part XI** requires an organization to report its method of accounting and other information regarding its compiled, reviewed, or audited financial statements.

NOTE: The IRS offers an online "mini-course" providing information on how to file the redesigned Form 990. For more information, see http://www.irs.gov/charities/article/0,,id=166625,00.html.

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§12.5 b. Glossary and Appendix

The Instructions for the redesigned IRS Form 990 include a glossary of commonly used terms and an Appendix of Special Instructions. The Appendix of Special Instructions includes all of the following appendixes.

Appendix A: Exempt Organizations Reference Chart. This is a chart detailing the different types of organizations and their corresponding IRC sections.

Appendix B: How to Determine Whether an Organization's Gross Receipts are Normally $25,000 (or $5000) or Less. This includes definitions of gross receipts and calculations of gross receipts.

Appendix C: Special Gross Receipts Test for Determining Exempt Status of Section 501(c)(7) and Section 501(c)(15) Organizations. This includes the gross receipts tests for IRC §501(c)(7) and §501(c)(15) organizations.

Appendix D: Public Inspection of Returns. This appendix describes the requirements of IRC §6104, and the applicable procedure to request the inspection of relevant documents. It details the time and manner of fulfilling written requests.

Appendix E: Group Returns—Reporting Information on Behalf of the Group. This includes the instructions for reporting information on group returns.

Appendix F: Disregarded Entities and Joint Ventures— Inclusion of Activities and Items. This includes the definitions of disregarded entities and joint ventures, and instructions relating to both.

Appendix G: Excess Benefit Transactions. This appendix includes the relevant definitions, and guidelines detailing how to correct an excess benefit transaction contained in IRC §4958.

Appendix H: Forms and Publications to File or Use. This appendix is a list of internet links, CDs, and forms.

Appendix I: Use of IRS Form 990 or IRS Form 990-EZ to Satisfy State Reporting Requirements. This is the instructions for determining state filing requirements, identifying potential differences in reporting requirements, and using Form 990 or 990-EZ.

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§12.6 c. Schedule A (Form 990 or 990-EZ)

Schedule A requests information regarding an entity's public charity status, public support, and supporting organizations. This schedule must be completed by organizations described in IRC §501(c)(3), and nonexempt charitable trusts described in IRC §4947(a)(1), to provide information regarding public charity status and public support. This includes organizations described in IRC §§501(e)-(f), 501(k), and 501(n).

NOTE: The new Schedule A incorporates recently enacted temporary regulations eliminating the advance ruling process and IRS Form 8734. In place of the advance ruling process, the IRS will monitor public charity status based on public support information reported on the revised Schedule A. Temporary regulations provide that an organization will be a public charity in its first 5 years if it can show, in its application for exemption, that it can reasonably be expected to receive the requisite public support during such period. Temporary regulations also change the public support computation period for purposes of IRC §§170(b)(1)(A)(vi) and 509(a)(1)-(a)(2), from a 4-year period before the tested year to a 5-year period that includes the current year. The temporary regulations became effective on September 9, 2008, and apply to taxable years beginning on or after January 1, 2008. TD 9423, 2008-43 Int Rev Bull 966.

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§12.7 d. Schedule B (Form 990, 990-EZ, or 990-PF)

Schedule B requires information relating to contributions reported as revenues. Generally, any organization that received $5000 or more from any one contributor must complete Schedule B. The schedule, which requires reporting of limited contributor and contribution information, is substantially the same as the old Schedule B.

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§12.8 e. Schedule C (Form 990 or 990-EZ)

Schedule C requests information regarding political campaign and lobbying activities. Schedule C applies to IRC §501(c) and §527 organizations that file IRS Form 990 or Form 990-EZ. It must be completed by organizations that conduct lobbying or political activities.

NOTE: Schedule C requests new information on political activities and intercorporate funds transfers (particularly as they relate to IRC §527 organizations) not referenced in the old Form 990. See Instructions for Schedule C. The IRS expects Schedule C to result in an additional recordkeeping and reporting burden for organizations not described in IRC §501(c)(3), because they were not required to report this information on the previous Form 990. See Internal Revenue Service Background Paper, *Forms 990: Moving From the Old to the New* (Aug. 19, 2008).

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§12.9 f. Schedule D (Form 990)

Schedule D requires information for donor-advised funds, conservation easements, certain art and museum collections, escrow accounts and custodial arrangements, endowment funds, and supplemental financial information relating to the financial statements. Only an organization that is required to file IRS Form 990 must file Schedule D.

Schedule D simplifies certain balance sheet reporting for organizations of all types and sizes. It allows organizations to report four asset categories (land, buildings, and equipment; other securities; program-related investments; and other assets) on the basis of asset types, rather than on an asset-by-asset basis, as previously required. Further, Schedule D eliminates the old form's detailed reporting requirements for loans, mortgages, and notes (payable or receivable). Although these measures help to reduce organizations' recordkeeping and reporting burdens, the enhanced or new reporting requirements for donor-advised funds, conservation easements, collections held by museums and similar organizations, escrow organizations, escrow and custodial accounts, and endowment funds, will likely increase the recordkeeping and reporting burden for those organizations that are significantly involved in these activities. See Instructions for Schedule D; Internal Revenue Service Background Paper, *Forms 990: Moving From the Old to the New* (Aug. 19, 2008).

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§12.10 g. Schedule E (Form 990 or 990-EZ)

Schedule E must be completed by certain organizations that file IRS Form 990 or 990-EZ, to report information concerning private schools. This schedule contains much of the same information found on the private school questionnaire from the old Form 990, Schedule A, Part V. See Rev Proc 75-50, 1975-2 Cum Bull 587. Generally, all private schools must complete this schedule. However, if an organization is not required to file Form 990 or Form 990-EZ, it is not required to file Schedule E.

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§12.11 h. Schedule F (Form 990)

Schedule F requests information on an organization's activities conducted outside the United States by the organization at any time during the tax year. Organizations that have a foreign account or office, or have employees or activities outside the United States, must complete the schedule. Schedule F requires reporting of information relating to foreign activities from organizations that conduct fundraising, grant-making, trade or business, or exempt activities outside the United States, or have accounts, offices, employees, or other agents outside the country. See Instructions for Schedule F. The IRS provides tips for filing Schedule F at http://www.irs.gov/charities/article/0,,id=211325,00.html.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.12 i. Schedule G (Form 990 or 990-EZ)

§12.12 i. Schedule G (Form 990 or 990-EZ)

Schedule G must be completed by certain organizations that file IRS Form 990 or IRS Form 990-EZ to report professional fundraising services, fundraising events, and gaming. Schedule G applies to all organizations with more than $15,000 from fundraising events or outside fundraising costs. The schedule expands reporting to certain professional fundraising. See Gaming Publication for Tax-Exempt Organizations, IRS Pub. 3079 (4-98), Cat. No. 25706L; Instructions for Schedule G.

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§12.13 j. Schedule H (Form 990)

Organizations operating at least one hospital. Schedule H must be completed by an organization that operates at least one facility that is, or required to be, licensed, registered, or similarly recognized by a state as a hospital. This requirement covers organizations that operate at least one hospital facility that provides hospital or medical care, and entities that operate as part of a hospital system or university.

Organizations required to report. Generally, Schedule H requires organizations to report the aggregate community benefit for all facilities, and certain information regarding billings, collections, and joint ventures. This includes aggregate information of (see Instructions for Schedule H):

- Hospitals directly operated by the organization;
- Hospitals operated by disregarded entities of which the organization is the sole member;
- Other facilities or programs of the organization or any of the entities described in the two preceding paragraphs, even if provided by a facility that is not a hospital or if provided separately from the hospital's license;
- Hospitals operated by any joint venture taxed as a partnership, to the extent of the organization's proportionate share (determined by reference to the ending capital account percentage) of the joint venture; and
- In the case of a group return filed by the organization (see Instructions for Schedule H):
- Hospitals operated directly by members of a group exemption that are included in the group return;
- Hospitals operated by a disregarded entity of which a member included in the group return is the sole member;
- Hospitals operated by a joint venture taxed as a partnership to the extent of the group member's proportionate share; and
- Other facilities or programs of a member included in the group return even if those facilities are not hospitals or if the programs are provided separately from the hospital's license.

The schedule also requires reporting of certain policies and activities to communities served by the organization.

PRACTICE TIP: For 2008, organizations are only required to complete Part V, Facility Information. They may, but are not required to, complete the other parts of the schedule for the 2008 tax year. Organizations will be required to complete the parts of Schedule H that are optional during the 2008 tax year beginning with the 2009 tax year filings.

NOTE: The IRS expects Schedule H to increase the reporting burden for most organizations required to file it, because the schedule is entirely new.

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§12.14 k. Schedule I (Form 990)

Schedule I requests information relating to grants or other assistance made by the filing organization to organizations, governments, and individuals in the United States. Activities conducted by the organization directly or indirectly through a disregarded entity, or through a joint venture treated as a partnership, should also be reported. Schedule I must be completed by organizations that make more than $5000 of applicable aggregate grants. See Instructions for Schedule I.

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§12.15 I. Schedule J (Form 990)

Schedule J must be completed by certain organizations that file IRS Form 990 to report compensation information for certain officers, directors, individual trustees, key employees, and the highest compensated employees. Schedule J also requires information relating to an organization's compensation practices. Generally, organizations that pay more than $150,000 reportable compensation to at least one individual, or that compensate former officers, directors, trustees, or key employees, must complete Schedule J. See Instructions for Schedule J.

PRACTICE TIP: The redesigned core form of Form 990 allows for simplified compensation reporting using information from an individual's Form W-2 or Form 1099.

NOTE: Schedule J requests information beyond that required in the redesigned core form. TD 9423, 2008-43 Int Rev Bull 966. See §§12.3-12.4.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.16 m. Schedule K (Form 990)

§12.16 m. Schedule K (Form 990)

Schedule K must be completed by certain organizations that file the IRS Form 990 to provide information on outstanding liabilities associated with tax-exempt bond issues. This Schedule applies to those organizations that reported an outstanding tax-exempt bond issue that (see Instructions for Schedule K):

- Had an outstanding principal amount in excess of $100,000 as of the last day of the tax year; and
- Was issued after December 31, 2002.

PRACTICE TIP: Only Part I must be completed for the 2008 tax year, to report basic information regarding outstanding bond issues. The other parts are optional for the 2008 tax year, but all parts must be completed beginning with the 2009 tax year. See Instructions for Schedule K.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.17 n. Schedule L (Form 990 or 990-EZ)

§12.17 n. Schedule L (Form 990 or 990-EZ)

Certain organizations that file the IRS Form 990 or 990-EZ must complete Schedule L to provide information regarding excess benefit transactions and loans with certain interested persons. Organizations that complete the schedule must provide information detailing financial transactions or arrangements between the organization and IRC §4958 disqualified persons or other interested persons. See Instructions for Schedule L.

NOTE: Schedule L is also used to determine whether a member of the organization's governing body is an independent member for purposes of Form 990, Part VI, line 1b.

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§12.18 o. Schedule M (Form 990)

Schedule M requires reporting of the types of noncash contributions an organization receives during the year, and information regarding those contributions. Schedule M requests information relating to the quantity and reported financial statement amount of noncash contributions received, categorized by type of property. Noncash donated items are reported even if sold immediately after received. In contrast, organizations need not report noncash contributions received by the organization in a prior year, or donations of services or the use of facilities.

Schedule M applies to organizations that report more than $25,000 of aggregate noncash contributions, or that received contributions of works of art, historical treasures, or other similar assets, or qualified conservation contributions, regardless of whether they reported any cash revenues for those contributions on IRS Form 990.

PRACTICE TIP: Schedule M creates new reporting requirements that are expected to result in new recordkeeping and reporting practices for those organizations that receive significant noncash contributions. The reporting exceptions and threshold limitations, and the ability to report based on financial statement methods, may help reduce the burden for other organizations. See Internal Revenue Service, Background Paper, *Forms 990, Moving From the Old to the New*, August 19, 2008.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.19 p. Schedule N (Form 990 or 990-EZ)

§12.19 p. Schedule N (Form 990 or 990-EZ)

An organization must complete Schedule N to provide information relating to the termination, dissolution, or significant disposition of assets. Schedule N applies to those organizations that have ceased activities or that made a significant disposition of assets (more than 25 percent of net assets).

NOTE: Part I of Schedule N expands on the termination reporting requirements in the old Form 990. Additionally, Part II requires new reporting for dispositions of more than 25 percent of net assets regardless of whether the transfer of assets was at fair market value.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.20 q. Schedule O (Form 990 or 990-EZ)

§12.20 q. Schedule O (Form 990 or 990-EZ)

Organizations use Schedule O to provide the IRS with narrative and other supplementary information required for responses to specific questions on the IRS Form 990 or applicable schedules. If an organization is not required to file Form 990 or 990-EZ, then it is not required to file Schedule O.

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§12.21 r. Schedule R (Form 990)

Organizations use Schedule R to provide information on related organizations, certain transactions with related organizations, and certain unrelated partnerships through which the organization conducts significant activities. Organizations that own a controlling interest (or are under common control) in a partnership, LLC, corporation, trust, or other exempt entity must complete the schedule. For this purpose, "significant" generally means activities that are the greater of 5 percent of the filing organization's gross revenues or 5 percent of its total assets. See Instructions for Schedule R.

NOTE: Schedule R adds new reporting requirements for unrelated partnerships through which an organization conducts significant exempt, business, or investment activities. See Instructions for Schedule R; Internal Revenue Service Background Paper, *Forms 990: Moving From the Old to the New* (Aug. 19, 2008).

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§12.22 3. IRS Form 990-EZ, Short Form Return of Organization Exempt From Income Tax

IRS Form 990-EZ is a shorter version of IRS Form 990. With the redesign of Form 990, the IRS has granted transitional relief to small and mid-size organizations, allowing many to file Form 990-EZ for the 2008 and 2009 tax years in place of filing Form 990. The IRS provided this transitional relief to give organizations enough time to become familiar with the new Form 990 and its requirements. Modified thresholds for filing Form 990-EZ (in lieu of Form 990) during the transition period are as follows (Instructions for Form 990, at 3):

May file 990-EZ for:	If gross receipts are:	And if total assets are:
2008 Form (generally filed in 2009)	less than $1,000,000	less than $2,500,000
2009 Form (generally filed in 2010)	less than $500,000	less than $1,250,000
2010 and later Forms	less than $200,000	less than $500,000

Additional schedules may also need to be filed with Form 990-EZ. See §§12.6-12.21.

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§12.23 4. IRS Form 990-T, Exempt Organization Business Income Tax Return

An exempt organization that earns more than $1000 in gross income included in computing unrelated business taxable income for the year must file IRS Form 990-T, the annual return related to the imposition of tax on unrelated business income. Treas Reg §1.6012-2(e).

PRACTICE TIP: In lieu of reporting its lobbying expenses to members, an organization exempt under IRC §501(c)(4), (5), or (6) may pay a proxy tax, to be reported on and paid with Form 990-T. See §19.36.

The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) added a new requirement that Form 990-T be made available for public inspection and copying. A technical corrections bill signed into law in 2007 narrowed the Form 990-T disclosure requirements to the annual return and any schedules or documents relating to the imposition of tax on unrelated business income. Tax Technical Corrections Act of 2007 (Pub L 110-172, 121 Stat 2473; IRS Notice 2008-49, 2008-20 Int Rev Bull 979. See §12.74.

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§12.24 5. IRS Form 990-PF, Private Foundation Annual Return

An exempt private foundation must annually file IRS Form 990-PF in lieu of Form 990 or 990-EZ. Treas Reg §1.6033-2(a)(2)(i). See Treas Reg §§1.6033-2—1.6033-3 for information that must be filed with Form 990-PF.

Parts IX-A and IX-B of Form 990-PF, requesting information on direct charitable activities and program-related investments, should be carefully completed and reviewed to ensure that the responses given cast the foundation's activities in the most favorable light. These responses can be the basis of an IRS "office audit" of an organization's right to retain its tax-exempt status.

NOTE: With regard to a new organization's private foundation status, temporary regulations eliminate the advance ruling process for new organizations, and change the public support computation period for organizations described in IRC §§170(b)(1)(A)(vi) and 509(a)(1)-(a)(2) to 5 years, consistent with the redesigned Form 990. TD 9423, 2008-43 Int Rev Bull 966. See Temp Treas Reg §§1.170A-9T, 1.509(a)-3T.

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§12.25 6. IRS Form 990-W, Estimated Tax on Unrelated Business Income for Tax-Exempt Organizations

Quarterly estimated taxes. Private foundations must make quarterly estimated payments of the tax on unrelated business taxable income and the excise tax imposed under IRC §4941 on its investment income. IRC §6655(g)(3). Tax-exempt organizations and private foundations use IRS Form 990-W to compute whether and in what amounts they must pay estimated taxes. Form 990-W is not filed. Tax-exempt corporations, tax-exempt trusts, and domestic private foundations must make estimated tax payments if the total expected tax for the tax year is $500 or more. Form 990-W, at 4.

Installment methods. The regulations under IRC §6655 provide guidance to corporations with respect to estimated tax requirements. For corporations that elect to use the annualized income installment method, extraordinary items generally must be taken into account after annualizing the taxable income for the annualization period. Similar rules apply if the corporation uses the adjusted seasonal installment method. See Form 990-W, at 4. Treas Reg §1.6655-2(f)(1)(ii).

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§12.26 7. IRS Form 8282, Donee Information Return

Disposition within 3 years of receipt. If the donee of charitable deduction property sells, exchanges, or otherwise disposes of the donated property within 3 years after its receipt, the donee must file IRS Form 8282 and provide the donor with a copy of the return. IRC §§6050L(a), 6050L(c). "Charitable deduction property" is property (other than money or publicly traded securities) for which a donee must sign an IRS Form 8283 appraisal because the claimed value of the charitable contribution exceeds $5000. IRC §6050L(a)(2). Form 8282 need not be filed, however, if the donee sells an item and the appraisal summary signed by the donee contains the donor's statement that the item's value is $5000 or less.

NOTE: For purposes of determining whether a return must be filed, items of a set, such as a collection of books written by the same author, or silverware, are considered to be one item.

The information required to be reported on Form 8282 includes the following:

- The donee's name, address, and taxpayer identification number;
- A description of the property;
- The donor's name and taxpayer identification number;
- The date of the contribution;
- The date of the property's disposition and amount received by the donor;
- A description of the donee's use of the property;
- A statement indicating whether the use of the property was related to the purpose or function constituting the basis for the donee's exemption; and
- Any other information specified by the form or its instructions.

Time for filing. IRS Form 8282 must be filed within 125 days after the disposition. See generally Treas Reg §1.6050L-1.

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§12.27 8. Time for Filing Form 990

IRS Form 990 must be filed with the IRS no later than the 15th day of the 5th month after the close of the organization's taxable year. IRC §6072(e); Treas Reg §1.6033-2(e). Thus, for a calendar year organization, the filing deadline is May 15.

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§12.28 9. IRS Form 8868, Application for Extension of Time to File Form 990

Automatic 3-month extension. Exempt organizations required to file IRS Form 990 are entitled to an automatic 3-month extension of time to file the return if the organization meets the following requirements (IRC §6081(b); Treas Reg §1.6081-9(a)-(b)):

- The organization submits IRS Form 8868 (Application for Extension of Time to File an Exempt Organization Return) on or before the prescribed date for filing Form 990;
- The IRS Form 8868 shows the full amount of the organization's estimated tentative tax for the taxable year; and
- The organization pays the full amount of the estimated tentative tax which is unpaid as of the date prescribed for filing the return.

NOTE: The automatic extension period for filing IRS Form 990-T is 6 months. Treas Reg §1.6081-9(a).

IRS may terminate extension at any time. Advisers should be aware that the automatic 3-month extension may be terminated by the IRS at any time. All the IRS needs to do is mail a notice of termination to the exempt organization at least 10 days before the termination date fixed in the notice. IRC §6081(b); Treas Reg §1.6081-9(c).

Written application for additional extension. District directors and directors of service centers are authorized to grant reasonable extensions of time for filing a return. Treas Reg §1.6081-1(a). To obtain such an extension, the exempt organization must file a written application before the due date for filing the return (as extended by the automatic extension) properly signed by the organization's duly authorized agent, clearly setting forth the return (including taxable year) for which an extension is requested, and an explanation of the reasons for requesting the extension. The application may be made in the form of a letter. Treas Reg §1.6081-1(b)(1).

PRACTICE TIP: The organization must first obtain an automatic extension before it will be permitted to seek an extension pursuant to Treas Reg §1.6081-1. Treas Reg §1.6081-9(e).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.29 10. IRS Form 990-N, Electronic Notice (e-Postcard)

§12.29 10. IRS Form 990-N, Electronic Notice (e-Postcard)

Under the Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), organizations that are generally exempt from filing an information return (*i.e.,* organizations having gross receipts less than $25,000) may be required to file electronically IRS Form 990-N (Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ) annually. See Treas Reg §1.6033-6(a)-(b). The first e-Postcards were due in 2008 for tax years ending on or after December 31, 2007.

Required information. The Form 990-N annual notification requires the following information (IRC §6033(i); Treas Reg §1.6033-6 (c)):

- The legal name of the organization;
- Any name under which the organization operates or does business;
- The organization's mailing address and any Internet website address (see Treas Reg §§1.6033-6(c)(2), 301.6212-2);
- The organization's employer identification number (EIN);
- The name and address of a principal officer;
- A statement that the organization's annual gross receipts are still normally $25,000 or less;
- Additional information needed to process the notification (*e.g.,* the tax period for which the organization is submitting the electronic notification); and
- If applicable, a statement that the organization is terminating (going out of business).

NOTE: Certain organizations are not required to file an information return or IRS Form 990-N, including churches and educational institutions affiliated with or operated by a religious order. See Treas Reg §1.6033-6(b)(2).

CAUTION: If an organization required to electronically submit IRS Form 990-N instead files a complete Form 990 or Form 990-EZ, the annual notification requirement will be deemed satisfied. However, if the Form 990 or Form 990-EZ contains only the information required by Form 990-N, the annual notification requirement is *not* satisfied. Treas Reg §1.6033-6(c)(4). In addition, the filing of a complete Form 990 or Form 990-EZ, rather than Form 990-N, is the filing of a return that starts the limitations period for assessment under IRC §6501(g)(2). Treas Reg §1.6033-6(c)(4).

Form 990-N must be based on the established accounting period of the organization, or on a calendar basis if the organization has none. Treas Reg §1.6033-6(e). It must be submitted on or before the 15th day of the fifth calendar month following the close of the period for which the notification is required. Thus, an organization with an accounting period ending December 31, 2008, is required to submit annual notification by May 15, 2009. Treas Reg §1.6033-6(f).

PRACTICE TIP: Form 990-N must be filed electronically at the following website: http://www.epostcard.form990.org/. More information about the e-postcard requirement is available on the IRS website at http://www.irs.gov/charities/article/0,,id=169250,00.html.

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§12.30 11. Penalties

The IRS imposes penalties for an organization's failure to (IRC §6652(c)(1)(A)(i)-(ii), (c)(3)):

- Timely file an annual information return;
- Include any information required to be shown on IRS Form 990; or
- Show correct information.

The penalty is $20 per day for each day the failure continues, and the maximum penalty for any one return is the lesser of $10,000 or 5 percent of the gross receipts for the year of the return. However, the penalty is $100 per day up to a maximum of $50,000 for an organization that has gross receipts above $1 million per year. IRC §6652(c)(1)(A)(ii). A responsible person who fails to respond to an IRS demand that a Form 990 be filed or to furnish information that should have been shown on Form 990 is subject to a penalty of $10 per day, up to a maximum of $5000. IRC §6652(c)(1)(B). Additional penalties exist for failing to timely pay any tax due, for willfully failing to file a return, and for filing fraudulent returns or making fraudulent statements. IRC §§6651-6652, 7203, 7206-7207. The penalties outlined in these sections range from misdemeanor offenses and minor monetary penalties to felony offenses, large monetary penalties (from 75 percent of the taxes owed to no more than $500,000 for a corporation) and up to 5 years' imprisonment.

NOTE: No penalty will be due if the organization establishes that the failure to file a timely, complete, and correct return was due to reasonable cause. IRC §6652(c)(4); Treas Reg §301.6652-2(a), (f).

Twenty-percent accuracy penalty. Taxes reported on Form 990-T are subject to a 20-percent accuracy penalty, which is based on the amount of any underpayment shown to result from (IRC §6662(a), (b)):

- Negligence or disregard of rules or regulations;
- A substantial understatement of income tax; or
- A substantial income tax valuation misstatement.

If any part of an underpayment of tax is due to fraud, the IRS may impose a penalty of 75 percent of the underpayment attributable to the fraud. IRC §6663(a). Once the IRS has established that any part of an underpayment is due to fraud, the entire underpayment is presumed to be due to fraud unless and only to the extent that the organization can establish by a preponderance of the evidence that the underpayment was not due to fraud. IRC §6663(b).

CAUTION: The failure to file IRS Form 990-N, Form 990, or Form 990-EZ with the IRS for 3 consecutive years will result in revocation of the organization's tax-exempt status. See IRC §6033(j)(1).

To obtain reinstatement of its tax-exempt status, the organization must apply for recognition of tax exemption to the IRS regardless of whether that organization was originally required to apply for tax-exempt status. If, on application for tax-exempt status after revocation, the organization shows to the satisfaction of the IRS reasonable cause for failing to file the required notice, the organization's tax-exempt status may, in the discretion of the IRS, be reinstated retroactive to the date of revocation. IRC §6033(j)(2)-(3).

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B. Reports and Returns to Franchise Tax Board

§12.31 1. Required Filings

FTB Form 199. With certain exceptions noted immediately below, all organizations that have been granted tax-exempt status by the Franchise Tax Board, and organizations that received a federal exemption under IRC §501(c)(3) and submitted FTB Form 3500A, with a copy of its IRS determination letter, must file FTB Form 199 (California Exempt Organization Annual Information Return). The form must be filed on or before the 15th day of the fifth full calendar month following the close of the organization's taxable year. Rev & T C §23772(a)(1).

Exceptions from filing requirement. The following are not required to file FTB Form 199 (Rev & T C §23772(a)(2); Instructions for FTB Form 199):

- Churches, their integrated auxiliaries, and conventions or associations of churches;
- The exclusively religious activities of any religious order;
- Organizations (other than private foundations) whose gross receipts in each taxable year do not normally exceed $25,000;
- Organizations formed to carry out a function of a state, or a public body that is carrying out that function and is controlled by the state, or a public body;
- Political organizations exempt under Rev & T C §23701r;
- Qualified state tuition programs exempt under Rev & T C §23711;
- Coverdell ESA exempt under Rev & T C §23712; and
- Stock bonus, pension, or profit-sharing trusts exempt under Rev & T C §17631.

Annual statement. Each of the above entities exempt from filing Form 199 may be required to file an annual statement showing the following information (Rev & T C §23774(a)):

- The name and address of the organization;
- The Internal Revenue Code section under which it is exempt;
- Its major activities;
- Its sources of income; and
- For organizations exempt from filing Form 199 because their annual gross receipts are less than $25,000, information about their gross receipts and assets.

NOTE: Instead of FTB Form 199, the Franchise Tax Board will accept copies of IRS Form 990 or 990-PF, attached to a completed page 1 of FTB Form 199. The attached Form 990 or Form 990-PF should be marked "Filed in lieu of Form 199."

FTB Form 109. In addition to Form 199, an exempt corporation must file a return on FTB Form 109 (California Exempt Organization Business Income Tax Return), if it has gross taxable income derived from an unrelated business of more than $1000. Rev & T C §23771. See chap 17; see also Instructions for Form 109.

Exempt corporations. Exempt political corporations must report and pay tax on "political organization taxable income," as defined in Rev & T C §23701r.

Exempt homeowners' associations. These associations (including condominium management associations, residential real estate management associations, timeshare associations, and cooperative housing corporations) must report and pay tax on "homeowners association taxable income," as defined in Rev & T C §23701t. A corporation exempt under Rev & T C §23701t that receives more than $100 in taxable income must file a return on FTB Form 100, whether or not an FTB Form 199 is required. Rev & T C §23701t(c). See Rev & T C §23732. See Guidelines for Homeowners' Associations, FTB Pub. 1028 (Rev 02-2003).

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§12.32 2. Penalties for Failure to File

Suspension. Failure to file any of the forms described in §12.31 on or before the last day of the 12th month following the close of the organization's taxable year may result in suspension of any or all of the corporation's powers, rights, privileges, and exempt status, or revocation of the organization's exempt status. Rev & T C §§23775, 23777.

Relief from suspension requires (Rev & T C §§23701, 23776, 23778):

- The submission of an application for reviver and payment of applicable fee;
- The possible submission of a new application for exemption and payment of applicable fee;
- Compliance with the reporting requirements and payment of amounts due; and
- When reestablishing exempt status, payment of tax accrued while the corporation was not exempt.

Relief from revocation requires (Rev & T C §23778):

- The filing of a new application for exemption and payment of the required fee; and
- The filing of any returns, statements, or payments not previously paid, and that resulted in revocation.

For revocations resulting from an organization's failure to confine itself to exempt activities, an organization must provide satisfactory proof that it has corrected its nonexempt activities, that it will operate in a nonexempt manner in the future, and remit tax payments for periods the organization was not qualified for exemption. Rev & T C §23778.

Filing fees. There is a $10 initial filing fee, and an additional $25 filing fee if FTB Form 199 is filed late without reasonable cause. Rev & T C §23772(a)(3). The fees are waived for the following organizations exempt under Rev & T C §23701d (Rev & T C §23772(a)(4)):

- Exclusively religious organizations;
- Designated educational organizations;
- Designated organizations that receive broad support from the public, the United States, or any state or political subdivision of a state; and
- Organizations operated, supervised, or controlled by or in connection with an exclusively religious organization.

Monetary penalties. If a complete return is not timely filed, a penalty of $5 per month (not to exceed $40) is imposed on the organization unless reasonable cause is shown for the failure to file on time. Rev & T C §23772(c)(1). If a private foundation fails to file a return after written demand by the Franchise Tax Board, the person or persons responsible for the failure will be subject to a penalty of $5 per month, not to exceed $25 for all persons who fail to file, unless reasonable cause for the failure can be shown. Rev & T C §23772(c)(2).

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§12.33 C. Reports to State Board of Equalization and County Assessor

A nonprofit corporation that owns, claims, processes, or controls property in California subject to local assessment must make available to the county assessor, on request, a copy of business records relevant to the amount, cost, and value of that property within the county. Corp C §§6214, 8214, 9660(a). If the property is used for the exempt activities described in Rev & T C §§251-261 and the corporation wants an exemption from local property taxes, it must file a claim for an organizational clearance certificate with the State Board of Equalization and then file a claim for exemption with the county assessor. Rev & T C §254.6. See chap 11.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.34 D. Other Sanctions for False Information and Failing to Report

§12.34 D. Other Sanctions for False Information and Failing to Report

The following sanctions apply when required reports are either false or not filed:

- Officers, directors, employees, and agents of corporations who, directly or by participating, make, issue, deliver, or publish certain documents concerning the corporation, knowing any document to be false in a material respect, are jointly and severally liable for all damages to the corporation and to anyone who relied on those documents. Corp C §§6215(a), 8215(a), 9660(a).
- The Attorney General may file suit for injunctive relief, dissolution, receivership, or any other appropriate remedy to compel compliance with the reporting requirements of the public benefit corporation law, the mutual benefit corporation law, and the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). The Attorney General may act on a complaint by a member, director, or officer, or sua sponte. Corp C §§6216, 8216, 9660(b); Govt C §12591.

Penal sanctions. Directors or officers who knowingly concur in making or publishing materially false, or willfully or fraudulently exaggerated, financial reports or statements of the corporation's financial condition, if the statements induce or have the tendency to induce contributions or donations, are subject to penal sanctions. Corp C §§6812(a), 8813(a), 9690. It is also a crime for a director, officer, or agent of a nonprofit corporation, or anyone who proposes to organize such a corporation, to knowingly exhibit any false, forged, or altered document to certain public officers or boards with intent to deceive. Corp C §§6814, 8815, 9690.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/ III. RECORDKEEPING/ A. Records That Must Be Maintained/§12.35 1. Copies of Articles and Bylaws

III. RECORDKEEPING

A. Records That Must Be Maintained

§12.35 1. Copies of Articles and Bylaws

Each nonprofit corporation with a California office must keep an up-to-date original or copy of its articles and bylaws at its principal California office. Corp C §§5160, 7160, 9160.

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§12.36 2. Books of Account, Minutes of Proceedings, and Membership Lists

Every nonprofit corporation is required to keep the following (Corp C §§6320(a), 8320(a), 9510(a)):

- Adequate and correct books and records of account;
- A record of its members, including each member's name, address, and class of membership; and
- Minutes of the proceedings of its members, board of directors, and committees of the board of directors.

Format. Minutes and other books and records must be kept in written form or any form that can be converted into "clearly legible tangible form" (*e.g.,* in computer data form). Corp C §§6320(b), 8320(b), 9510(b). See also Corp C §§6310, 8310.

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§12.37 3. Waivers of Notice, Consents to Holding, and Approvals of Board Meetings

Notice of a board meeting need not be given to a director who attends the meeting without protesting before or at the commencement of the meeting, or to a director who signs a waiver of notice, a written consent to holding the meeting, or a written approval of its minutes. All waivers, consents, and approvals must be either filed with the corporate records or made a part of the minutes of the meeting. Corp C §§5211(a)(3), 7211(a)(3), 9211(a)(3). See §§9.70-9.77.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.38 4. Consents to Board Action Without Meeting

§12.38 4. Consents to Board Action Without Meeting

The board of directors may act without a meeting by unanimous written consent. The consents must be filed with the minutes of board proceedings. Corp C §§5211(b), 7211(b), 9211(b). See §§9.98-9.102.

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§12.39 5. Waivers of Notice, Consents to Holding, and Approvals of Membership Meetings

Irregularities in calling and noticing membership meetings are ignored if none of the members present protests the lack of notice before or at the commencement of the meeting, or if a quorum is present and each member entitled to vote (but who is not present in person or by proxy) signs a written waiver of notice, a consent to the holding of the meeting, or an approval of its minutes. Corp C §§5211(a)(3), 7211(a)(3), 9211(a)(3). The waivers, consents, and approvals must be filed with the corporate records or made a part of the minutes of the membership meeting. Corp C §§5211(a)(3), 5511(e), 7211(a)(3), 7511(e), 9211(a)(3), 9411(d). See §§10.79-10.91.

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§12.40 6. Consents to Membership Action Without Meeting

The members of any nonprofit corporation may act without a meeting if they act by unanimous written consent. The consents must be filed with the minutes of the proceedings of the members. Corp C §§5211(b), 5516, 7211(b), 7516, 9211(b), 9420. See §10.73.

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§12.41 7. Tax Records: Returns by Tax-Exempt Organizations and Certain Nonexempt Organizations

Organizations exempt from taxation under IRC §501(a) file an annual information return on IRS Form 990 (Treas Reg §1.6033-2(a)(1)); private foundations file an annual information return on IRS Form 990-PF (Treas Reg §1.6033-2(a)(2)(i)). See §§12.2-12.24. These annual information returns must be maintained by the organization and made available for public inspection for 3 years. On public inspection, see §§12.74-12.85.

NOTE: Although each organization is required to file a separate annual information return, the central or parent organization may file a single return on Form 990 on behalf of the group members. Treas Reg §1.6033-2(d)(1)-(2).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.42 B. Sanctions for Failing to Keep Records

§12.42 B. Sanctions for Failing to Keep Records

A director or officer "who refuses to make or direct to be made any book entry… required by law in the manner required by law" is guilty of a crime. Corp C §§6812(b), 8813(b), 9690. If a director, officer, or agent of a nonprofit corporation knowingly receives corporate property and, with intent to defraud, fails to make "a full and true entry" in the books or accounts of the corporation, that failure is a crime. Corp C §§6813(a), 8814(a), 9690. It is also a crime for a director, officer, agent, or member, with intent to defraud to (Corp C §§6813(b), 8814(b), 9690):

- Destroy or falsify documents or securities belonging to the corporation; or
- Make or omit a material entry in a corporate record or document kept by the corporation. Corp C §§6813(b), 8814(b), 9690.

Violation is punishable by imprisonment in state prison, by a fine of up to $1000, by imprisonment in county jail for up to 1 year, or by fine and imprisonment. Corp C §§6812(c), 6813(c), 8813(c), 8814(c), 9690.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/ IV. REPORTING/§12.43 A. Summary of Reporting Requirements

IV. REPORTING

§12.43 A. Summary of Reporting Requirements

The following summary is an overview and is not meant to replace the more detailed discussion in §§12.44-12.69. Generally speaking, religious corporations are subject to only a few reporting and inspection right requirements. See, *e.g.,* Corp C §§9510-9514.

Annual Reports to Members and Directors

- **Public benefit corporations.** A public benefit corporation must send an annual report to its members and board of directors within 120 days after the close of the fiscal year. See §§12.44, 12.48, 12.53.
- **Mutual benefit corporations.** A mutual benefit corporation must prepare an annual report within 120 days after the close of the corporation's fiscal year. See §§12.45, 12.48.
- **Religious corporations.** A religious corporation need not report to its members unless its bylaws so require. See §§12.46, 12.52.
- **Accountant's certification of annual reports.** If an independent accountant prepares a written opinion or report regarding the annual report of a public benefit or mutual benefit corporation, the accountant's report must accompany the annual report. If no independent accountant's report was prepared, the annual report must be accompanied by the certificate of an authorized corporate officer, without audit, from the books and records of the corporation. See §12.47.
- **Annual statement of loans, indemnifications, and self-dealing transactions**. A public benefit or mutual benefit corporation that does not issue an annual report must furnish a statement to its members and directors within 120 days after the close of its fiscal year on certain types of loans, indemnifications, and self-dealing transactions. See §12.49.

Reports to Secretary of State

- **Biennial statement.** Each public benefit, mutual benefit, and religious corporation must file with the California Secretary of State a biennial statement on Form SI-100. See §12.54.
- **Statement designating new agent for service of process.** If the agent for service of process changes, the corporation must immediately file with the Secretary of State a designation of a new agent for service of process. See §12.56.

Reports to Attorney General

Public benefit corporations must file two annual reports (see §§12.58-12.64):

- The Registration/Renewal Fee Report (Form RRF-1), due no later than 4 months and 15 days after the close of the organization's accounting period; and
- The nonprofit corporation's annual report, which is due 4 months and 15 days after the close of the corporation's fiscal year, and consists of IRS Form 990 (or Form 990 EZ, if appropriate) and all applicable schedules.

Public benefit corporations. A public benefit corporation must provide the Attorney General with the following documents (see §12.69):

- **On incorporation, or amendment of articles of incorporation.** A copy of the articles of incorporation or a certificate of amendment of the articles furnished to the Secretary of State when the original document is filed;
- **Consummation of merger.** A copy of any proposed merger agreement, furnished at least 20 days before the merger is consummated;
- **Transfer of substantially all of corporation's assets.** A written notice, furnished at least 20 days before any sale, lease, conveyance, exchange, transfer, or other disposition of all or substantially all of the corporation's assets, unless the transaction is in the usual and regular course of the corporation's activities, or unless the

Attorney General has given the corporation a written waiver.

Public benefit corporations. Public benefit corporations that are required to file reports with the Attorney General under Govt C §12583 and have annual revenue in excess of $2 million must prepare an annual financial statement that is audited by an independent certified public accountant and must make it available to the Attorney General and to the public. Govt C §12586(e). See §12.53.

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B. Reports to Members and Directors

§12.44 1. Annual Report—Public Benefit Corporations

Subject to certain exemptions (see §12.48), a public benefit corporation must send an annual report to its members and board of directors within 120 days after the close of the corporation's fiscal year. Corp C §6321(a). The report must contain the following "in appropriate detail" (Corp C §6321(a)):

- The corporation's assets and liabilities, including trust funds, as of the end of the fiscal year;
- The principal changes in assets and liabilities, including trust funds, during the fiscal year;
- The corporation's revenues or receipts, both unrestricted and restricted to particular purposes, for the fiscal year;
- The corporation's expenses or disbursements for both general and restricted purposes; and
- A statement of the transactions and information described in Corp C §6322 involving self-dealing, indemnifications, or advances between the corporation, its parent, or a subsidiary and any director, officer, or holder of more than 10 percent of its voting power.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.45 2. Annual Report--Mutual Benefit Corporations

§12.45 2. Annual Report—Mutual Benefit Corporations

Subject to certain exemptions (see §12.48), the board of directors of a mutual benefit corporation must prepare an annual report within 120 days after the close of the corporation's fiscal year. The report must be sent to any member who requests a copy in writing. (The corporation must notify each member yearly of the member's right to receive the report.) Corp C §8321(a). The report must contain the following, "in appropriate detail" (Corp C §8321(a)):

- A balance sheet as of the end of the fiscal year;
- An income statement and statement of cash flows for the fiscal year;
- A statement of where the records of current members' names and addresses are located; and
- A statement of transactions involving self-dealing, indemnifications, or advances between the corporation, its parent, or a subsidiary and any director, officer, or holder of more than 10 percent of its voting power. This part of the annual report requires the same information required by Corp C §8322 ("Annual Statement of Certain Transactions and Indemnifications").

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§12.46 3. Annual Report—Religious Corporations

A religious corporation need not report to members unless its bylaws so require. Corp C §9151(c)(7). However, unless its articles or bylaws provide otherwise, a religious corporation must make available its accounting books and records and its minutes of proceedings of the members, the board, and committees of the board on the written demand of any member at any reasonable time for a purpose reasonably related to that person's interest as a member. Corp C §9512.

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§12.47 4. Accountant's Certification of Annual Reports—Public Benefit and Mutual Benefit Corporations

Required documentation. If an independent accountant prepares a written opinion or report regarding the annual report of a public benefit or a mutual benefit corporation, the accountant's report must accompany the annual report. If no independent accountant's report was prepared, the annual report must be accompanied by the certificate of an authorized corporate officer stating that the information in the annual report was prepared, without audit, from the books and records of the corporation. Corp C §§6321(b), 8321(b).

Liability shield. The decision of whether to obtain an independent accountant's opinion or to simply rely on an officer's certificate is generally made on the basis of the resources available to the organization. It is generally believed that a "clean" audit opinion from an independent certified public accountant serves as a "liability shield" for the directors. This belief partly stems from the fact that the CPA has a professional duty to disclose any contingent liabilities in the audited financial statements. Thus, a CPA's regular audit of a tax-exempt organization necessarily involves a search for undisclosed liabilities.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.48 5. Exemptions From and Alternatives to Annual Reports--Public Benefit and Mutual Benefit Corporations

§12.48 5. Exemptions From and Alternatives to Annual Reports—Public Benefit and Mutual Benefit Corporations

Public benefit corporation. It may be totally or partially exempt from some annual report requirements:

- A corporation that receives less than $25,000 in gross revenues or receipts during a fiscal year need provide a copy of its annual report only to its board of directors, not to its membership. An individual member may obtain a copy of the report by requesting one in writing. Corp C §6321(c), (e)(1)-(2).
- If the bylaws provide for regular membership meetings less often than annually, then an annual report need be sent to members only as often as regular membership meetings are required, unless the articles or bylaws require a report more often or a member makes a specific written request. Corp C §§5510, 6321(d).
- As an alternative to an annual report, if the periodic report filed by a corporation with the Registrar of Charitable Trusts (see §§12.57-12.69) contains the same information required in the annual report, then whenever the corporation is required to furnish an annual report it may instead substitute a copy of the periodic report. Corp C §6324(a).
- A corporation that solicits contributions in writing from 500 or more persons need not send its members an annual report if it (Corp C §6321(f)):
- Includes with any written material used to solicit contributions a written statement that its latest annual report will be mailed on written request that is sent to the corporation at a name and address set forth in the statement;
- On receipt of a request for its latest annual report, promptly mails a copy of the report to the requesting person; and
- Publishes its annual report within 120 days after the close of its fiscal year in a newspaper of general circulation in the same county as the corporation's principal office.

NOTE: The time during which the corporation must have made 500 solicitations to qualify for the above alternative is not stated in the Corporations Code. Presumably, the solicitations must have occurred during either the fiscal year just ended or the current fiscal year.

Mutual benefit corporation. A mutual benefit corporation that receives less than $10,000 in gross revenues or receipts during a fiscal year need not prepare an annual report. Corp C §8321(c).

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§12.49 6. Annual Statement of Loans, Indemnifications, and Self-Dealing Transactions—Public Benefit and Mutual Benefit Corporations

Within 120 days after the close of its fiscal year, a public benefit or mutual benefit corporation that does not issue an annual report must furnish a statement to its members and directors on the following types of loans, indemnifications, and self-dealing transactions:

- A brief description of the amount and circumstances of any indemnifications, advances, loans, or guaranties aggregating more than $10,000 paid or made under Corp C §5238 or §7237 in the preceding fiscal year to any officer or director. Corp C §§6322(e), 8322(a).

NOTE: No statement is required if the members approved the transaction. See Corp C §§6322(e), 8322(e).

- A statement briefly describing the following (Corp C §§6322(d), 8322(d)):
- Any "covered" transactions in the preceding fiscal year that, alone or in the aggregate, exceeded $50,000 in which the same "interested person" had a material financial interest; and
- The names of the "interested persons" in the covered transactions, stating the person's relationship to the corporation, the nature of his or her interest in the transaction, and, when practicable, the amount of such interest. In a transaction with a partnership, if the interested person is a partner, only the partnership's interest need be stated.

"Covered" transaction. A "covered transaction" is a transaction to which the corporation, its parent, or its subsidiary was a party and in which any director or officer of the corporation or of its parent or subsidiary, or any holder of more than 10 percent of the voting power of either the corporation or its parent or subsidiary, had a direct or indirect material financial interest. Any such person is an "interested person." Corp C §§6322(b), 8322(b). A mere common directorship is not a material financial interest. Corp C §§6322(c), 8322(c).

Self-dealing transactions. Self-dealing transactions are void or voidable unless specified prior actions have been taken. Corp C §§5233, 7233(a). See §§9.131-9.138.

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§12.50 7. Special Rules for Certain Loans and Guaranties

Public benefit corporations. As a general rule, public benefit corporations may not lend money or property to, nor guarantee the obligation of, any director or officer without the Attorney General's approval. Corp C §5236(a). This rule is subject to specific exceptions. See §9.146.

PRACTICE TIP: Any loan authorized by Corp C §5236(b) or (c) must be reported in the annual report required by Corp C §6322.

Mutual benefit corporations. Unless prohibited by the articles or bylaws, mutual benefit corporations may lend money or property to, or guarantee obligations of, any officer or director of the corporation or of its parent, affiliate, or subsidiary, if certain requirements are met. See Corp C §7235(a); see also §9.147.

Religious corporations. Religious corporations are not prohibited from making loans to, or guaranteeing obligations of, their directors or officers. See Corp C §9241(c); see also §9.148.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.51 8. Methods of Reporting to Members--Public Benefit and Mutual Benefit Corporations

§12.51 8. Methods of Reporting to Members—Public Benefit and Mutual Benefit Corporations

A corporation may give a required report to a member in one of five ways:

- By personal delivery (Corp C §§5511(b), 7511(b));
- By mail or other written communication, addressed to the member at the address on the corporation's books or the address the member has given to the corporation for notice purposes (Corp C §§5511(b), 7511(b));
- By electronic transmission by the corporation (Corp C §§5511(b), 7511(b));
- By including the report in a public benefit corporation's news letter, magazine, or other publication regularly sent to members, addressed and mailed or delivered to each member (Corp C §5016); or

NOTE: If more than one member has the same address, notice to one member is considered notice to the others. Corp C §5016.

- If no address appears on the corporation's books or has been given by the member for notice purposes, then either
- By mail or other written communication, addressed to the member at the corporation's principal office; or
- By publication in a newspaper of general circulation in the same county as the corporation's principal office. Corp C §§5511(b), 7511(b).

On a member's request, a public benefit or mutual benefit corporation must send the member a copy of any periodic report on assets held in charitable trust filed with the Registrar of Charitable Trusts. The corporation may charge the member a reasonable fee for copying and mailing the report. Corp C §§6324(b), 8324(b).

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§12.52 9. Reports to Directors of Religious Corporations

Unless expressly required by its bylaws, a religious corporation need not report to its directors. However, each director of a religious corporation has the right at any reasonable time to inspect and copy all books, records, and documents of every kind, and to inspect the physical properties of the corporation, for any purpose reasonably related to that person's interests as a director. Corp C §9513; see Corp C §9151(c).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.53 10. Reports by Entities Receiving $2 Million or More in Assets

§12.53 10. Reports by Entities Receiving $2 Million or More in Assets

Certain public benefit corporations and trusts are subject to additional reporting requirements under the Nonprofit Integrity Act (Stats 2004, ch 919), which amended the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). These requirements apply to charitable corporations, unincorporated associations, and trusts that (1) must file reports with the Attorney General under Govt C §12583 and (2) have annual revenue in excess of $2 million, exclusive of grants from or contracts for services with governmental entities for which the governmental entity requires an accounting. Govt C §12586(e). An entity that meets these criteria must do the following:

- **Prepare annual financial statements.** The entity must prepare annual financial statements that are audited by an independent certified public accountant in conformity with generally accepted accounting standards. Govt C §12586(e)(1). If the entity required to prepare this statement is controlled by another organization, that organization may prepare a consolidated financial statement. The statements must be available for inspection by the Attorney General and by the public no later than 9 months after the close of the fiscal year. A charity must make its annual audited financial statement available to the public in the same manner as for IRS Form 990. Govt C §12586(e)(1).
- **Appoint audit committees.** If the entity is a charitable corporation, the board of directors must appoint an audit committee, which may include nonboard members, but not staff members, the president or CEO, or treasurer or CFO. The audit committee must be separate from any finance committee, although finance committee members may serve on the audit committee. However, the chair of the audit committee may not be a member of the finance committee, and finance committee members must comprise less than half of the audit committee. Govt C §12586(e)(2). The audit committee is responsible for overseeing the audit of the annual financial statement. See Govt C §12586(e)(2). For a bylaws provision establishing an audit committee, see §7.82

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C. Reports to Secretary of State

§12.54 1. Biennial Statement

Contents. Each public benefit, mutual benefit, and religious corporation must file with the California Secretary of State a biennial statement containing (Corp C §§6210(a)-(b), 8210(a)-(b), 9660):

- The names and complete business or residence addresses of its chief executive officer, secretary, and chief financial officer;
- The street address of its principal California office, if any;
- The mailing address of the corporation, if different from the street address of its principal executive office in California or if the corporation has no principal executive office in California; and
- A designation of an agent for service of process (and that person's complete address, if the agent is not a corporation).

Filing. The statement must be on Secretary of State Form SI-100 (Statement of Information). The fee for filing the statement is $20. Govt C §12186(g). The form is available and may be completed online at the Secretary of State's website at http://www.sos.ca.gov/business/corp/pdf/so/corp_so100.pdf.

NOTE: Credit unions and consumer cooperative corporations must file the statement annually. See Instructions to Secretary of State Form SI-100 (Statement of Information).

Penalties. A nonprofit corporation that fails to file the statement within 60 days after the Secretary of State mails it a notice of delinquency is assessed a $50 penalty. Corp C §§6810, 8810, 9690. If the corporation has not filed a statement for the preceding 24 months and has been assessed a $50 penalty for the prior year, it is subject to suspension rather than further monetary penalties. Corp C §5008.6(a). In that event, the Secretary mails a notice to the corporation that its corporate powers will be suspended at the end of 60 days if the required annual statement is not filed. Corp C §5008.6(b). If the statement is not filed within the 60-day period, the Secretary will notify both the Franchise Tax Board and the corporation of the suspension, and the corporation's powers and privileges will be suspended (except for the purpose of filing for exempt status or amending its articles as necessary either to perfect that application or to adopt a new name). Corp C §5008.6(c).

NOTE: If the corporation files the required annual statement during suspension, the Secretary will notify the FTB and the corporation may then be relieved from suspension under Rev & T C §23305a, unless the FTB holds it in suspension under Rev & T C §23301, §23301.5, or §23775 for failure to file a tax return or pay assessed taxes. Corp C §5008.6(d).

Use for submitting amended statements. The Biennial Statement form may also be used to submit an amended statement between the applicable filing periods to report changed information. The form is available and may be completed online at the Secretary of State's website at http://www.sos.ca.gov/business/corp/pdf/so/corp_so100.pdf.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.55 2. Statement Designating New Agent for Service of Process

§12.55 2. Statement Designating New Agent for Service of Process

Nonprofit corporations must maintain a current designation of agent for service of process with the Secretary of State. Therefore, a corporation must immediately file a designation of a new agent for service of process when (Corp C §§6212, 8212, 9660(a)):

- A natural person designated as agent for service of process dies, resigns, or no longer resides in California; or
- A corporate agent for service of process resigns, dissolves, withdraws from California, forfeits its rights to transact intrastate business, is suspended, or ceases to exist.

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§12.56 3. Amendments to Articles and Restated Articles

A nonprofit corporation's articles may be amended in two ways:

- The corporation may file a "certificate of amendment" with the Secretary of State containing the wording of the amendment or amended articles and other information prescribed by statute. See Corp C §§5810-5818, 7810-7818, 9620(a).
- The corporation may file a document titled "Restated Articles of Incorporation of _ _[*name of corporation*]_ _" restating the entire text of its articles as amended. Corp C §§5819, 7819, 9620(a).

For discussion of and forms for amending the articles of incorporation, see §§6.34-6.46.

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D. Reports to Attorney General

§12.57 1. Through Registrar of Charitable Trusts

The Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) is administered by the Attorney General through the Registrar of Charitable Trusts. Reports under the Act are intended to provide enough information about charitable organizations to enable the Attorney General to ascertain whether they are being properly administered. Govt C §§12586(b), 12588. Regulations adopted under the Act appear in 11 Cal Code Regs §§300-312.

The Registrar of Charitable Trusts may be contacted at:

Registrar of Charitable Trusts
P.O. Box 903447
Sacramento, CA 94203-4470
Telephone: (916) 445-2021
Fax: (916) 444-3651
Website: http://www.ag.ca.gov/charities/

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.58 a. Corporations Required to Report

§12.58 a. Corporations Required to Report

Two annual reports. Nonprofit public benefit corporations must file two annual reports:

- The Registration/Renewal Fee Report, California Attorney General Form RRF-1; and
- The corporation's annual report, which is due 4 months and 15 days after the close of the corporation's fiscal year, and now consists only of IRS Form 990, Form 990-EZ, or Form 990-PF, and all schedules to the applicable form.

Time for filing. Every registered charitable nonprofit corporation, association, or trustee holding assets for charitable purposes is required to file Form RRF-1 no later than 4 months and 15 days after the end of the organization's accounting period. Govt C §12586(b); 11 Cal Code Regs §305. However, the Attorney General's office may allow an extension of time for filing Form RRF-1 for an organization that has received an extension from the IRS for filing IRS Form 990, Form 990-PF, or Form 990EZ. Form RRF-1 may be filled in online and printed at the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/rrf1_form.pdf.

Contents of filing; fees. The organization must file both Form RRF-1 and IRS Form 990, Form 990-PF, or Form 990-EZ at the same time with the Registry of Charitable Trusts, along with copies of all requests to the IRS for an extension, and when approval of the extension is not automatic, a copy of each approved extension request. See Instructions to Form RRF-1, available on the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/rrf1_instructs_05.pdf. 11 Cal Code Regs §305. In addition to a registration fee, a charitable corporation may be assessed a late fee or an additional fee of $25 for each month or part of the month after the date when Form RRF-1 was due or after any period of extension granted. Govt C §12586.1.

Charitable or public benefit purposes. The Attorney General interprets the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) to include nonprofit corporations whose articles include purpose statements that are within the broad legal meaning of "charitable" or "public benefit," or that contain a clause irrevocably dedicating the corporation's assets to charitable purposes. A dissolution clause providing that assets will be distributed for charitable purposes might similarly be viewed as further evidence that the corporation is subject to the Act.

NOTE: A corporation may provide in its articles that on dissolution the assets will go to a charity or for charitable purposes without becoming subject to the Act, because no charitable trust is imposed on the assets until dissolution occurs. Govt C §12585(a). However, the Attorney General may assert jurisdiction for actions before such dissolution if he or she fears that waste may occur. Govt C §12598.

Financial statements. Entities required to file other reports with the Attorney General that also prepare financial statements that are audited by a certified public accountant must make them available to the Attorney General and the public within 9 months after the end of the fiscal year to which the statements relate. Govt C §12586(f).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.59 b. Entities Exempt From Filing Form RRF-1

§12.59 b. Entities Exempt From Filing Form RRF-1

Nonprofit corporations and organizations that are not required by law to register with the Attorney General are not required to file Form RRF-1. These entities include the following (Govt C §12583; see Instructions for Form RRF-1):

- A government agency;
- A religious corporation sole or other religious corporation or organization that holds property for religious purposes;
- A cemetery corporation regulated under Bus & P C §§9600-9789;
- A political committee, as defined in Govt C §82013, that is required to and does file with the Secretary of State any statement under Govt C §§84200-84226;
- A charitable corporation or unincorporated association organized and operated primarily as a religious organization, educational institution, or hospital;
- A health care service plan licensed under Health & S C §1349 that reports annually to the Department of Managed Healthcare; and
- Corporate trustees subject to the jurisdiction of the Superintendent of Banks of the State of California or to the Comptroller of Currency of the United States. However, trustees for testamentary trusts should file a copy of a complete annual financial summary that is prepared in the ordinary course of business. See Prob C §§16060-16063.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.60 c. Filing and Fee

§12.60 c. Filing and Fee

Form RRF-1. No later than 4 months and 15 days after the end of the calendar year or fiscal year, all registered charities, regardless of receipts or assets, except for those listed in §12.59 as being exempt, must file Form RRF-1 with the Attorney General's Registrar of Charitable Trusts (see §12.57). No extension of time for filing Form RRF-1 will be granted. Govt C §12586; 11 Cal Code Regs §305.

IRS Form 990. Within 4 months and 15 days after the close of the organization's fiscal year, charities with revenue or assets over $25,000 must file a copy of IRS Form 990, Form 990-EZ, or Form 990-PF, together with attachments, with the Attorney General's Registrar of Charitable Trusts. If the IRS has granted an extension for delayed filing of the charitable entity's Form 990, the Attorney General will recognize that extension for the delayed filing of forms with the Registrar of Charitable Trusts. In this case, a copy of the applicable Form 990 must be filed with the Registrar of Charitable Trusts when it is submitted to the IRS. See Instructions to Form RRF-1.

Fee based on gross revenues. When filing Form RRF-1, charities and trustees registered with the Attorney General's Registrar of Charitable Trusts must pay a fee based on gross revenues as follows (Instructions to Form RRF-1, available on the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/rrf1_instructs_05.pdf:

Gross Annual Revenue	Fee
Less than $25,000	0
Between $25,000 and $100,000	$25
Between $100,001 and $250,000	$50
Between $250,001 and $1 million	$75
Between $1,000,001 and $10 million	$150
Between $10,000,001 and $50 million	$225
Greater than $50 million	$300

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.61 d. Registration and Reporting Requirements

§12.61 d. Registration and Reporting Requirements

Initial filing; fees. Each organization to which the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) applies must submit an Initial Registration Form (CT-1 Registration Form) to the Attorney General's Registry of Charitable Trusts (see §12.57). The form calls for certain information and documentation prescribed by the Attorney General. The form may be completed online and printed from the Attorney General's website at http://www.ag.ca.gov/charities/forms/charitable/ct1-form.pdf. It must be filed within 30 days after the organization's receipt of assets for the charitable purpose for which it was organized, accompanied by a $25 registration fee. Govt C §12585.

Annual reports. In addition to its initial registration, an organization must file annual reports with the Registrar of Charitable Trusts. For more information on these requirements of the Supervision of Trustees and Fundraisers for Charitable Purposes Act, see §12.62.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.62 e. Annual Reports

§12.62 e. Annual Reports

An organization subject to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) must file two periodic written reports with the Registrar of Charitable Trusts. Govt C §§12586-12587; 11 Cal Code Regs §§301, 311-312.

Subject to the limitations discussed in §12.57, charitable corporations must annually file a Registration/Renewal Fee Report, Form RRF-1, no later than 4 months and 15 days after the close of each calendar or fiscal year. Even if the corporation is a "small" charity and is not required to pay an annual fee (see §12.60), and even if the organization is on extended reporting, it still must submit Form RRF-1 no later than 4 months and 15 days after the close of the calendar or fiscal year. Form RRF-1 may be filled in online at the Attorney General's website at http://www.ag.ca.gov/charities/.

Form RRF-1 is a one-page form, which asks only the following nine substantive questions, each under penalty of perjury and each applying to the 2 years preceding the date that Form RRF-1 report is signed:

- Were there any contracts, loans, leases, or other financial transactions between the organization and any officer, director, or trustee of the organization, either directly or with an entity in which such officer, director, or trustee had any financial interest?
- Was there any theft, embezzlement, diversion, or misuse of charitable property or funds?
- Did nonprogram expenditures exceed at least 50 percent of gross revenues?
- Were any organization funds used to pay any penalty, fine, or judgment?
- Were the services of a professional fundraiser or fundraising counselor used? If so, provide an attachment listing the name, address, and telephone number of the service provider.
- Did the organization receive any governmental funding? If so, provide an attachment listing the name of the agency, mailing address, contact person, and telephone number.
- Did the organization hold a raffle for charitable purposes? If so, provide an attachment indicating the number of raffles and the date(s) they occurred.
- Does the organization conduct a vehicle donation program? If so, provide an attachment indicating whether the program is generated by the charity or whether the organization contracts with a commercial fundraiser for charitable purposes.
- Did the organization have prepared an audited financial statement in accordance with generally accepted accounting principles?

PRACTICE TIP: If the organization filed IRS Form 4720 with the IRS, it must attach a copy to Form RRF-1.

The organization must also file annually, within 4 months and 15 days after the close of the organization's fiscal year, a copy of the organization's IRS Forms 990, 990-EZ, or 990-PF, as applicable. The organization may obtain an extension of time "for good cause" to file succeeding reports. 11 Cal Code Regs §305. The Registrar of Charitable Trusts recognizes extensions granted by the IRS for filing Forms 990, 990-EZ, or 990-PF if a copy of the form is submitted to the Registrar of Charitable Trusts at the time the filing is made.

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§12.63 f. Mixed and Split-Interest Trusts

Mixed trusts. A trust formed for both charitable and noncharitable purposes is referred to as a "mixed trust." For purposes of registration with the Registrar of Charitable Trusts, a mixed trust is considered a charitable trust required to report to the Attorney General and is subject to that office's supervision.

Distinguished from split-interest trusts. A mixed trust should be distinguished from a "split-interest trust," which is any charitable trust in which a part of the unexpired interests is not devoted to charitable purposes and is not exempt from tax (see §§15.47-15.65). An example of a split-interest trust is a charitable remainder trust. In a charitable remainder trust (*i.e.,* one so qualified under IRC §664), the trustee is required to pay the annuity or unitrust amount to a private person until his or her death, or for a term of years. After that death or term of years, the trustee must distribute the trust corpus to a designated or determinable charity. The trustee of a charitable remainder trust must register with the Registrar of Charitable Trusts within 30 days after the death of the life income beneficiary or after expiration of the term of years, as appropriate. See Govt C §12585(a).

Mixed trusts valid. Unlike a charitable remainder trust in which the charitable distribution is authorized only for a future time when the noncharitable interests expire, a mixed trust is one that is simultaneously conducted for both charitable and private purposes. If trust funds may be allocated reasonably between private and charitable purposes, a trust created for mixed charitable and noncharitable purposes is valid. For example, in *Davenport v Davenport Found.* (1950) 36 C2d 67, 222 P2d 11, a trust was created for several purposes, some of which were charitable and some of which were not. The supreme court reversed a nonsuit against causes of action attacking the validity of the trust and remanded the case to the trial court to determine whether the charitable provisions of the trust were severable from the noncharitable provisions. In the words of the California Supreme Court, "[V]alid trusts should not be disregarded because in the instrument creating them one particular invalid trust is declared, unless the latter is so inseparably blended with the others that it cannot be eliminated without destroying the main intent of the trustor, or working manifest injustice to the other beneficiaries." 36 C2d at 74. See also *In re Coe* (NM 1992) 826 P2d 576; *Estate of Teubert* (W Va 1982) 298 SE2d 456; *Rice v Morris* (Tex 1976) 541 SW2d 627; Bogert, The Law of Trusts and Trustees §372 (rev 2d ed 1977).

PRACTICE TIP: If a trust for mixed charitable and noncharitable purposes is valid and enforceable, it must register and report its charitable assets to the Attorney General within 30 days after "any charitable interest in a trust becomes a present interest." Govt C §12585(a).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.64 g. Reports Provide Accountability

§12.64 g. Reports Provide Accountability

Charitable corporations often operate without the accountability to stockholders or members that is required of other corporations. The beneficiaries of charitable corporations are the public or a class of the public, the number and identity of which are uncertain. The reports filed on Registration/Renewal Fee Report (Form RRF-1) and the annual submission of IRS Form 990, Form 990-EZ, or Form 990-PF provide accountability to the public and to the Attorney General in the role of legal representative of the public interest. Passive or inactive corporations may be prodded into activity, those with an unreasonable accumulation of funds will be encouraged to use the funds for charitable purposes, and questionable transactions and unreasonable salaries will be investigated. The Attorney General ordinarily administratively resolves these issues, but may impose the sanctions described in §§12.65-12.66.

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h. Sanctions for Failing to File Report

§12.65 (1) Disallowance of Tax Exemption

The franchise tax exemption of any charitable corporation may be disallowed for any year for which it fails to register or file any required report with the Registrar of Charitable Trusts. Rev & T C §23703(a). Disallowance occurs after the Attorney General sends written notice of noncompliance to the Franchise Tax Board. Rev & T C §23703(b). The current practice is for the Attorney General to warn the corporation and extend an opportunity to comply before notifying the FTB. The exemption may be reinstated after compliance, but the corporation must still pay the minimum franchise tax for each year for which its exemption was disallowed. Rev & T C §23703(c).

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§12.66 (2) Other Sanctions

Appropriate proceedings. The Attorney General may "institute appropriate proceedings to secure compliance [with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7)] and to invoke the jurisdiction of the court." Govt C §12591. "Appropriate proceedings" probably include proceedings for injunctive relief and for mandamus. Most actions by the Attorney General in this field are subject to a 10-year statute of limitations. Govt C §12596. A judgment in favor of the state allows the costs of the state's investigation and prosecution to be collected from the person who had the duty to report. Govt C §12597.

Late fee. In addition to a registration fee, a charitable corporation or trustee, commercial fundraiser, fundraising counsel, or coventurer may be assessed a late fee or an additional fee of $25 for each month or part of the month after the date on which the registration statement and financial report were due to be filed or after the period of extension granted for the filing if the charitable corporation or trustee, commercial fundraiser, fundraising counsel, or coventurer does any of the following (Govt C §12586.1):

- Exists and operates in California without being registered;
- Solicits contributions in California without being registered or, if applicable, bonded;
- Fails to file its first report no later than 4 months and 15 days following the close of each calendar or fiscal year and has not requested an extension of time to file the annual report;
- Fails to file its subsequent annual report no later than 4 months and 15 days following the close of each calendar or fiscal year subsequent to the filing of the first report and has not requested an extension of time to file the annual report;
- Fails to file its annual registration/renewal form within the time specified by the Attorney General irrespective of other report filing requirements; or
- Fails to correct the deficiencies in its registration or annual report within 10 days of receipt of written notice of those deficiencies.

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§12.67 i. Reports Under Uniform Prudent Management of Institutional Funds Act

California has adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18500-18510), which repeals and replaces the Uniform Management of Institutional Funds Act (UMIFA) (Prob C §§18500-18509). The UPMIFA updates UMIFA, and applies to endowment funds held for charitable purposes by nonprofit charitable institutions.

The UPMIFA addresses three principal issues: the scope of coverage, investment obligations, and expenditure of funds. It applies to charitable institutions no matter how organized, and refines the investment obligations set forth by UMIFA. Additionally, UPMIFA provides an express rule for the prudent expenditure from an endowment fund.. Under UPMIFA, expenditures can be made from corpus as long as it is prudent to do so. The UPMIFA abolishes the concept of historic dollar value as a limit for endowment expenditures. It also provides a modern rule for the exercise of cy pres. See *The Uniform Prudent Management of Institutional Funds Act*, National Conference of Commissioners on Uniform State Laws, October 10, 2006.

For detailed discussion of UPMIFA, see chap 16.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.68 j. Filings With Registrar of Charitable Trusts Required on Basis of Fundraising Revenues and Expenditures

§12.68 j. Filings With Registrar of Charitable Trusts Required on Basis of Fundraising Revenues and Expenditures

A charitable organization engaged in any solicitation or sales solicitation for charitable purposes (see chap 14) must file three copies of Attorney General Form CT-694 with the Registrar of Charitable Trusts if it (see Form CT-694; Bus & P C §17510.9):

- Collects contributions of more than $1 million and more than 50 percent of its annual income in California; and
- Spends more than 25 percent of that income on "nonprogram activities."

For further discussion of fundraising regulations and related issues, see chap 14.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.69 2. Other Reporting Requirements: Articles of Incorporation, Certificates of Amendment, Mergers, and Disposition of Assets

§12.69 2. Other Reporting Requirements: Articles of Incorporation, Certificates of Amendment, Mergers, and Disposition of Assets

Public benefit corporations. A public benefit corporation must provide the Attorney General with the following documents:

- A copy of its articles of incorporation or a certificate of amendment of the articles, furnished to the Secretary of State when the original document is filed (Corp C §§5120(d), 5817; see Corp C §5120(e); see also chap 6);
- A copy of any proposed merger agreement, furnished at least 20 days before the merger is consummated (Corp C §6010(b)); and
- A written notice, furnished at least 20 days before any sale, lease, conveyance, exchange, transfer, or other disposition of all or substantially all of the corporation's assets, unless the transaction is in the usual and regular course of the corporation's activities, or unless the Attorney General has given the corporation a written waiver (Corp C §5913) (obtaining the waiver may take substantial time and may involve the Attorney General's imposition of significant conditions on the transfer).

Health facilities. If a nonprofit public benefit corporation operates or controls a health facility as defined in Health & S C §1250, or a facility that provides similar health care, then (Corp C §§5914-5925):

- The Attorney General must conduct a public meeting and notify the charity in writing of its decision to consent, conditionally consent, or not consent to the agreement or transaction; and
- The Attorney General is authorized to consult with, and receive advice from, any state agency and/or private expert or consultant.

The public benefit corporation must reimburse the Attorney General for the costs of these activities.

Mutual benefit and religious corporations. The above provisions may also apply to mutual benefit and religious corporations. See chap 20.

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E. Best Voluntary Reporting Practices

§12.70 1. Anti-Terrorist Financing Guidelines

The United States Department of the Treasury has issued Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities (Guidelines). The full text of the Guidelines can be found online at http://www.treas.gov/offices/enforcement/key-issues/protecting/charities-intro.shtml.

Purpose. The Guidelines are intended to prevent the diversion of charitable funds to terrorist organizations. The Guidelines assist charities in developing or strengthening a risk-based approach to guard against the threat of diversion of charitable funds to terrorist organizations. In addition, the Guidelines facilitate compliance with existing government legal requirements related to combating terrorist financing. The Guidelines achieve these ends by suggesting voluntary best practices concerning due diligence required of United States-based charities before disbursement of funds to foreign organizations. However, the Guidelines go even further and suggest overall best practices relating to governance and transparency having nothing to do with foreign grantees or activities. See §12.71.

Humanitarian activities in sanctions countries. Federal law includes various sanctions administered by the Office of Foreign Assets Control (OFAC). OFAC sanctions are based on transfers to particular countries, as well as transfers to identified groups or individuals. OFAC guidelines for nongovernmental organizations wishing to undertake humanitarian activities in sanctions countries are available online. See http://www.treas.gov/offices/enforcement/ofac/regulations/ngo_reg.pdf.

Criminal statutes. Several anti-terrorist statutes that may affect a charity's grant-making program include 18 USC §2339A (providing support to terrorists), 18 USC §2339B (providing support to designated terrorist organizations), and 18 USC §2339C (financing terrorism). However, the Ninth Circuit has held that 18 USC §§2339A(b) and 2339B(a) are unconstitutionally vague. See *Humanitarian Law Project v Mukasey* (9th Cir 2009) 552 F3d 916, cert granted as *Holder v Humanitarian Law Project* (2009) 174 L Ed 2d 632, 130 S Ct 48 and 175 L Ed 2d 342, 130 S Ct 49.

CAUTION: California practitioners are cautioned to review and ensure compliance with the Unruh Civil Rights Act (CC §51) and other California law before advising their clients to adopt the Guidelines or any portion of them. Because the Guidelines are not federal law they do not have supremacy over conflicting local law. On the Unruh Civil Rights Act, see §10.28.

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§12.71 2. Voluntary Best Practices Under the Guidelines

The Guidelines suggest voluntary best practices concerning due diligence required of United States–based charities before disbursement of funds to foreign organizations, as well as overall best practices, including disclosure and transparency in governance and finances.

- **Governance accountability and transparency.** The Guidelines suggest that the charity should operate in accordance with its governing instruments and that the governing instruments should delineate the charity's basic goals and purposes, define the structure of the charity, set forth requirements concerning financial reporting and accountability, and state that the charity will comply with all applicable regulations. Additionally, to encourage independent oversight, the Guidelines suggest that the charity should make publicly available a list of its board members and the salaries they are paid; maintain records containing additional identifying information about its board members, *e.g.,* home address, Social Security number, and citizenship; and maintain records containing identifying information for the board members of any subsidiary or affiliate receiving funds from the charity.
- **Key employees.** The Guidelines suggest that the charity should make publicly available a list of its five highest-paid employees (the key employees) and the salaries or direct or indirect benefits they receive; maintain records containing additional identifying information about its key employees, *e.g.,* home address, and Social Security number; and maintain records containing identifying information for the key employees of any subsidiary or affiliate receiving funds from the charity.
- **Distribution of funds.** The Guidelines suggest that the charity should publicly identify any subsidiaries or affiliates that receive funds from the charity; provide upon request an annual report, which should describe the charity's purpose(s), programs, activities, tax-exempt status, the structure and responsibility of the governing body of the charity, and financial information; and provide upon request complete annual financial statements that should present the overall financial condition of the charity and its financial activities in accordance with generally accepted accounting principles and reporting practices.
- **Solicitation of funds.** The Guidelines suggest that the charity should clearly state its goals and purposes so that anyone examining its disbursement of funds can determine whether the charity is adhering to those goals; accurately and transparently tell donors how and where their donations are going to be expended; and substantiate on request that solicitations and informational materials, distributed by any means, are accurate, truthful, and not misleading, in whole or in part.
- **Vetting grantees.** The Guidelines suggest a basic vetting of grantees, particularly of each grantee in a foreign county, to include the following:
- Conduct a reasonable search of publicly available information, including the Terrorist Exclusion List (TEL) created by the Secretary of State pursuant to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act) (Pub L 107-56, 115 Stat 272).
- Confirm that the proposed grantee is not on OFAC's master list of Specially Designated Nationals (SDN).
- Obtain information regarding the proposed grantee's key employees; members of its governing board (including if possible, their respective country of residence, date of birth, and place of birth); and check public information to identify whether any of these individuals have any relationship with terrorist financing or other terrorist support activities.
- Check for local country compliance with United Nations Security Council Resolution 1373 (2001) as manifested by publication of a list of terrorist-related individuals and organizations, and if so, confirm that the proposed grantee is not on that country's list. See http://www.un.org/Docs/scres/2001/sc2001.htm.
- As a precondition to the issuance of a charitable grant, a charity should require the grantee to certify that (1) the grantee's receipt of the grant will not cause a violation of any law, statute, or regulation restricting United States persons from dealing with any individuals, entities, or groups subject to OFAC sanctions, and (2) that

the grantee does not deal with any individuals, entities, or groups subject to OFAC sanctions, or with any other persons known to the grantee to support terrorism or to have violated OFAC sanctions.

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3. Crisis Management

§12.72 a. Preparation Required

It is in every exempt organization's best interest to maintain good public relations. Presenting information to the public in a clear and understandable manner, particularly in a crisis or emergency situation, is an important type of voluntary reporting.

Exempt entities are as prone to crises as for-profit entities. Although no one can predict when a crisis will occur, it is almost a certainty that one or more will occur at some point during every organization's life. Nonprofit entities are beholden to the public at large and are often dependent on public contributions for financial survival. Thus, it is more urgent from a public relations standpoint to practice good communications in crisis situations.

Since the possibility of a crisis is foreseeable, best voluntary reporting practices mandate that the organization should prepare for the event. Management only at the time of a crisis is rarely good management. Ad hoc communications resulting from lack of preparedness when a crisis occurs often do more harm than good. A nonprofit organization should take steps well in advance of any crisis to minimize the damage caused both by the crisis itself and by the public perception of it.

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§12.73 b. Best Voluntary Reporting Practices

An outline approach to crisis management, which organizations should adapt to their particular circumstances, is suggested here.

- **Identify risks.** Identify the risks to which your organization is exposed. Department heads should provide lists of the top ten risks their departments face. The lists will duplicate each other in many respects; for example, almost everyone might list such enterprise-wide items as earthquake, employee sabotage, and sustained power outage. Management collates the several lists to a unified list of risks, circulates it, asking employees and others to rank the items and add any omitted.
- Risks involve internal operational and communicational deficiencies, as well as external factors such as susceptibility to power outages, for example. Management should also consider conducting confidential interviews to determine internal risks.
- A unified list of risks and selected interviews are only the initial steps of risk identification. Risk identification is not complete until management assesses the results and acts upon them. Management should institute appropriate precrisis risk-management steps.
- **Establish a crisis response team.** Establish in advance the group of persons in the organization having primary responsibility for public communications regarding crises and appoint backups in case those persons are unavailable.
- **Establish communications procedures.** Because a crisis can occur at any level, it is important that everyone within the organization knows what to do and to whom to report the situation.
- **Role playing.** Office buildings conduct fire drills so that if the real situation occurs, people know where the exits are and are familiar with which stairwells to use. Likewise, organizations should, on a periodic basis, have the crisis response team meet to role play their responses to a particular hypothetical crisis.
- **Assess severity of crisis.** Appropriate responses are required in an actual crisis. To communicate effectively and to show adequate concern, it is imperative to assess the severity of the actual crisis early on. Establishing a procedural checklist in advance will facilitate this important activity when the real crisis occurs.
- **Prepare key messages.** Although responses specific to a particular crisis are required, it is also advisable to prepare standard language to supplement particular messages in a given situation so that those responsible can remain focused on resolving the situation.
- **Determine communication methods.** Today's information age provides a variety of means of communicating. Management should determine the most appropriate communication method in advance of any crisis and take into account that portion of the public a particular crisis is most likely to affect. For example, in case of a widespread and sustained power outage, the Internet may not be available to the organization.
- **Internal guidance.** Staff are by default spokespersons for any organization, even if "official" spokespersons are appointed. In any crisis, management must communicate to all levels of staff what message they should provide. It is generally preferable to allow positive statements such as that the organization has a response plan and has instituted it, as opposed to a simple "no comment."
- **Manage the media.** Management should act positively toward any media involvement and accommodate the media as far as possible.
- **Expect negative reactions.** No amount of preparation will avoid all adverse reactions—it can only minimize them. When reactions are bad, be prepared to deal with them—do not let them surprise you.
- **Employee workplace injury issues.** One form of crisis that a California nonprofit corporation may face is a workplace injury situation in which multiple employees are injured, *e.g.,* by exposure to a toxic substance. For guidance on developing a workplace injury and illness prevention program, see the California Division of Occupational Health and Safety (Cal/OSHA) website. See http://www.dir.ca.gov/dosh/.

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V. RIGHTS OF INSPECTION

A. Inspection by General Public

§12.74 1. Inspection of IRS Form 990, Form 990-PF, and Form 990-T

Available for inspection for 3 years. A copy of the annual return required to be filed by IRC §6033 (*i.e.,* IRS Form 990 and Form 990-PF) must be made available for public inspection during regular business hours at the principal office of the organization during the 3-year period that begins on the filing date for that annual return and, if the organization regularly maintains one or more regional or district offices having three or more employees, at each such regional or district office. IRC §6104(d).

Regional and district offices. If the organization regularly maintains regional or district offices having three or more employees, then the organization must also permit inspection and copying at those offices. IRC §6104(d)(1)(A). A site is not considered a regional or district office if (Treas Reg §301.6104(d)-1(b)(5)(ii)):

- The only services provided at the site further the organization's exempt purposes; and
- The site does not serve as an office for management staff, other than managers who are involved solely in managing the exempt-function activities at the site.

PRACTICE TIP: If the organization does not maintain a permanent office, it may make the annual return available for inspection at a reasonable location of its choice. Treas Reg §301.6104(d)-1(c)(2).

Written request for copy. If an individual makes a written request, the organization must provide a copy within 30 days, without charge other than a reasonable fee for copying and mailing costs. If the request is made in person, the copy must be provided immediately. IRC §6104(d)(1)(B) (but see §12.84 concerning documents made widely available on the Internet).

For discussion of conditions and restrictions on inspection and copying, see §12.82.

The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780). This Act extended the inspection and disclosure requirements and penalties applicable to Form 990 to the unrelated business income tax return (Form 990-T). IRC §6104(d)(1). Certain information that could adversely affect the organization, similar to the information that may be withheld with respect to applications for tax exemption and Form 990 (*e.g.,* information relating to trade secrets), may be withheld. The PPA added a new requirement that Form 990-T be made available for public inspection and copying. A technical corrections bill signed into law in 2007 narrowed the Form 990-T disclosure requirements to the annual return and any schedules or documents relating to the imposition of tax on unrelated business income. Tax Technical Corrections Act of 2007 (Pub L 110-172, 121 Stat 2473) 2007 HR 4839.

PRACTICE TIP: Organizations not required to comply with the requirements of IRC §6104 must still make Form 990-T publicly available if required to file. See IRS Notice 2008-49, 2008-20 Int Rev Bull 979.

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§12.75 a. Organizations to Which IRS Form 990, Form 990-PF, and Form 990-T Inspection Rights Apply

The inspection rights discussed in §12.74 apply to any organization that (1) is described in IRC §501(c) or §501(d) and is exempt from taxation under IRC §501(a), or (2) is a political organization that is exempt from taxation under IRC §527. IRC §6104(a)(1). Internal Revenue Code §501(c) entities include almost any tax-exempt organization that files IRS Form 990 or Form 990-PF, including charities, social welfare organizations, labor unions, business leagues (such as chambers of commerce or realty boards), and social clubs. Section 501(d) organizations include certain religious and apostolic organizations.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.76 b. Nondisclosure of Contributors

§12.76 b. Nondisclosure of Contributors

An organization that files IRS Form 990 need not publicly disclose any contributor's name or address. Private foundations that file IRS Form 990-PF are required to disclose this information. IRC §6104(d)(3)(A).

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§12.77 c. Nondisclosure of Information Previously Withheld by Secretary of the Treasury

Tax-exempt organizations are not required to disclose certain information previously withheld from public inspection by the Secretary of the Treasury. IRC §§6104(a)(1)(D), (d)(3)(B). Thus, if the Secretary, on the request of the organization, withheld information because the Secretary determined that disclosure would adversely affect the organization, then that information need not be disclosed in annual returns subject to inspection. Information that may be shielded from disclosure includes information relating to trade secrets, patents, process, style of work, or apparatus of the organization.

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2. Application for Tax-Exempt Status and Related Documents

§12.78 a. Public Inspection at IRS Office

Applications for tax-exempt status (IRS Form 1023) and papers filed in support of those applications are available for public inspection at the IRS's national office. IRC §6104(a)(1)(A). Letters or documents issued to the applicant by the IRS that relate to the application for tax-exempt status are also available for public inspection. Treas Reg §301.6104(a)-1.

Public inspection rights also apply to materials filed by organizations described in IRC §501(c) or §501(d) that are exempt from taxation under IRC §501(a).

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b. Public Inspection at Organization's Office

§12.79 (1) Exemption Application and Supporting Papers

Inspection at principal office. If an IRC §501(c) or §501(d) organization is exempt from taxation under IRC §501(a) and if the organization filed an application to be recognized as exempt under IRC §501, a copy of that application (*i.e.,* IRS Form 1023 or Form 1024 and any papers submitted in support of the application) must be made available by the organization for inspection at the request of any individual during regular business hours at the organization's principal office and without charge. However, the organization may charge a reasonable fee for any reproduction fees and mailing costs if the person inspecting the returns requests a photocopy. IRC §6104(d)(1)(A).

Regional and district offices. If the organization regularly maintains regional or district offices having three or more employees, then the organization also must permit inspection and copying of the application materials at those offices. IRC §6104(d)(1)(A). A site is not considered a regional or district office if (1) the only services provided at the site further the organization's exempt purposes (such as day care, health care, or scientific or medical research); and (2) the site does not serve as an office for management staff, other than managers who are involved solely in managing the exempt-function activities at the site. Treas Reg §301.6104(d)-1(b)(5)(ii).

PRACTICE TIP: If the organization does not maintain a permanent office, it may make the annual return available for inspection at a reasonable location of its choice. Treas Reg §301.6104(d)-1(c)(2).

Written request for copy. If an individual makes a written request, the organization must provide a copy within 30 days, without charge other than a reasonable fee for copying and mailing costs. If the request is made in person, the copy must be provided immediately. IRC §6104(d)(1)(B) (but see §12.84 concerning documents made widely available on the Internet).

For discussion of conditions and restrictions on inspection and copying, see §12.82.

Contents of exemption application. Generally, the application for tax exemption is defined to include the following (Treas Reg §301.6104(d)-1(b)(3)(ii); Rev Proc 2009-10, 2010-2 Int Rev Bull 258):

- The application letter and a copy of the articles of incorporation, declaration of trust, or other instrument setting forth the corporation's permitted powers or activities;
- The bylaws and any other code of regulations;
- Statements showing the character of the organization, the purpose for which it was organized, and its actual activities;
- The latest financial statement showing assets, liabilities, receipts, and disbursements;
- Statements showing sources of income, receipts, the disposition of those amounts, and whether any income or receipts are credited to surplus or may inure to the benefit of any private shareholder or individual; and
- Any other statements or documents the IRS requires to be filed with an application letter.

NOTE: For the requirements of a substantially completed application, see Rev Proc 2010-9, §3.08, 2010-2 Int Rev Bull 261.

The following documents are *not* included in the term "application for exemption" for purposes of the public inspection requirement:

- Any application for exemption filed by an organization that has not been recognized by the IRS, on the basis of the application, as exempt from taxation for any taxable year; or
- Any material, including the material listed in Treas Reg §301.6104(a)-1(i), that is not available for public inspection under IRC §6104.

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(2) Determination Letter

§12.80 (a) Protected Information

Information that may be deleted before inspection. Generally, written determination letters and background file documents relating to the determination letter must be open to public inspection at the organization's principal office and at any regularly maintained regional or district office having three or more employees. IRC §6110(a); Treas Reg §301.6104(b)-1. However, before making any determination letter or background document available for public inspection, the IRS is directed by IRC §6110(c) to delete the following information (the organization may also delete this information in copies made available for inspection at its offices):

- The names, addresses, and other identifying details of the person to whom the determination letter pertains and of any other person identified in the determination letter or any background file document;
- Information that is specifically authorized to be kept secret in the interest of national defense or foreign policy under criteria established by an Executive Order and that is in fact properly classified under the Executive Order;
- Information specifically exempted from disclosure by any other statute applicable to the IRS;
- Trade secrets and commercial or financial information that is privileged or confidential;
- Information that, if disclosed, would clearly constitute an unwarranted invasion of personal privacy;
- Information in or related to examination, operating, or condition reports prepared by, on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and
- Geological and geophysical information and data, including maps, concerning wells.

IRS liability. It is the IRS's responsibility to determine what information should be deleted. Unless the IRS intentionally or willfully disregards IRC §6110, it will not be liable for failing to delete information unless it has specifically agreed to those deletions or the agency was ordered by a court to make those deletions. IRC §§6110(c), (d)(3). Civil remedies are available, including an action for actual damages and costs against the IRS in the United States Claims Court for intentional or willful failure to make deletions. IRC §6110(j).

CAUTION: The IRC §6110 redaction rules do not apply to written determinations for organizations that fall under IRC §6104. IRC §6110(*l*)(1). Internal Revenue Code §6104 applies to organizations described in IRC §§501(c) or §501(d) that are exempt from taxation, or political organizations exempt from taxation under IRC §527. IRC §6104(a)(1)(A). Internal Revenue Code §6104 contains its own rules regarding suppression of identifying information. See IRC §§6104(a)(1)(C)-(D), (a)(2). However, the IRC §6110 redaction rules apply to all documents not excepted by IRC §6104 or other applicable provisions. IRC §6110(*l*). See §12.81.

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§12.81 (b) Other Matters Not Completely Open to Public Inspection

Previously, certain types of documents relating to tax-exempt organizations were not open to public inspection. Past regulations interpreted the Internal Revenue Code to disallow the IRS from disclosing certain written determinations, including those relating to the *denial* or *revocation* of tax-exempt status. Treas Reg §§301.6104(a)-1(i), 301.6110-1(a). However, these regulations were held to be invalid because they contradicted the plain language of IRC §§6110 and 6104. See *Tax Analysts v IRS* (DC Cir 2003) 350 F3d 100, 102. Thus, the following documents, formerly undisclosed under previous regulations, are now open to public inspection in redacted form (Treas Reg §301.6104(a)-1(i); IRC §§6104, 6110; *Tax Analysts v IRS*, *supra*):

- Unfavorable rulings or determination letters (see Treas Reg §601.201(n)) issued in response to applications for tax exemption;
- Rulings or determination letters revoking or modifying a favorable determination letter (see Treas Reg §601.201(n)(6));
- Technical advice memorandums (see Treas Reg §601.201(n)(9)) relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;
- Any letter or document filed with or issued by the IRS about whether a proposed or completed transaction is prohibited under IRC §503;
- Any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or operating foundation (see IRC §509(a) or §4942(j)(3)) unless the letter or document relates to the organization's application for tax exemption; and
- Any other letter or document filed with or issued by the IRS that, although it relates to an organization's tax-exempt status as an organization described in IRC §501(c) or §501(d), does not relate to the organization's application for tax exemption within the meaning of IRC §6104(e).

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§12.82 3. Organization's Rights and Obligations Concerning Inspections and Requester's Right to Complain

Inspection; employee presence. A tax-exempt organization is permitted to have an employee present in the room during an inspection. The organization must allow the individual conducting the inspection to take notes freely during the inspection and to photocopy documents at no charge if the individual provides the photocopying equipment at the place of inspection. Treas Reg §301.6104(d)-1(c)(1).

Written request. When a written request is made to the organization for photocopies of documents, the organization must comply within 30 days and may charge a reasonable fee for copying and postage. IRC §6104(d)(1)(B); Treas Reg §301.6104(d)-1(d)(2).

In-person request. When an in-person request is made, the organization must provide the copies to the requester on the day the request is made unless unusual circumstances exist making it unreasonably burdensome for the organization to comply. Treas Reg §301.6104(d)-1(d)(1)(ii). In this case, the organization must provide copies on the next business day following the day the unusual circumstances cease to exist or, if earlier, the fifth business day after the request. Unusual circumstances include the following (Treas Reg §301.6104(d)-1(d)(1)(ii)):

- A volume of requests exceeding the organization's daily copying capacity;
- Requests received shortly before the end of regular business hours requiring extensive copying; and
- Requests received on a day when the organization's managerial staff capable of fulfilling such request are conducting special duties, such as student registration or off-site meeting or conventions, rather than simply carrying on regular administrative duties.

Local agents. An organization may retain a local agent to process requests made in person for copies of its documents. The agent is subject to the same time limits as the organization and must be reasonably close to the organization's relevant office. Treas Reg §301.6104(d)-1(d)(iii).

NOTE: If the organization denies an individual's request for inspection and copying of an application for exemption or an annual information return, the individual may alert the IRS to the possible need for enforcement action by providing a statement to the IRS district director in which the applicable tax-exempt organization's principal office is located, describing the reason why the individual believes the denial was in violation of the requirements of IRC §6104(d). Treas Reg §301.6104(d)-1(g). See Rev Proc 2010-9, §2.01, 2010-2 Int Rev Bull 260 (eliminating key IRS districts).

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§12.83 4. Harassment Limitation

Inspection not required in harassment cases. If, on application by the organization, the IRS determines that a request for inspection is part of a harassment campaign and that compliance with the request is not in the public interest, the organization need not provide its IRS Form 990 or Form 990-PF, as applicable, for inspection. IRC §6104(d)(4).

Factors indicating harassment campaign. The following facts and circumstances are indicative of a harassment campaign (Treas Reg §301.6104(d)-3(b)):

- A sudden increase in the number of requests for an organization's tax-exemption application or annual information return;
- An extraordinary number of requests made through similarly worded correspondence or form letters;
- Requests that contain language hostile to the organization;
- Evidence that the organization has already provided the requested documents to a member of the purported harassing group;
- A demonstration by the tax-exempt organization that it routinely provides document copies on request;
- Direct evidence of bad faith by the organizers of the purported harassment campaign; and
- Other evidence of a purpose to deter significantly the organization's employees or volunteers from pursuing the organization's exempt purpose.

Application for determination of harassment. An organization may apply in writing to the IRS for a determination that it is the subject of a harassment campaign, describing in detail the facts and circumstances that the organization believes support this determination. The organization may suspend compliance with requests for copies of its documents because of its reasonable belief that the request is part of a harassment campaign, provided it files an application for determination within 10 business days from the day it first suspends compliance. The organization may suspend compliance with any request it reasonably believes is part of the harassment campaign until it receives a response to its application for a harassment determination. Treas Reg §301.6104(d)-3(d). The determination received may attach conditions to its stipulation that an organization is not required to comply with requests it believes are part of the campaign. Treas Reg §301.6104(d)-3(e).

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§12.84 5. Making Documents Widely Available

An organization is relieved of its obligation to provide copies of its application for exemption and supporting documents if, in accordance with Treasury regulations, it has made those documents "widely available." Treas Reg §301.6104(d)-2(a).

Posting on website. A tax-exempt organization can make its application for exemption or its information return widely available by posting the application or return on a website that the organization maintains, or by having the application or return posted as part of a database of similar documents of other tax-exempt organizations on a website maintained by another entity. Treas Reg §301.6104(d)-2(b)(2).

Posting on GuideStar. An entity that maintains a website where tax-exempt organizations can post their documents is GuideStar and Philanthropic Research, Inc., commonly referred to as GuideStar. The website address is http://www.guidestar.org. GuideStar is an IRC §501(c)(3) public charity and describes itself as the national database of nonprofit organizations. Its mission is to bring information technology to the realm of exempt organizations and activities. It effectively operates as a public utility. Information returns of participating organizations can be accessed from GuideStar's website. Currently GuideStar does not post applications for exemption. The posting of returns complies with the requirements of Treas Reg §301.6104(d)-2 for making documents widely available, thus relieving exempt organizations from having to comply with requests for copies of documents posted. The posted documents are available at no charge and are exact duplicates of the original filed documents.

NOTE: GuideStar provides additional fee-based services for subscribers, such as provision of reports on charities prepared by GuideStar analysts and a service enabling verification of an organization's tax-exempt status. GuideStar also provides fee-based services to tax-exempt organizations, such as allowing them to compare compensation practices with other organizations and to assist in their outreach needs.

This other entity must have procedures for ensuring the reliability and accuracy of the application or return that it posts and must take reasonable precautions to prevent alteration, destruction, or accidental loss of the documents posted. Treas Reg §301.6104(d)-2(b)(2)(iii).

Requirements for posting documents. Furthermore, the application or return will be considered widely available only if (Treas Reg §301.6104(d)-2(b)(2)(i)):

- The website through which it is available clearly informs readers that the document is available and provides instructions for downloading it.
- The document is posted in a format that, when accessed, downloaded, viewed, and printed in hard copy, exactly reproduces the image of the application for tax exemption or annual information return as it was originally filed, except for any information permitted by statute to be withheld from public disclosure.
- Any individual with access to the Internet can access, download, view, and print the document without special computer hardware or software required for that format (other than software that is readily available to members of the public without payment of any fee) and without payment of a fee to the tax-exempt organization or to another entity maintaining the website.

Availability for public inspection still required. If the organization's application for exemption and annual information return are "widely available" within the guidelines described above, it need not comply with a request for copies of those documents. Nevertheless, it still must make those documents available for public inspection. Treas Reg §301.6104(d)-2(a). Thus, even if documents are posted on the Internet, an organization must still maintain its documents for inspection and, if they are not accessible on the Internet for any reason, for copying.

PRACTICE TIP: Because the possibility always exists that GuideStar cannot offer its services, for whatever reason, an organization planning to use its services must still maintain its information returns for copying if necessary. This applies more particularly to applications for exemptions, because GuideStar does not post such documents.

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§12.85 6. Obtaining Information Returns

GuideStar (see §12.84) is the fastest way to obtain copies of exempt organizations' information returns. Another avenue that should not be overlooked in California is the Registrar of Charitable Trusts administered by the Attorney General. As noted in §12.58, every registered charitable nonprofit corporation, association, or trustee holding assets for charitable purposes is required to file its annual report every year, in conjunction with Attorney General Form RRF-1. The Attorney General through the Registrar, located in Sacramento, has proven very good at responding rapidly to requests for copies of annual returns. For the address, see §12.57. A service bureau may be used to procure these requests for attorneys without offices in Sacramento.

Confidentiality issues. Both GuideStar and the Attorney General's office are preferable sources for obtaining information returns. These are often required for a variety of business reasons that may be prejudiced if an organization is alerted to an inspection request, as would be the case if the organization was approached directly. GuideStar and the Attorney General's office are not only efficient sources of information returns but, more importantly, are confidential in that the exempt organization concerned is not alerted to inspection requests.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.86 B. Inspection by Members

§12.86 B. Inspection by Members

The members of a nonprofit organization have various rights of inspection. See §§10.108-10.120. For the rules on reporting of lobbying and political expenditures to members and to the IRS, see §19.9.

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§12.87 C. Inspection by Directors

For discussion of the inspection rights of directors, see §§9.163-9.164.

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D. Inspection by Attorney General

§12.88 1. Through Registrar of Charitable Trusts

The Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) requires the Attorney General to maintain a register of charitable corporations, unincorporated associations, and trustees subject to the Act. Govt C §12584. The Act further authorizes the Attorney General to investigate transactions and relationships of nonprofit corporations to ascertain whether their charitable purposes are being carried out in accordance with their articles of incorporation. In fulfilling these duties, the Attorney General has the power to require production of all information, copies of instruments, reports, books, memorandums, papers, documents of title, and other corporate records. Govt C §§12584, 12588. The register established by the Attorney General under the Act and the reports and other corporate records filed with the Registrar by nonprofit corporations are open to public inspection. Govt C §12590.

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§12.89 2. Under Corporations Code

Public benefit and mutual benefit corporations. The Attorney General may at any time examine public benefit corporations and mutual benefit corporations holding assets in charitable trust to ascertain whether they are complying with the charitable trust they have assumed. Corp C §§5250, 7240. A public benefit corporation is also subject to the Attorney General's examination to ascertain the condition of its affairs and whether it has departed from its original purposes. Corp C §5250. These powers of examination clearly include broad powers of inspection.

Religious corporations. Except when enforcing criminal laws (see Corp C §§9230(a), 9690), when acting as counsel for another state agency (see Corp C §9230(c)(3)), or on dissolution (see Corp C §9680), the Attorney General has very limited authority over religious corporations. See Corp C §9230(a). The Attorney General's right to inspect the records of religious corporations appears to be limited to discovery rights in certain types of actions. See, *e.g.,* Corp C §9230(b), (d) (judicial action to determine qualification as religious corporation, or action to enforce specific charitable use of contributed property).

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VI. BROWN ACT APPLICABILITY TO CALIFORNIA NONPROFITS

§12.90 A. Overview of Ralph M. Brown Act

A full discussion of the Ralph M. Brown Act (Brown Act) (Govt C §§54950-54963) is beyond the scope of this chapter, but the material in §§12.91-12.98 covers several issues for practitioners whose public benefit corporation clients administer governmental funds or programs.

Open-meeting requirements. The Brown Act governs meetings conducted by local legislative bodies, such as boards of supervisors, city councils, and school boards. It represents the legislature's determination of how a balance should be struck between public access to meetings of public bodies on one hand and the need for confidential candor, debate, and information gathering on the other. See *McKee v Orange Unified Sch. Dist.* (2003) 110 CA4th 1310, 2 CR3d 774 (California resident has standing to sue for violation of Brown Act even though not resident of county where school district was located). The legislature has established a presumption in favor of public access, and violation of this presumption by any individual or entity subject to the Brown Act will subject that individual or those individuals to criminal sanctions. Govt C §54959. The Brown Act, however, does not allocate authority to members of the public to decide which items will be placed on agendas for debate. *Coalition of Labor Agric. & Bus. v County of Santa Barbara Bd. of Supervisors* (2005) 129 CA4th 205, 28 CR3d 198.

Exceptions construed narrowly. The Brown Act also contains specific exceptions to the open-meeting requirements when the government has a demonstrated need for confidentiality. (On the "emergency" and "dire emergency" exceptions, see §12.95.) These exceptions have been construed narrowly; thus, if a specific statutory exception authorizing a closed session cannot be found, the matter must be conducted in public regardless of its sensitivity. Govt C §54962; *Rowen v Santa Clara Unified Sch. Dist.* (1981) 121 CA3d 231, 175 CR 292; 68 Ops Cal Atty Gen 34, 41 (1985).

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§12.91 B. Nonprofit Corporation Activity Potentially Subject to Brown Act

Under specified circumstances, meetings of boards of directors, commissions, committees, or other multimember bodies that govern nonprofit corporations may become subject to the open-meeting requirements of the Brown Act. See Govt C §54952(c).

Public authority delegated to nonprofit. The Brown Act expressly applies to private corporations and other entities that are created by a "legislative body" for the purpose of exercising authority that can be lawfully delegated to such an entity. Govt C §54952(c)(1). For example, that authority might be delegated to a nonprofit corporation established jointly by various government agencies for the purpose of building, operating, or maintaining a public works project or public facility.

Public funding; member of legislative body on board. An entity that (1) receives funds from a local agency and (2) has an appointed member of the legislative body of the local agency as a member of its own governing board is subject to the Brown Act. Govt C §54952(c)(2). However, the Brown Act does not automatically apply to a nonprofit corporation's board when the legislative body appoints someone other than one of its own members to the nonprofit's board. The mere receipt of public funds by a nonprofit corporation or other entity does not, by itself, subject the recipient nonprofit to the requirements of the Brown Act.

EXAMPLE 1: California City Library, Inc., is a California nonprofit public benefit corporation created to operate public libraries in California City. The city council of California City donates funds to California City Library, Inc., to further its charitable purpose.

EXAMPLE 2: If California City Library, Inc.'s board of directors includes one member of the city council appointed to that board by the city council, California City Library, Inc., is subject to the Brown Act.

EXAMPLE 3: If California City Library, Inc.'s board of directors includes one member of the general public appointed to that board by the city council, the Brown Act does not apply to board proceedings.

Hospitals. The Brown Act also expressly applies to a hospital or any part of a hospital that was leased after January 1, 1994, when the lessee exercises any authority delegated to it by a local government agency. This requirement applies whether the lessee was organized and operated by the local government agency or a delegated authority. Govt C §54952(d).

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§12.92 C. "Meeting" Defined

The term "meeting" includes any gathering or congregation of a majority of the members of a legislative body subject to the Brown Act at the same time and location (including teleconference location as permitted by Govt C §54953) to hear, discuss, deliberate, or take action on any matter that is under the subject matter jurisdiction of the legislative body. Govt C §54952.2(a).

Social gatherings. A meeting can include anything from formal, scheduled, face-to-face sessions to informal social gatherings at which a majority of the legislative body happens to be present. However, if the members do not discuss specific business at such a social gathering, it is not a "meeting" within the meaning of the Brown Act. Govt C §54952.2(c)(5).

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D. Notice and Agenda Requirements

§12.93 1. Regular Meetings

The time and place for regular meetings of a legislative body (but not standing or advisory committees of that body) are set by ordinance, resolution, or bylaws. Govt C §54954(a).

Agenda rules. The agenda, specifying the time and location of the regular meeting and including a brief discussion of issues to be considered, must be posted in a location freely accessible to the public at least 72 hours before the meeting. For purposes of the agenda requirement, "brief" means no more than 20 words; the legislative body is free to provide a more detailed description, but has no obligation to do so. See Govt C §54954.2(a)(1). Every agenda must provide an opportunity for members of the public to directly address the legislative body on any item under the jurisdiction of the body. Govt C §§54954.2(a)(2), 54954.3(a).

NOTE: The agenda need not provide an opportunity for the public to address the legislative body on an item that has already been considered by a committee, composed exclusively of members of the legislative body, at a public meeting at which all interested members of the public were afforded the opportunity to address the committee on the item, before or during the committee's consideration of the item, unless the item has been substantially changed since the committee heard the item, as determined by the legislative body. Govt C §54954.3(a).

ADA issues. The agenda must include information regarding how, to whom, and when a request for disability-related modification or accommodation (including auxiliary aids or services) may be made by a person with a disability who requires a modification or accommodation to participate in the public meeting. Govt C §54954.2(a)(1). If requested, the agenda must also be made available in appropriate alternative formats to persons with a disability, as required under the Americans with Disabilities Act of 1990 (ADA) (42 USC §§12101-12213). Govt C §54954.2(a)(1); see 42 USC §12132.

Only agenda items discussed; exceptions. No action may be taken on any item *not* appearing on the agenda unless the action is otherwise authorized by Govt C §54954.2(b). Govt C §54954.2(a)(2). However, members of the legislative body or its staff may briefly respond to statements or questions by persons exercising their public testimony rights (see Govt C §54954.3); these individuals may also, on their own initiative or in response to questions posed by the public, ask a question for clarification, make a brief announcement, or make a brief report on their own activities. Govt C §54954.2(a)(2). Further, the rule limiting action to items listed on the agenda does not apply to the following (Govt C §54954.2(b)(1)-(3)):

- Emergency meetings (see §12.95);
- When a specified vote of the legislative body determines that immediate action is required and that the cause for immediacy arose after posting the agenda; and
- Previously posted items continued to a subsequent meeting that occurs within 5 calendar days.

NOTE: The legislative body must publicly identify non-agenda matters before discussion. Govt C §54954.2(b).

The public testimony requirement seems to apply to closed sessions as well as to open meetings. But see Govt C §11125.7(c) of the Bagley-Keene Open Meeting Act (Govt C §§11120-11132), concerning state bodies, which expressly provides otherwise.

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§12.94 2. Special Meetings

24 hours' notice. A legislative body may call a special meeting by providing 24 hours' written notice to all members and all media outlets that have requested notification. The notice must be delivered personally or by any other means, and must also be publicly posted. Govt C §54956; 53 Ops Cal Atty Gen 242 (1970).

NOTE: Written notice may be dispensed with as to any member who, at or before the time of the meeting, files a written waiver of notice with the clerk or secretary of the legislative body. The waiver may be given by telegram. Written notice is also not required for any member who is actually present at the meeting when it convenes. Govt C §54956.

Contents. The notice must state the time, place, and business to be transacted at the meeting; no other business may be considered at the special meeting. Govt C §54956.

Public opportunity to be heard. The legislative body must give the public an opportunity to be heard on any item addressed in the special notice. Govt C §54954.3(a).

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§12.95 3. Emergency Meetings

An emergency meeting may be called if a majority of the legislative body determines that an emergency situation exists. Thus, in an emergency situation involving matters requiring prompt action due to the disruption or threatened disruption of public facilities, the legislative body may hold an emergency meeting without complying with the 24-hour notice requirement, the 24-hour posting requirement of Govt Code §54956, or both of the notice and posting requirements, if telephonic notice is at least 1 hour in advance to all media outlets who requested notice. Govt C §54956.5(b). All special meeting requirements (see Govt C §54956) apply to emergency meetings with the exception of the 24-hour notice requirement. Govt C §54956.5(d). See §12.94.

"Emergency" defined. The Brown Act defines an "emergency" as a work stoppage, crippling activity, or other activity severely impairing public health and/or safety. A "dire emergency" is defined as a crippling disaster, mass destruction, terrorist act, or threatened terrorist activity that poses peril so immediate and significant that requiring a legislative body to provide one-hour notice before holding an emergency meeting might endanger the public health and/or safety. Govt C §54956.5(a).

Closed Session. Emergency meetings may be held in closed session if agreed to by two-thirds vote of the members of the legislative body present, or by a unanimous vote of the members present if less than two-thirds of the members are present. Govt C §54956.5(c). See §12.96.

PRACTICE TIP: The minutes of an emergency meeting, a list of persons whom the presiding officer of the legislative body, or designee of the legislative body, notified or attempted to notify, a copy of the rollcall vote, and any actions taken at the meeting must be posted for a minimum of 10 days in a public place as soon after the meeting as possible. Govt C §54956.5(e).

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/§12.96 4. Closed-Session Meetings

§12.96 4. Closed-Session Meetings

Notice requirements. Closed-session meetings have three notice requirements:

- Each item to be discussed or transacted in a closed session must be briefly described in the agenda for the meeting. Govt C §§54954.2(a)(1), 54954.5. See *Moreno v City of King* (2005) 127 CA4th 17, 25 CR3d 29 (city finance director's termination void because city failed to properly include item on its closed session agenda).
- Before adjourning an open meeting to a closed session, a representative of the legislative body must announce the items to be discussed in closed session. Govt C §54957.7(a).
- Once the closed session is adjourned, the agency must reconvene in open session, where it may be required to report votes and actions taken in closed session. Govt C §54957.1(a).

Agenda requirements. The agenda requirement for a closed-session meeting is substantially similar to that of the open meeting. See §12.93. Additional requirements apply in pending litigation or in the legislative body's potential exposure to litigation. Govt C §54956.9. See also Govt C §54962 for agencies that are prohibited from conducting closed sessions.

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Source: Business Law/Advising California Nonprofit Corporations/12 Required Tax Filings, Recordkeeping, Reporting, and Rights of Inspection/ E. Penalties and Remedies for Violation of Act/§12.97 1. Criminal Penalties

E. Penalties and Remedies for Violation of Act

§12.97 1. Criminal Penalties

The Brown Act (Govt C §§54950-54963) provides criminal misdemeanor penalties for certain violations. Specifically, it punishes attendance by a member of a body at a meeting where action is taken in violation of the Brown Act and where the member intends to deprive the public of information to which the member knows or has reason to know the public is entitled. Govt C §54959. In some instances, mere deliberation by the body without taking action will not trigger the criminal penalty. See *Sacramento Newspaper Guild v Board of Supervisors* (1968) 263 CA2d 41, 69 CR 480.

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§12.98 2. Civil Remedies

Civil remedies under the Brown Act include injunction, mandamus or declaratory relief, voidability of the action taken in violation of the Act, and attorney fees. Govt C §§54960-54960.1, 54960.5. These remedies are available to prevent further or future violations and do not require knowledge of action taken—elements required for imposing criminal liability. Attorney fees, if granted, are awarded against the agency, not the individual member or members who violated the Act. Govt C §54960.5. If the agency prevails, it may recover attorney fees from the plaintiff only if the action is found to be "clearly frivolous and totally lacking in merit." Govt C §54960.5.

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13

Nonprofit Operations

Pamela S. Kaufmann

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.1 I. SCOPE OF CHAPTER: BEYOND SECURING NONPROFIT STATUS

§13.1 I. SCOPE OF CHAPTER: BEYOND SECURING NONPROFIT STATUS

There are many legal and practical steps that a new nonprofit may need to take in addition to various corporate and tax filings. These steps include:

- Establishing the nonprofit as an employer (including setting up payroll withholdings, personnel practices, and benefits plans) (see §§13.2-13.47);
- Obtaining appropriate licenses and permits (see §§13.49-13.55);
- Securing insurance (see §§13.56-13.71);
- Opening bank accounts (see §§13.72-13.75);
- Entering into leases (see §§13.76-13.78); and
- Securing intellectual property rights (see §13.79-13.99).

This chapter provides counsel representing nonprofit corporations with helpful information regarding various transactions, accounts, and relationships that the client might need to consider.

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II. EMPLOYMENT ISSUES

§13.2 A. Employer Identification Number

All corporations, even those without a staff, must secure a federal employer identification number (EIN) from the IRS. Like an individual's Social Security number, an EIN identifies the corporation in a variety of governmental filings. IRS Form SS-4, the form used to apply for an EIN, should generally be filed immediately after incorporation and must be filed with the IRS no later than the seventh day after the first payment of wages that are subject to the Federal Insurance Contributions Act (FICA) (IRC §§3101-3128) (Social Security). Treas Reg §31.6011(b)-1(a)(2). See §13.6.

PRACTICE TIP: Applications for an EIN can be obtained and filed online at the IRS website at http://www.irs.gov/businesses. There is no filing fee, and a new EIN is issued immediately on proper completion of the form. Requests from addresses outside the United States cannot be made electronically.

PRACTICE TIP: The founders of the nonprofit should incorporate before seeking an EIN. If they do not, the IRS will require them to apply for a new EIN for the corporation.

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B. Employer Taxes and Withholding

§13.3 1. Federal Taxes

Corporations with employees must ordinarily withhold federal income taxes and Social Security (Federal Insurance Contributions Act (FICA)) taxes from taxable wages paid to their employees. IRC §§3101-3102, 3111, 3121, 3401-3403, 3501-3505, 3509. Detailed instructions for establishing federal withholdings appear in IRS Circular E (Publication 15), Employer's Tax Guide. This publication and many of the other IRS forms and publications mentioned in this chapter are available on the IRS website at http://www.irs.gov.

Many of the federal and state withholding rates described in this chapter are reported online at http://www.adp.com/taxfin/toolbox/statewage. On payroll taxes generally, see Advising California Employers and Employees §§7.15-7.29 (Cal CEB 2005).

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§13.4 a. IRS Form W-4 (Employee's Withholding Allowance Certificate)

Every employee must complete an IRS Form W-4 (Employee's Withholding Allowance Certificate). The employer uses the information in this certificate and various tables provided in IRS Circular E to determine the amount to withhold from every paycheck. (The withholding may be determined by a wage bracket method, a percentage method, or one of several other alternative methods.) See IRS Circular E (Publication 15), Employer's Tax Guide. A new Form W-4 must be submitted whenever the employee wishes to change the withholding. See IRS Publication 505, Tax Withholding and Estimated Tax, for detailed instructions for completing Form W-4.

An employer who pays wages to nonresident aliens must withhold income taxes (unless exempted by federal regulations), withhold Social Security and Medicare taxes, and take certain steps when completing Form W-4 to avoid underwithholding income taxes. See IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Corporations, and Publication 519, U.S. Tax Guide for Aliens.

Publications 15, 15-T, 505, 515, and 519 are available from the IRS website.

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§13.5 b. IRS Form W-2 (Wage and Tax Statement)

Employers must furnish their employees (including nonresident alien employees) with a IRS Form W-2 (Wage and Tax Statement) for the calendar year, listing the employee's taxable wages and the federal withholdings from such wages. This form must be distributed no later than January 31, or earlier if the employee's employment is terminated sooner. For employer information regarding W-2 requirements, see http://www.ssa.gov/employer.

NOTE: The W-2 can be combined with the California withholding statement (EDD Form DE 4) described in §13.15.

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§13.6 c. Social Security Taxes (FICA)

Both employers and employees must pay Social Security taxes (Federal Insurance Contributions Act (FICA) (IRC §§3101-3128); see §13.3). Employers must withhold FICA taxes from each employee's wages and match the amount withheld dollar for dollar. Employers and employees must *each* pay the following percentages of the employee's wages as FICA tax (IRC §§3101(a), 3101(b)(6), 3111(a), 3111(b)(6)):

- 6.2 percent for the old-age survivors and disability portion on wages up to an annual specified amount (71 Fed Reg 62636); and
- 1.45 percent for the Medicare hospital insurance portion (there is no wage base limit on this component of FICA).

NOTE: The wage base limit for 2010 did not increase over the prior year's wage limit, the first time this has happened since 1975.

The employee is required to pay these taxes up to the maximum percentage only once during a calendar year, regardless of the number of employers he or she had during the year. Each employer, however, must pay its full percentage unless the common paymaster rules pertaining to related corporations apply. See Treas Reg §31.3121(s)-1.

Helpful instructions for complying with employers' FICA obligations can be found at the Social Security Administration's website (http://www.ssa.gov/employer).

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§13.7 d. Federal Unemployment Taxes (FUTA)

With a few key exceptions, all employers are subject to federal unemployment taxes (Federal Unemployment Tax Act (FUTA) (IRC §§3301-3311)) for all wages paid, including those to nonresident aliens. Unless exempt, each employer must pay 6.2 percent of each employee's federal wages up to an annual specified amount. IRC §§3301, 3306(b).

An employer may receive a credit of up to 5.4 percent of taxable wages for payments made to a certified state unemployment insurance fund. See IRC §§3302(a)-(b), 3304. See also §13.17. California's unemployment insurance fund is certified. When making FUTA payments, employers must file IRS Form 940 (Employer's Annual Federal Unemployment Tax Return) and attach IRS Form 940-V, an IRS payment voucher, to any payments made with the return.

Organizations described in IRC §501(c)(3) and exempt from federal income taxes under IRC §501(a) are not subject to FUTA taxes. IRC §§3301, 3306(c)(8).

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e. Deposit of Taxes

§13.8 (1) Requirements

Employers must deposit withheld income and Social Security taxes at an authorized commercial bank depository (usually the same bank at which the corporation has its other accounts) or at a Federal Reserve Bank or branch, along with IRS Form 8109-B (Federal Tax Deposit Coupon).

If an employer's federal withholding deposit exceeds a specified dollar amount in a calendar year, the employer must use electronic funds transfer (see Treas Reg §31.6302-1(h)(4)(i)) to make all deposits of taxes required to be made for return periods beginning after December 31 of the following year. The employer must then continue to deposit by electronic funds transfer (either by personal computer or touch-tone phone) in all succeeding years. Treas Reg §31.6302-1(h)(2). See IRS Circular E (Publication 15), Employer's Tax Guide at http://www.irs.gov/businesses. There is a 10-percent penalty for failing to file electronically if the employer is required to do so. Form 8109-B should not be used for electronic deposits.

Even if they are not required to do so, taxpayers may voluntarily participate in the electronic deposit program. Information regarding the Electronic Federal Tax Payment System is available at https://www.eftps.gov/eftps.

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§13.9 (2) Frequency of Deposits

Deposits must be made bi-weekly or monthly, depending on the amount of taxes reported during the "look-back" period. A new employer is considered a monthly depositor during its first tax year because its tax liability for the look-back period is deemed to be zero. A federal withholding tax return, IRS Form 941 (Employer's Quarterly Federal Tax Return), must generally be filed on or before the end of the month following every calendar quarter. See IRS Circular E (Publication 15), Employer's Tax Guide. Certain small employers may be eligible to file the federal withholding tax return on an annual basis rather than quarterly. See Rev Proc 2009-13, 2009-3 Int Rev Bull 323.

NOTE: If an employer accumulates a tax liability of $100,000 or more on any day during a deposit period, it must deposit the tax by the next banking day, regardless of whether it is a monthly or bi-weekly depositor.

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f. Earned Income Credit Payments

§13.10 (1) Advance Payments

An employee who is eligible (based on income and other criteria) for the earned income credit (EIC) and has at least one qualifying child is entitled to receive part of his or her EIC payments with his or her paychecks during the year. IRC §3507. To receive these payments, the employee must complete IRS Form W-5 (Earned Income Credit Advance Payment Certificate). The maximum total EIC varies depending on the number of qualifying children.

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§13.11 (2) After-the-Fact Payments

Certain employees who do not have a qualifying child may still be able to claim the earned income credit (EIC) on their tax return (IRC §32(c)(1)(A)(ii)) even though they are not entitled to receive *advance* EIC payments. See IRS Circular E (Publication 15), Employer's Tax Guide. Employers must notify employees who have no income tax withheld, other than employees claiming exemptions on IRS Form W-4, that they may be eligible for a tax refund based on EIC.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.12 g. Independent Contractors

§13.12 g. Independent Contractors

Certain workers providing services to an organization may be sufficiently independent and free of the principal's control to be deemed independent contractors not subject to the employee withholding or employer tax requirements described in §§13.3-13.7 or any of the corresponding state requirements. See §§13.13-13.27. The general test of independent contractor status is whether the principal *has the right to* control the manner or means by which the work is accomplished, regardless of whether he or she *exercises* the right. Approximately 20 common law factors are considered when determining whether the principal has such right. See, *e.g.,* Rev Rul 87-41, 1987-1 Cum Bull 296; Treas Reg §31.3401(c)-1. See also Training Materials for IRS Examiners on Worker Classification and IRS Publications 15 and 15-A at http://www.irs.gov. Compensation paid to independent contractors is reported on IRS Form 1099 MISC.

Relief from penalties for incorrectly characterizing an employee as an independent contractor and thus failing to withhold taxes from his or her remuneration is available under Revenue Act of 1978 §530 (Pub L 95-600, 92 Stat 2885).

NOTE: Characterization of a worker as an independent contractor may go unchallenged for years until the worker pursues unemployment or disability benefits. At that time, the EDD may choose to challenge the organization's characterization of entire classes of workers. Even if the putative employer ultimately prevails in such challenges, it will have expended considerable time, effort, and money to justify its practices in this area.

PRACTICE TIP: Alleged misclassification of employees as independent contractors is an area of great focus for the IRS and the FTB. Proper analysis and documentation of independent contractor status is essential to avoid recharacterization and the attendant taxes, interest, and penalties. See Working With Independent Contractors, Leased Workers, and Outsourcing, Step 26 (Cal CEB Action Guide November 2005).

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§13.13 2. California Taxes

The procedures for withholding taxes under California law are similar to those under federal law except that California imposes more types of taxes on employers and employees than the IRS does. EDD Publication DE 44, California Employer's Guide, discusses in detail California employers' various withholding and taxpaying obligations. This form is available through the California Employment Development Department (EDD). It and many other publications and forms can be downloaded from the EDD website at http://www.edd.ca.gov.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.14 a. Registration With EDD; Report of New Employees and Independent Contractors

§13.14 a. Registration With EDD; Report of New Employees and Independent Contractors

California employers must register with the Employment Development Department (EDD) and secure an EDD account number within 15 days after paying over $100 of taxable wages to one or more employees in a calendar quarter. EDD Form DE 1NP (Registration Form for Nonprofit Employers) is used for this purpose. California employers must report all newly hired employees to the EDD within 20 days after their hiring. See EDD Form DE 34. See also §13.32.

California employers also must report independent contractor information to the EDD if they are required to file IRS Form 1099-MISC for services performed by an individual or sole proprietor. See EDD Form DE 542. The form must be filed within 20 days after employers pay the independent contractor $600 or more or enter into a contract with the independent contractor for $600 or more.

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§13.15 b. Wage Withholdings

The California equivalent of IRS Form W-4 is EDD Form DE 4 (Employee's Withholding Allowance Certificate). Like Form W-4, this form records the employee's declaration of the number of withholding allowances the employee is electing and authorizes the income tax withholding. However, it is unnecessary to file Form DE 4 if the employee claims the same marital status, number of regular withholding allowances, and additional dollar amount to be withheld for federal and state purposes. State withholding tables are in Form DE 4, available from the EDD (http://www.edd.ca.gov).

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§13.16 c. Personal Income Taxes

California employers must withhold personal income taxes (PIT) from taxable wages paid to employees. See Rev & T C §§17001-18181. The withholding threshold for state PIT varies, depending on whether the employer makes quarterly deposits. These funds must be deposited with the state. The process is similar to that used for depositing federal income taxes. See §13.8.

In addition, like federal PIT, state PIT withholdings can be computed in more than one manner, *i.e.,* a wage bracket table method and an exact calculation method. See the EDD website at http://www.edd.ca.gov. Certain employees of IRC §501(c)(3) charitable organizations, including duly ordained ministers and members of religious orders in the exercise of their duties, are exempt from PIT withholding. See EDD Form DE 231NP (Information Sheet: Nonprofit and/or Public Entities), available at http://www.edd.ca.gov.

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§13.17 d. State Unemployment Insurance Taxes

California employers are generally subject to unemployment insurance (UI) taxes on the taxable wages paid to employees. No similar tax is imposed on employees. The tax rate for new employers is 3.4 percent of each employee's wages up to a prescribed dollar amount ($7000 in 2010) for the first 3 years (Un Ins C §§930, 982); new employers that acquire an established business also have the option of adopting their predecessor's UI tax rate. After 3 years of operations, the UI rate is calculated on the basis of the employer's claims experience and ranges from 1.5 percent to 6.2 percent of each employee's wages in the previous year. For more information on unemployment insurance rates, see EDD Publication DE 44 (California Employer's Guide) and EDD Form DE 231Z (System of Experience Rating), available at http://www.edd.ca.gov.

NOTE: Each year, EDD determines the applicable rate schedules. There is a 15 percent emergency surcharge in the UI rate for 2010. For updated state payroll withholding information, see http://www.edd.ca.gov/Payroll_Taxes/Rates_and_Withholding.htm.

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§13.18 e. Section 501(c)(3) Organizations: Options for Financing UI Costs

Although subject to the unemployment insurance (UI) tax, nonprofit entities that are exempt from taxation under IRC §501(c)(3) have two options for financing their UI costs:

(1) Pay the same UI taxes paid by commercial (for-profit) employers (the tax-rate method); or

(2) Reimburse the State of California for the full cost of all UI benefits paid to their former employees (the reimbursable method).

To elect the reimbursable method, eligible nonprofit California employers must file EDD Form DE 1SNP (Selection of Financing Method by a Nonprofit Organization) *and* EDD Form DE 1NP (Registration Form for Nonprofit Employers) with the Employment Development Department. If the Form DE 1SNP is filed after the Form DE 1NP, it is effective as of the first day of the quarter in which it is filed.

PRACTICE TIP: The reimbursable method may be advantageous if the employer has had few UI claims and expects few in the future. The tax-rate method may be preferable if the employer anticipates heavy layoffs in the near future, or if it needs to predict its unemployment insurance expenses with greater certainty than the reimbursable method allows.

Certain employees of IRC §501(c)(3) nonprofit organizations are exempt from state UI and disability insurance coverage. See §13.21.

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§13.19 f. Employment Training Tax

California employers must normally pay an employment training tax (ETT) to help pay for retraining California employees. See Un Ins C §§930, 976.6. The tax is payable four times a year and is included in the state unemployment insurance (UI) tax paid on behalf of new employees. Employers that have elected the reimbursable method of financing UI contributions (see §13.18) or that have a negative reserve account balance, *i.e.,* have paid less taxes into their reserve account than the total UI benefits that have been paid to their former employees, are not required to pay the ETT. Employers with a negative balance in their reserve accounts must pay UI taxes at a higher rate.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.20 g. State Disability Insurance (SDI) and Family Temporary Disability Insurance (FTDI)

§13.20 g. State Disability Insurance (SDI) and Family Temporary Disability Insurance (FTDI)

Although California *employees* are responsible for paying the state disability insurance (SDI) tax to fund the state disability program, the *employer* is responsible for withholding SDI taxes from the wages paid to its employees. The withholding schedule is set annually. All California employers must deduct family temporary disability insurance (FTDI) contributions from employees covered by the SDI program. FTDI coverage is extended to individuals who take time off work to care for a seriously ill child, spouse, or parent. See §13.47. The SDI rate (including FTDI contributions) is set annually. See Un Ins C §§984, 3300-3303.

Employers have the option of establishing a private disability insurance coverage plan. The plan must provide all the benefits of SDI and at least one benefit not offered by SDI. If an employer elects this option, its employees may be required to make contributions directly to the plan in lieu of the tax withholding in an amount not to exceed the maximum contributions under SDI. See Un Ins C §§2601-3306. See also the Employment Development Department's website at http://www.edd.ca.gov.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.21 h. Special Exemption for Certain Employees of Nonprofit Corporations

§13.21 h. Special Exemption for Certain Employees of Nonprofit Corporations

Despite the general requirement that nonprofit entities pay various payroll taxes and make various payroll withholdings, an exclusion from coverage for state unemployment insurance (UI; see §13.17) and state disability insurance (SDI; see §13.20) exists for certain employees of certain charitable organizations described in IRC §501(c)(3). Exempt employees include, among others:

- Employees of a church or a convention or association of churches;
- Workers receiving rehabilitative or compensatory work in a program conducted for people with impairments who cannot be absorbed in the competitive labor market (*e.g.,* Goodwill Industries employees); and
- Employees whose compensation is less than $50 per calendar quarter.

For a complete listing of exemptions, see EDD Form DE 231NP (Information Sheet: Nonprofit and/or Public Entities). Despite these exemptions, any employer that wishes to do so may elect to provide unemployment insurance to exempt employees. See EDD Form DE 231EC (Information Sheet: Elective Coverage for Employers and Self-Employed Individuals), available at http://www.edd.ca.gov.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.22 i. Single Rate Notice for UI, ETT, and SDI

§13.22 i. Single Rate Notice for UI, ETT, and SDI

California employers receive a single rate notice that shows UI, ETT, and SDI taxes owed annually. This form, Notice of Contribution Rates and Statement of UI Reserve Account (EDD Form DE 2088), is mailed in December. Employers have 60 days from the assigned December 31 "mailing date" to protest any UI figure they believe is in error. On how to file a protest, see EDD Form DE 2088C.

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§13.23 j. Workers' Compensation Insurance

Virtually every California employer is subject to California's workers' compensation laws, even if it has only one part-time employee. See Lab C §§3300, 3351. The workers' compensation regime imposes liability on the employer for industrial accidents (*i.e.,* injuries occurring on the job) and provides a schedule of benefits to be paid to the injured employee or his or her dependents or heirs. This law is a strict liability statute, *i.e.,* coverage is available regardless of the presence or absence of negligence by the employee or employer. On workers' compensation law, see California Workers' Compensation Practice (4th ed Cal CEB 2000).

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.24 (1) Choosing an Insurer

§13.24 (1) Choosing an Insurer

Employers may insure against workers' compensation liability either through an authorized insurance company or by securing a Certificate of Consent to self-insure from the Director of Industrial Relations. Lab C §3700(a)-(b). Employers who choose to purchase insurance may do so through either the State Compensation Insurance Fund or a licensed workers' compensation private carrier.

PRACTICE TIP: The primary advantage of the state fund is that it covers an employer regardless of its claims history or the inherent risk of the industry in which it engages. For many employers, it is the only option for securing commercial workers' compensation coverage because relatively few private carriers cover workers' compensation risk in California.

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§13.25 (2) Using a Broker

Regardless of whether insurance is purchased from the state or from a private insurer (see §13.24), the nonprofit corporation may want to purchase the insurance through a broker to help ensure that it has an advocate if a claim or a dispute arises.

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§13.26 (3) Self-Insurance and Other Alternatives to Commercial Insurance

In response to periodic spikes in premiums and concerns about risk and claims management, many California nonprofit organizations have pursued the following alternatives to the State Compensation Insurance Fund or other commercially available workers' compensation insurance. As with other forms of insurance, the market for workers' compensation insurance is somewhat cyclical, with alternatives being most attractive during periods of marked premium increases. The key alternatives are self-insurance (group or solo) and offshore captive insurance.

Self-insurance. "Self-insurance" permits risk management that is more tailored to the employer's operations and claims management that is more consistent than commercial insurance. Self-insurance plans require approval of the Office of Self Insurance Plans (SIP) of the California Department of Industrial Relations. "Self-insurance" can be obtained by a single employer or by a group of employers within the same industrial classification. The advantages of group plans include certain economies of scale and pooling of risk, but the disadvantages include joint and several liability for the expenses and liabilities of the group and a long-term commitment (often at least 3 years).

Offshore captive insurance. This model has some risk and expense and may not be well suited to nonprofit organizations.

NOTE: "Captive" refers to an insurance company owned by one or more parent organizations that underwrites the insurance needs of the parent or parents (and any subsidiaries). An "offshore" company is one incorporated in a jurisdiction outside the country. Offshore status confers certain tax benefits and can afford privacy.

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§13.27 (4) Covering Volunteers

Although California nonprofit corporations are not legally required to secure workers' compensation insurance on behalf of their volunteers, it may be advisable to do so. Even the best-intentioned volunteer might file a claim against the organization if he or she is injured while providing services to the organization. Coverage by the workers' compensation program limits the organization's financial exposure for injuries.

To be eligible for workers' compensation coverage, volunteers must receive no remuneration for their services other than meals, transportation, lodging, or reimbursement for incidental expenses. Lab C §3352(i). A volunteer is deemed an employee for workers' compensation purposes if the organization's board of directors, in its sole discretion, declares in writing, *before any injury,* that the person is an employee for such purposes. Lab C §3363.6.

If the nonprofit corporation decides to cover volunteers, its board of directors should (1) pass a resolution to this effect, and (2) notify the insurer, who will add an endorsement to the policy reflecting the employer's election and calculate the premium on the assumption that the volunteer earns the minimum wage. The number of hours worked and the worker's classification also will be considered.

PRACTICE TIP: Recognizing volunteers as employees for this one narrow purpose, without the attendant liability of deeming them to be employees for other purposes, affords nonprofit organizations significant protection at a relatively modest cost.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.28 k. Independent Contractors

§13.28 k. Independent Contractors

Independent contractors are not subject to either the employer tax or the employee withholding requirements described in §§13.13-13.27. For factors used to determine independent contractor status, see EDD Form DE 44 (California Employer's Guide); EDD Form DE 38 (Employment Determination Guide); *Empire Star Mines Co. v California Employment Comm'n* (1946) 28 C2d 33, 168 P2d 686, overruled on other grounds in *People v Sims* (1982) 32 C3d 468, 479, 186 CR 77; 22 Cal Code Regs §4304-1.

NOTE: Unlike federal law (see §13.12), California law does not provide any relief from payment of back taxes on behalf of misclassified workers.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.29 I. Employer Tax Credits

§13.29 I. Employer Tax Credits

California and local governments may offer employer tax credits, such as an Enterprise Zone Act (Govt C §§7070-7089) tax credit (see Rev & T C §23622.7) and local tax credits for new jobs, summer youth employment, or enterprise zone employment. Some of these credits are available only for finite periods of time.

PRACTICE TIP: Employers should investigate the availability of such credits with their local government or chamber of commerce; they are generally advertised on the sponsoring agency's website.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.30 3. Local Payroll Taxes

§13.30 3. Local Payroll Taxes

In certain cities, employers may be obligated to pay a local payroll tax on behalf of their employees.

PRACTICE TIP: Attorneys should consult with their clients' local municipal tax offices for more information.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.31 C. Immigration and Naturalization

§13.31 C. Immigration and Naturalization

Under the Immigration Reform and Control Act of 1986 (IRCA) (Pub L 99-603, 100 Stat 3359), all employers must verify, under penalty of perjury, that all employees are United States citizens or authorized aliens by completing IRS Form I-9 (Employment Eligibility Verification). See 8 USC §1324a(b)(2). The purpose of Form I-9 is to verify an employee's identity and to confirm that an employee is eligible for employment by either being a United States citizen or having appropriate visas or other documents establishing the right to work legally in the United States. Employers must physically examine the documentation presented by the employee for this purpose. The instructions accompanying this form, which must be provided to the employee while he or she fills out the form, list all the documents that establish identity, employment eligibility, or both.

Employers are prohibited from specifying which documents they will accept from an employee, and refusal to hire an individual because of a future expiration date of one of these documents may constitute illegal discrimination. To avoid a discrimination claim, employers should not request additional evidence of the worker's eligibility for employment beyond that required by the IRCA. For a detailed discussion of workplace privacy considerations, see Privacy Compliance and Litigation in California, chap 8 (Cal CEB 2008).

Even if an employer knows (*e.g.,* through a family relationship or other acquaintance) that a new hire is entitled to work in the United States, the employer must secure a Form I-9 from that worker. Form I-9 must be retained until 3 years after hire or 1 year after termination, whichever occurs later. 8 USC §1324a(a)(6)(B). An employee's refusal to present proof of identity and authorization to work is grounds for refusal to hire.

NOTE: Effective January 15, 2009, certain federal contractors are required to enroll and participate in an E-Verify program to verify the employment eligibility of all new hires and the eligibility of employees who perform work under the federal contract.

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§13.32 D. New Employee Registry

The Employment Development Department (EDD) requires all California employers to file information about new employees with the New Employee Registry. The purpose of this program is to help locate parents who were delinquent in paying child support. See Un Ins C §1088.5. All businesses must report all employees who are newly hired, rehired, or returning to work from a furlough, separation, leave of absence without pay, or termination. Required information includes the employee's name, address, Social Security number, and start-of-work date; and the employer's name, address, California employer account number, and federal employer identification number. Un Ins C §1088.5(d)(4). Although EDD Form DE 34 (Report of New Employee(s)) was expressly created for filing this report, an employer may instead submit its information through EDD's online service (iNER), or submit its IRS Form W-4 on "alternate equivalent format" or "magnetic media," provided that all required information is included. For this option, see EDD Form DE 340 (Magnetic Media Reporting Requirements for New Employee Registry Program). Reports must be filed within 20 days after the newly hired or rehired employee's start-of-work date. Un Ins C §1088.5(d)(1).

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.33 E. Access to Employment Records

§13.33 E. Access to Employment Records

California employees and former employees have a right to

- Inspect certain personnel records (Lab C §1198.5);
- Receive copies of any documents they have signed that relate to obtaining or holding employment (Lab C §432); and
- Inspect or copy their payroll records (Lab C §226).

Employers are not required, however, to allow employees to inspect letters of reference or records relating to the investigation of a possible criminal offense. Lab C §1198.5(d).

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F. Personnel Practices

§13.34 1. Survey of Applicable Laws

Employers are subject to a vast and complex array of state and federal laws regulating employment conditions. These laws include the following:

- The National Labor Relations Act (29 USC §§151-169), governing collective activity and union organizing in private employment;
- The federal Fair Labor Standards Act of 1938 (29 USC §§201-219), *e.g.,* covering minimum wages, overtime pay;
- The Occupational Safety and Health Act of 1970 (OSHA) (29 USC §§651-678), describing workplace safety requirements;
- The California Occupational Safety and Health Act of 1973 (Cal-OSHA) (Lab C §§6300-6719), also governing workplace safety;
- Other California Labor Code provisions, covering such matters as minimum wage, overtime pay, and time and manner of payment; and
- Several state and federal antidiscrimination laws (see §13.38).

California also recognizes various common law employment claims, such as breach of implied contract to terminate only for good cause and wrongful discharge in violation of public policy. See Advising California Employers and Employees, chaps 5, 17 (Cal CEB 2005); Wrongful Employment Termination Practice, chap 5 (2d ed Cal CEB 1997).

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2. Wage and Hour Laws

§13.35 a. Federal Fair Labor Standards Act; California Wage Orders

Both California and the federal government prescribe wage and hour laws. The Fair Labor Standards Act of 1938 (29 USC §§201-219) established federal minimum wages and overtime obligations that apply to all employees of employers engaged in interstate commerce, with certain exceptions (notably executive, administrative, professional, and outside sales personnel). See 29 USC §213. Interstate commerce is liberally defined. *Atlantic Co. v Walling* (5th Cir 1942) 131 F2d 518. Independent contractors are not considered "employees" under the Act. For the distinction between independent contractors and employees under the Act, see *Real v Driscoll Strawberry Assocs.* (9th Cir 1979) 603 F2d 748. For this distinction for withholding purposes, see IRS Publication 15-A and EDD Form DE 38 (California Employment Determination Guide).

Wages and hours under California law are governed by wage orders found in 8 Cal Code Regs §§11000-11538, as well as a general minimum wage order. Local municipalities also may have ordinances mandating certain wage and hour requirements. For example, the minimum wage for employees in San Francisco is higher than the California rate and is adjusted every year based on the regional CPI. On federal and California wage and hour regulations, see Advising California Employers and Employees, chap 5 (Cal CEB 2005). See also Simmons, Wage and Hour Manual for California Employers (13th ed 2008); Wilcox, California Employment Law (1989).

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§13.36 b. Overtime

Overtime rules are dictated by wage orders promulgated by the Industrial Welfare Commission at the state level under the California Labor Code and at the federal level by the Fair Labor Standards Act of 1938 (29 USC §§201-219). Nonprofit employers should contact the California Department of Labor Standards Enforcement for the wage order governing their specific industry.

California employers must follow whatever applicable rule is most beneficial to the employee. For example, federal law requires overtime pay at 1½ times the regular rate for all hours worked in excess of 40 hours in one week. 29 USC §207(a)(1). In contrast, California law requires overtime pay for all hours worked in excess of 8 hours in 1 day, with limited exceptions. See Lab C §§510-558.

When an employee works overtime, an employer may not reduce the employee's regular hourly rate to maintain compensation at a certain level. This prohibition includes paying a "short-shift differential" or higher hourly rate to employees who work shifts that involve no overtime. See *Huntington Mem. Hosp. v Superior Court* (2005) 131 CA4th 893, 32 CR3d 373. If such payments are made, they may need to be included in determining the employee's regular rate of pay for overtime purposes.

In addition, subject to exceptions, penalties apply to employers that require their nonexempt employees to work during any meal or break periods. Lab C §226.7.

California law is more rigid than federal law in its application of the salaried exemption from overtime. The higher California threshold requires that employees earn a monthly salary equal to at least twice the state minimum wage on a full-time basis and spend more than half their working time on exempt duties to qualify as exempt employees. Lab C §515(a), (c), (e). See, *e.g.,* 29 CFR §541.100(a)(1).

Certain nonprofit corporations that pay an employee an uncontracted bonus or severance payment to compensate for low wages or reward good work may inadvertently run afoul of state charitable trust restrictions. In *Queen* of *Angels Hospital v Younger* (1977) 66 CA3d 359, 136 CR 36, the court held that severance payments made by the hospital to an order of nuns were illegal "gifts" where the corporation had no legal obligation to pay them.

PRACTICE TIP: To avoid the risk of violating the charitable trust laws, nonprofit public benefit corporations and nonprofit mutual benefit corporations that hold assets in charitable trust should create bonus plans in which an employee can expect a bonus if he or she meets specified criteria. Alternatively, they can agree in writing to escalate an employee's salary once certain revenue or performance goals are achieved. Of course, any such compensation must be reasonable to avoid private benefit or private inurement concerns under IRC §501(c)(3) and to avoid prohibited self-dealing under state law. Charitable trust rules would not preclude a charitable employer from negotiating a cash settlement with a disgruntled employee or ex-employee who has sued or threatened to sue the employer. In this case, a written settlement agreement is essential, not only to protect the employer, but to demonstrate that the employer made payment to resolve or prevent a legal dispute.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.37 3. Occupational Safety Requirements

§13.37 3. Occupational Safety Requirements

Both the Occupational Safety and Health Act of 1970 (OSHA) (29 USC §§651-678) and the California Occupational Safety and Health Act of 1973 (Cal-OSHA) (Lab C §§6300-6719) impose various requirements on California employers, which are intended to provide a safe working environment. See 29 USC §§651-678; Lab C §§6300-6719. Among other requirements, Cal-OSHA mandates that all employers prepare and institute an effective injury and illness prevention program. See Lab C §6401.7. Employers of ten or more employees must adopt, retain on file with the organization, and have readily available for inspection written illness and injury prevention programs that include a system for regular communication with employees. 8 Cal Code Regs §3203.

PRACTICE TIP: Businesses with fewer than ten employees have less stringent recordkeeping obligations. These employers can substantially comply with the documentation requirements by maintaining a log of instructions provided to the employee with respect to the hazards unique to the employees' job assignment when first hired or assigned new duties. See 8 Cal Code Regs §3203.

All nonexempt employers of more than ten employees must maintain (and post) an annual log of all workplace injuries, exposures, and hazards, as well as complete an Injury and Illness Incident Report for each entry in the log. 8 Cal Code Regs §§14300-14400. Even when workplace risks appear to be extremely low, all employers must disclose health and safety risks, including those as innocuous as fumes from ink eradicators or photocopiers. Some less hazardous industries need not maintain or post records of occupational injuries and illnesses. See Lab C §6401.7(j)(2).

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.38 4. Nondiscrimination Laws

§13.38 4. Nondiscrimination Laws

The course that California employers must navigate to ensure legal compliance and avoid employment discrimination has become increasingly precarious. A host of state and federal nondiscrimination laws may govern California employers, depending on the number of employees and the source of funds. These laws include, without limitation, the following:

- Title VII of the Civil Rights Act of 1964 (42 USC §§2000e-1—2000e-17), prohibiting discrimination based on race, color, religion, sex, or national origin;
- Executive Order No. 11246 (Sept. 24, 1965), reprinted in 1965 US Code Cong & Ad News 4416 (also reprinted following 42 USC §2000e in USCA and USCS), prohibiting discrimination by employers with contracts or subcontracts with the federal government in excess of $10,000 (same discrimination categories as Title VII);
- Age Discrimination in Employment Act of 1967 (ADEA) (29 USC §§621-634), prohibiting age discrimination against workers age 40 and older by employers of 20 or more employees (see 29 USC §630(b));

NOTE: Uncompensated members of a nonprofit organization's board of directors are not deemed employees for purposes of the ADEA. *Fichman v Media Ctr.* (9th Cir 2008) 512 F3d 1157.

- Age Discrimination Act of 1975 (42 USC §§6101-6107), prohibiting age discrimination in programs or activities receiving federal financial assistance;
- Family and Medical Leave Act (FMLA) (29 USC §§2601-2654), providing certain employees of employers having at least 50 employees with job-protected family and medical leave, including protections against retaliation for using or requesting FMLA leave;
- California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996), prohibiting discrimination by employers of five or more employees on the basis of race, color, religion, national origin, marital status, medical condition, sex (including gender identity), disability, age, or sexual orientation (see Govt C §§12920-12921, generally providing greater employee protection than federal law); statute also requires employers of at least 50 employees to train all supervisory personnel in California on sex harassment every 2 years; anti-harassment provisions apply to employers with one or more employees;
- Equal Pay Act of 1963 (29 USC §206(d)), prohibiting sex discrimination in wages;
- Civil Rights Act of 1866 (42 USC §§1981-1996b), prohibiting race discrimination;
- Americans with Disabilities Act (ADA) of 1990 (42 USC §§12101-12213), prohibiting disability discrimination by employers of 15 or more employees (see 42 USC §12111(5)(A));

NOTE: Uncompensated members of a nonprofit organization's board of directors are not deemed employees for purposes of the ADA. *Fichman v Media Ctr.* (9th Cir 2008) 512 F3d 1157.

- Rehabilitation Act of 1973 (29 USC §§701-796*l*), prohibiting disability discrimination by recipients of federal funds;
- California Equal Pay Law (Lab C §§1197.5, 1199.5), prohibiting sex discrimination in wages; and
- Labor Code §96 (prohibiting adverse employment decisions as a result of off-duty, off-premises lawful conduct), Lab C §98.6 (protecting employees who file or threaten to file a bona fide complaint with the Labor Commissioner), Lab C §132a, (prohibiting discrimination against employees who file or make known their intention to file a workers' compensation claim), Lab C §233, (prohibiting discrimination against employees who use sick leave to care for an ill child, parent, spouse, domestic partner, or child of a domestic partner), Lab C §1102, (prohibiting discrimination based on political activities); Lab C §1102.5 (protecting certain whistleblowers), and Lab C §§6310-6311 (protecting certain whistleblowers who make health and safety complaints). Crimination ordinances may also apply.

Certain nonprofits may be exempt from some nondiscrimination statutes.

PRACTICE TIP: One of the best investments a new employer can make is to secure advice from competent labor and

employment counsel to assist in preparing up-to-date employment applications and personnel policies and to guide the employer toward compliance with this complex array of employment and discrimination laws.

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§13.39 5. Notices to Employees

California and federal law require employers to post or provide a daunting number of notices to their employees. For example, employers must provide notice of salary withholding, family and medical leave, and the minimum wage. Generally, these notices must be posted in a conspicuous location where employees and, in certain instances, applicants may readily view them.

Required postings vary based on the employer's particular circumstances or industry. Citations for violating any of a number of laws may also need to be posted. Local ordinances and regulations may impose additional posting requirements. For posting requirements, see Advising California Employers and Employees, chap 9 (Cal CEB 2005).

PRACTICE TIP: Composite posters that satisfy several of the most common posting requirements are available from the California Chamber of Commerce at http://www.calchamber.com/.

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§13.40 6. Employee Benefit Plans

Federal law allows corporations to establish a variety of tax-favored employee benefit plans. Certain benefits available to for-profit corporations are not available to nonprofit corporations. For example, because California nonprofit corporations cannot issue stock, they cannot offer their employees stock purchase or stock bonus plans. In addition, IRC §501(c)(3) charitable organizations that provide deferred compensation, retirement, and profit-sharing plans must take certain precautions to avoid private inurement or private benefit. See IRC §457(f); GCM 39674 (Oct. 23, 1987); GCM 39670 (Oct. 14, 1987). On excess benefit transactions under IRC §4958, see §3.22. Other benefits, such as those described in §§13.41-13.44, may be available to employees of both for-profit and nonprofit organizations.

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§13.41 a. Deferred Compensation and Retirement Plans

Employees of nonprofit organizations may participate in an assortment of deferred compensation and retirement plans. These plans are subject to IRS rules and enforcement, including limits on total contributions and benefit distributions. Failure to comply with the complex tax rules governing these plans could result in immediate taxation of benefits.

PRACTICE TIP: Given the significance of the loss of favorable tax treatment, employers should work with attorneys and consultants well versed in these rules to ensure continued compliance with these rules. For example, employers sponsoring §403(b) plans were required to comply with new regulations as of January 1, 2009, and adopt a written plan by December 31, 2009. Section 403(b) plan sponsors that adopted written documents by December 31, 2009, will be able, retroactively and without penalty, to correct any plan failure found later if certain requirements are met. IRS Announcement 2009-89, 2009-52 Int Rev Bull 1009.

"Qualified" plans. The most common form of deferred compensation is a "qualified retirement plan" that meets specific IRS criteria. Qualified plans include plans funded by employers, such as traditional pension plans and defined contribution plans, and plans funded by employees' salary deferrals, such as IRC §401(k) plans. In addition, employees of IRC §501(c)(3) organizations may participate in IRC §403(b) plans, which are similar to §401(k) plans but are not considered qualified plans. IRC §403(b)(1)(A)(i). State employees providing services to certain tax-exempt educational organizations are also entitled to participate in these §403(b) plans. See IRC §403(b)(1)(A)(ii).

Nonqualified plans. Executives of nonprofit organizations may also defer compensation under a "top-hat" or nonqualified plan. IRC §457(b). These executives may make income deferrals under "top hat" §457(b) deferred compensation plans or participate in nonqualified deferred compensation plans. IRC §457(f). The rules governing nonprofit executives are more restrictive than those that apply to for-profit organizations. For example, executives of nonprofits are taxed on the present value of any deferred amounts in the first year the amounts are not subject to a substantial risk of forfeiture. This restriction severely limits the use of deferred compensation for executives of nonprofit organizations (beyond the §457(b) limit). See IRC §457(e)(15)(A). The IRS has stated its intent to issue restrictive new rules for these plans, but publication has been postponed.

NOTE: Internal Revenue Code §409A imposes substantial restrictions on nonqualified plans or arrangements that give an employee a legally binding right to compensation that is earned in one year but payable in a later year. Section 409A applies to a variety of arrangements, including deferred compensation plans under IRC §457(f), severance agreements, supplemental executive retirement plans, and incentive plans. Section 409A does not cap the total amount of compensation that can be paid to employees. Instead, it imposes stringent rules on the timing of elections and payment. Failure to comply with these rules subjects the payments to immediate taxation and substantial taxes. See Treas Reg §1.409A-4.

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§13.42 b. Health and Life Insurance; Cafeteria Plans

Employers may provide medical and dental insurance, group life insurance, medical spending accounts, health savings accounts (HSAs), and dependent care benefits as tax-free benefits to employees and their dependents. See IRC §§79, 104-105, 223. Any of these benefits may be offered through a "cafeteria plan," or employer-sponsored benefit package that allows employees to choose between receiving cash or qualified benefits. IRC §125. If the employee chooses "qualified benefits," their value is excluded from his or her income to the extent provided in various Internal Revenue Code sections. See, *e.g.,* IRC §§79, 104-105, 125.

Employees may also use pretax contributions to pay for qualifying medical and dental care expenses through flexible spending accounts. Doing so reduces the salary amounts subject to employer-paid payroll taxes. Amounts remaining in the account at the end of the year or applicable grace period are forfeited. If the employee elects to receive cash, it is included in his or her gross income as compensation.

Certain benefits are not deemed "qualified benefits" under IRC §125 and cannot be offered under a cafeteria plan. These include scholarships and fellowship grants (IRC §117), employer-provided educational assistance benefits (IRC §127), long-term care insurance, and excludable fringe benefits (such as "qualified employee discounts" and "qualified transportation fringe") (IRC §132). Special rules apply to highly compensated or key employees in years in which the plan discriminates in favor of key employees. IRC §125(c). The IRS originally published proposed regulations requiring cafeteria plans to be documented in a written plan format by January 1, 2009. Prop Treas Reg §1.125-1(d)(1).

NOTE: The IRS has postponed the effective date of the proposed regulations until January 1, 2011, at the earliest.

For additional information regarding health reimbursement arrangements and health savings accounts, see §13.45.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.43 c. ERISA Requirements

§13.43 c. ERISA Requirements

In developing qualified retirement (IRC §401 or §403(b)) plans and health plans (*e.g.,* medical, dental, vision), including many benefits available under cafeteria plans, the employer must adhere to certain formalities and various restrictions in the Internal Revenue Code and in the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461).

PRACTICE TIP: Because the law governing qualified employee benefit plans is complex and requires regular monitoring, employers should retain competent benefits counsel to help design, implement, and update these plans.

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§13.44 d. Transportation Benefits

Employers may offer plans that provide a limited amount of qualified transportation benefits tax-free to employees. IRC §132(f). Each year, employers may provide an aggregate monthly allowance for transit passes and commuter vans, and separate monthly allowances for parking and bicycle expenses. IRC §132(f)(2). The bicycle benefit cannot be provided to any employee simultaneously with any other commuter fringe benefit. Prop Treas Reg §1.132-9(b), Q&A 7.

In the alternative, the employee may contribute up to the same amounts on a pretax basis to fund such reimbursement of qualified transportation expenses other than bicycle expenses. The amounts contributed on a pretax basis are not subject to employment taxes, such as federal unemployment or Social Security taxes. Unlike medical and dependent care flexible spending accounts (see §13.42), the transportation benefit does not include a "use it or lose it" penalty. However, funds cannot be transferred between the reimbursement accounts established for mass transit and parking expenses.

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§13.45 e. Health Reimbursement Arrangements and Health Savings Accounts

In addition to providing medical and dental insurance (see §13.42), employers also may establish health reimbursement arrangements (HRAs) that permit employers to fund tax-free individual accounts for employees' health care expenses under IRC §§105-106. HRAs must be funded solely by employer contributions and cannot be funded through salary reductions or an IRC §125 cafeteria plan. HRAs can be used to reimburse an employee for medical care expenses for the employee and the employee's spouse and dependents. HRAs can provide reimbursements up to a maximum stated dollar amount for a coverage period established by the employer. Unlike medical and dependent care flexible spending accounts, under which employees fund these expenses on a pretax basis, any unused amounts can be carried over to increase the maximum reimbursement in a subsequent year. Reimbursable expenses include insurance premiums that cover medical care expenses and amounts paid under any COBRA continuation coverage for qualified beneficiaries. See IRS Notice 2002-45, 2002-2 Cum Bull 93.

NOTE: Healthcare reform legislation could change the types of expenses that are reimbursable under HRAs, flexible spending accounts, and health savings accounts.

Health savings accounts (HSAs) are available only to individuals in a "high-deductible health plan" (HDHP) who are not entitled to Medicare benefits. IRC §223. The dollar thresholds for HDHPs (individual and family) are set each year, as is the maximum tax-free contribution. There is also an annual catch-up contribution for individuals age 55 or older. IRC §223(b)(3). HSAs can be used to pay for qualified medical expenses for an employee, the employee's spouse, and dependents. The tax rules restrict an employee's ability to participate if the employee has health coverage other than HDHP coverage (*e.g.,* general purpose HRA coverage or medical spending account participation). Rev Rul 2004-45, 2004-22 Int Rev Bull 971; IRS Notice 2008-59, 2008-29 Int Rev Bull 123.

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§13.46 7. Personnel Policies

Although written personnel policies are not generally required by law, employers should develop policies to articulate their expectations regarding employee performance and to describe unambiguously employees' rights and obligations. Because legal requirements may vary, depending on the number of employees and the type of industry, it is essential that personnel policies be tailored to the employer. Personnel policies should:

- Be created for the particular employer (employers should not simply adapt existing personnel policies that were created for use in other states, were not recently prepared, or applied to an employer with a different number of employees or engaged in a different industry);
- Be internally consistent and consistent with other company policies;
- Discuss the nature and vesting of employment benefits; and
- Reflect family medical leave (see §13.47), various nondiscrimination requirements, and California laws on overtime, vacation time, and other matters.

Employers and counsel should pay careful attention to these policies because they may form the basis of a contractual obligation to an employee. To mitigate against an argument that an employee can only be terminated for cause, employers with at-will employees should make the at-will status clear in any personnel policy manual or employee handbook.

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§13.47 8. Family Medical Leave

Current state and federal laws recognize employees' rights to take unpaid personal leave to care for an ill or injured family member or a new child. See the federal Family and Medical Leave Act of 1993 (FMLA) (29 USC §§2611-2654) and California's Moore-Brown-Roberti Family Rights Act (CFRA) (Govt C §§12945.1-12945.2), both applicable to California employers with 50 or more employees. Federal law also provides for exigency leave for urgent needs related to a family member's call to covered active duty in the armed forces and for 26 weeks of leave for a caregiver of a family member injured while serving on covered active duty. 29 USC §2612(a)(1)(E).

California employees are entitled to 6 weeks of paid personal leave in a 12-month period, based on a percentage of their weekly pay, to care for a seriously ill child, spouse, parent, or domestic partner, or to bond with a new child (through birth, adoption, or foster care placement). Un Ins C §§3300-3303. The paid leave was originally funded through Family Temporary Disability Insurance (FTDI) contributions from increased SDI payroll deductions (see §13.20); the cost of Paid Family Leave insurance is incorporated into the base SDI contribution rate. Under the paid leave law, there is no length-of-service requirement or minimum number of employees. As a result, these benefits extend to a broader class of employees than are covered by the FMLA or the CFRA. The law does not, however, include an independent right of reinstatement.

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§13.48 III. OTHER TAXES

In addition to payroll and franchise taxes levied against certain nonprofit corporations, California nonprofit corporations may be subject to these additional taxes:

- Sales and uses taxes (Rev & T C §§6001-7176; see chap 8);
- Property taxes (see Rev & T C §§201-241 and Cal Const art XIII, §4, regarding welfare exemption from property taxes available to certain IRC §501(c)(3) organizations; see also chap 11);
- "In lieu" taxes (in lieu of property taxes);
- Federal excise taxes (IRC §§4001-5000); and
- Local business license taxes.

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IV. LICENSES AND PERMITS

§13.49 A. Federal Licenses and Consents

Nonprofit organizations generally do not need a federal license, consent, or permit to operate. However, if a corporation participates in certain federal programs, it may need to comply with various federal restrictions as a condition of participating in that program. For example, housing programs administered by the federal Department of Housing and Urban Development (HUD) must comply with very detailed restrictions as a condition of receiving financial assistance from HUD. See, *e.g.,* 12 USC §§1701-1706d-4; 42 USC §8011.

Various certifications and agreements with federal agencies may also be necessary. For example, a California hospital that wishes to participate in the Medicare program must be certified by the California Department of Health Care Services to participate, and must enter into a provider agreement with the Centers for Medicare and Medicaid Services (CMS) of the United States Department of Health and Human Services. See generally 42 USC §§1395-1395iii. This is in addition to state/federal joint approval to provide care under the Medi-Cal program for indigent patients.

The Medi-Cal program is a joint federal/state program. See Title XIX of the Social Security Act (42 USC §§1396-1396v); Welf & I C §§14000-14199.3. The Medicare program can be found at Title XVII of the Social Security Act (42 USC §§1395-1395iii).

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.50 B. State and Local Licenses and Permits

§13.50 B. State and Local Licenses and Permits

State and local licenses and permits are required for a wide variety of businesses and professions that a California corporation might conduct. Furthermore, California generally requires corporations to meet several criteria before issuing certificates of registration or business licenses. The California Department of Consumer Affairs oversees many of the state boards and bureaus that regulate professional and occupational licenses. See http://www.dca.ca.gov/.

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§13.51 1. Seller's Permit

If a corporation expects to sell tangible personal property that would be subject to California sales and use taxes, it must obtain a seller's permit from the State Board of Equalization. See Rev & T C §§6014, 6066, 6226. A permit must be secured for and displayed at every place of business of the corporation. Rev & T C §6067. Failure to do so, if required, is a misdemeanor. Rev & T C §7153. On sales and use tax, see chap 8.

NOTE: In California, nonprofit or tax-exempt status does not ensure exemption from sales or use taxes. See chap 8.

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§13.52 2. Nonprofit Mailing Permit

If a nonprofit corporation wishes to use special nonprofit postal rates, it must file an application for a nonprofit mailing permit (USPS Form 3624) with each post office from which the corporation intends to mail literature at the special rate. The application can be obtained from the corporation's local post office. The application must be accompanied by the corporation's articles and bylaws, its determination letter from the IRS recognizing its federal tax exemption (or other evidence demonstrating that the organization is a qualified nonprofit organization), and bulletins, brochures, and other evidence of how it is actually operating. See the instructions to Form 3624. Certain nonprofit organizations, such as chambers of commerce and social clubs, are ineligible for the special mailing rate. See USPS Domestic Mail Manual (DMM) 703 (1.4) (available at the post office and at http://www.usps.gov).

Nonprofit postal rates include a nonprofit periodicals rate, a nonprofit Standard A rate, and a library rate; these rates are a percentage of their counterpart commercial rates. See 39 USC §3626(a). The nonprofit Standard A rate is set so that the nonprofit revenue per piece is 60 percent of the commercial revenue per piece on an expected volume basis. 39 USC §3626(a)(6).

Certain mailings by nonprofit organizations are deemed ineligible for the nonprofit postal rate. For example, nonprofit organizations often offer back-end premiums such as tote bags and T-shirts when soliciting contributions or membership dues payments. The United States Postal Service has concluded that an announcement of such premiums will be considered an advertisement and thus ineligible for the nonprofit postal rate *unless* (1) the product advertised is directly related to the organization's primary purpose, and (2) the requested contribution or dues payment exceeds four times the cost of the premium items offered *and* twice their represented value (if any) in the announcement. See USPS Publication 417 (available at the post office and at http://www.usps.gov).

The Alliance of Nonprofit Mailers at www.nonprofitmailers.org provides updated guidance for complying with the often confusing and ever-evolving mail permit requirements. See also USPS Publication 417.

NOTE: To contain printing and postage costs, reduce staff time, and preserve the environment, nonprofit organizations rely increasingly on the Internet to disseminate everything from newsletters to donor solicitations. As a result, the nonprofit mailing permit is probably less valuable to nonprofits than it was previously.

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§13.53 3. Local Licenses

Many cities require corporations doing business within city limits to secure a local business license. These licenses serve a variety of purposes, from raising revenues to implementing environmental controls and zoning policies. Some localities may exempt nonprofit organizations from this requirement. Corporations should investigate local licensing requirements before deciding where to locate their business.

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§13.54 C. Solicitation Permits

Many California cities and counties require nonprofit organizations to register with the city or county as a condition of engaging in charitable solicitations in the city or county. See chap 14. For a list of cities and counties that have solicitation ordinances and the addresses and phone numbers of their offices, see the Appendix to this book.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.55 D. Commercial Driver's Licenses

§13.55 D. Commercial Driver's Licenses

Nonprofits must ensure that they are not using large vehicles to transport beneficiaries, employees, or volunteers without a proper license. If the organization uses a 10-passenger van to transport anyone, it must secure a Class B commercial driver's license. See Veh C §233(b).

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§13.56 V. INSURANCE

Nonprofit corporations usually need at least minimal levels of insurance to protect themselves against some business risks to which all corporations are, to some extent, vulnerable. The exact types and amounts of insurance vary dramatically, depending on the corporation's activities, revenues, size of workforce, risk experience, and other factors. Most organizations need, at a bare minimum, commercial general liability insurance, and most are well advised to secure directors' and officers' liability insurance. All organizations that employ even one worker must carry workers' compensation coverage. For a discussion of these policies and some key features, see §§13.57-13.66. For a more detailed discussion, see California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991).

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A. Officers' and Directors' Liability

§13.57 1. No Personal Negligence Liability If Nonprofit Is Insured

If a nonprofit public benefit, mutual benefit, or religious corporation and its uncompensated officers and directors meet the following requirements, none of the officers or directors is liable for negligence occurring within the scope of his or her duties (Corp C §5047.5(b)):

WARNING: The protections of Corp C §5047.5 do not apply to any corporation that unlawfully restricts membership, services, or benefits conferred on the basis of political affiliation, age, or any characteristic listed or defined in CC §51(b) or (e). Corp C §5047.5(h).

- The corporation must be exempt from taxation under IRC §501(c)(3) or §501(c)(6).
- The corporation must maintain a general liability insurance policy covering the cause of action. The policy must provide at least $500,000 coverage if the annual budget is less than $50,000, or $1,000,000 if the corporation's annual budget equals or exceeds $50,000.
- The officer or director must have acted in a manner that he or she believed to be in the best interests of the corporation, in good faith, and in the exercise of the director's or officer's policy-making judgment.

This statute does not protect against directors' and officers' intentional torts. See §9.116.

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§13.58 2. Public Benefit Corporations That Attempt to Purchase Insurance

Uncompensated officers and directors of a California nonprofit public benefit corporation that does not meet all the criteria of Corp C §5047.5 (described in §13.57) may still avoid personal liability for negligence if the corporation meets somewhat different criteria under Corp C §5239. These criteria, which significantly overlap the criteria described in §13.57, are more liberal in three important respects:

(1) Although the corporation must maintain liability insurance covering the act or omission, the policy can be a general liability or a directors' and officers' liability policy, and it can be purchased by the corporation or by an individual director or officer.

(2) Unlike the protection provided by Corp C §5047.5, the protection under Corp C §5239 applies if the board and affected officers or directors can demonstrate that they made good faith reasonable efforts to obtain available liability insurance but were not able to secure it (*e.g.,* because it was prohibitively expensive based on the organization's budget or risk experience). Corp C §5239(a)(4).

NOTE: More lenient rules apply to certain smaller nonprofit public benefit corporations. See Corp C §5239(h).

(3) Corporations Code 5239 applies to all public benefit corporations, regardless of whether they are tax-exempt. It does not, however, apply to nonprofit mutual benefit or religious corporations, and no other comparable statute applies to them.

Together, Corp C §§5047.5 and 5239 create an awkward patchwork of incomplete protection of nonprofits. This protection is inferior to that found in the General Corporation Law (Corp C §§204.5, 317). Although some California nonprofits qualify for protection under both sections, some will be denied protection under both.

NOTE: The Volunteer Protection Act of 1997 (42 USC §§14501-14505) helps ameliorate some of the deficiencies in the California volunteer protection laws. See §9.155.

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B. Types of Insurance

§13.59 1. Commercial General Liability

Probably the most essential insurance policy for nonprofit corporations is a commercial general liability (CGL) policy. (This policy was formerly referred to as a "comprehensive general liability" policy until insurance companies became concerned about the extent of their promises of comprehensive coverage.) Typically, this policy covers three general categories of risk: (1) bodily injury and property damage, (2) personal injury and advertising injury, and (3) medical payments.

The first type of coverage generally does not include coverage for economic injury or diminution in value; it is intended primarily to cover premises and operations liability and bodily injury. However, many insurers that issue CGL policies are beginning to offer coverage for emotional distress as part of this coverage. Personal injury coverage does not insure against bodily injury, as the name might suggest, but against such offenses as libel, slander, false arrest, false imprisonment, wrongful eviction, and malicious prosecution. "Advertising injury" is an injury committed in the course of the insured's advertising activities, such as trade libel. Medical payments coverage is usually minor and covers medical expenses incurred by third parties as a result of accidental bodily injury.

CGL policies are typically "occurrence" policies. For a definition and discussion of "occurrence" and "claims made" coverage, see §13.65.

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§13.60 2. Directors' and Officers' Liability Insurance

Directors' and officers' (D&O) liability insurance covers corporate officers and directors for claims arising from their activities as directors and officers. In contrast to commercial and general liability (CGL) policies (see §13.59), D&O policies typically exclude coverage for bodily injury, property damage, advertising injury, and personal injury, and restrict coverage to injuries arising from the directors' and officers' business decisions. Some insurance companies refuse to issue D&O policies unless the insured has a CGL policy in place. D&O policies are generally "claims made" policies. For a definition and discussion of "occurrence" and "claims made" coverage, see §13.65.

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§13.61 a. Coverage

True directors' and officers' (D&O) policies cover only officers and directors for claims arising from their wrongful acts and omissions. The corporation, its employees, and other individuals are not covered, except to the extent that the policy provides for reimbursement to the corporation of sums it is required to reimburse to its officers and directors for covered claims. In recent years, insurance carriers have begun to offer broad form D&O policies. These policies provide "entity coverage," which insures the corporation, employees, volunteers, and agents of the corporation. This more expansive coverage is frequently offered to nonprofit organizations.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.62 b. Exclusions

§13.62 b. Exclusions

Typical D&O policies exclude a number of claims one might make against a corporate officer or director, such as:

- Personal profit to which the officer or director was not legally entitled;
- Return of remuneration illegally paid to the officer or director;
- Dishonesty;
- Equitable and nonmonetary claims;
- Bodily injury and property damage;
- Defamation;
- Willful violation of a statute;
- Environmental claims; or
- Breach of the insured's fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461).

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§13.63 3. Workers' Compensation

The workers' compensation program provides a way to compensate employees for workplace injuries while preventing runaway jury verdicts that substantially exceed the actual injuries. Virtually every California employer is subject to California's workers' compensation laws. See §§13.23-13.27.

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§13.64 4. Professional Liability

Professional liability insurance, also known as "malpractice" or "errors and omissions" insurance, generally covers professionals such as lawyers, accountants, agents, brokers, architects, and medical professionals for business-related claims arising from their services. Because liability arising from professional services is typically excluded from standard commercial and general liability (CGL) policies, a separate policy or separate coverage within a commercial policy package is needed for this type of liability, when appropriate.

Professional liability policies vary widely in their coverage and exclusions. Most professional liability policies are specific to a profession or an industry (*e.g.,* medical malpractice). The typical professional liability policy is a "claims made" policy. On occurrence and claims made coverage, see §13.65.

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§13.65 C. "Occurrence" Versus "Claims Made" Coverage

There are two basic methods of triggering coverage under an insurance policy. Under an "occurrence" policy, coverage is triggered when the damage or injury occurs, and the policy in effect at the time of the injury covers the loss. Under a "claims made" policy, coverage is triggered when a claim is made, generally regardless of when the loss occurred.

Clients must understand what the policy period is for each insurance policy and must secure coverage appropriate to their needs. If the policy provides claims made coverage, it may also be essential to purchase "tail" coverage, which extends the claims period if the officer, director, or covered professional is no longer affiliated with the organization or if the organization changes insurance carriers. This is critical because the organization with which the officer, director, or professional is now affiliated may not carry claims made insurance; the new claims made policy secured by the first organization may not cover occurrences before its inception date or may not cover prior officers and directors; or new insurance covering the officer, director, or professional may not be secured.

Occurrence policies generally cost more than claims made policies. CGL policies (see §13.59) are generally occurrence policies, whereas D&O (see §§13.60-13.62) and professional liability policies (see §13.64) are generally claims made policies.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.66 D. Exclusions and Endorsements

§13.66 D. Exclusions and Endorsements

Endorsements can add insured parties, exclusions, or additional coverage not available in a standard insurance policy. Exclusions limit the coverage and can help eliminate duplicative, unnecessary, or prohibitively expensive coverage. Nonprofit corporations that do not pay adequate attention to such exclusions might be unpleasantly surprised when a loss they thought was covered is not compensated.

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§13.67 E. "Duty-to-Defend" Coverage

"Duty-to-defend" coverage compels the insurance company to pay for the legal defense of a claim. Commercial and general liability (CGL) policies (see §13.59) generally include a duty to defend directors and officers, and professional liability policies (see §13.64) may include this duty. In certain industries (such as health care and senior care), the self-insured retention under professional liability policies may be so high that it seriously erodes the duty to defend. (The insured must pay all defense costs until the self-insured retention level is reached.) An experienced insurance broker or agent can help advise a nonprofit client as to what coverage is necessary or appropriate in the client's circumstances.

PRACTICE TIP: Nonprofit corporations should try to negotiate the right to engage their own counsel until the self-insured retention is satisfied.

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§13.68 F. Obtaining Affordable Insurance

Some nonprofit corporations delay or even avoid purchasing essential insurance, despite their recognition of the need for it, because of its sometimes prohibitive cost. This extreme step may be both unwise and unnecessary. An organization may be able to reduce its premiums by using only one insurer or one broker for all of its insurance, or by purchasing a policy with a large deductible/self-insured retention. (In the latter event, the organization will end up "self-insuring" many claims.)

The organization may also find some relief by participating in purchasing alliances, which purchase insurance "in bulk" at cheaper rates, or by using insurance carriers dedicated to serving nonprofits. Common sources of reduced rates include trade associations, professional organizations (at least for professional liability insurance), and nonprofit insurance alliances. For example, low-cost insurance is available through the Nonprofits' Insurance Alliance of California (http://www.niac.org/). This tax-exempt organization also offers educational seminars and materials, free risk management and loss control services, and access to a toll-free telephone number to answer members' insurance-related questions. Membership is limited to IRC §501(c)(3) charitable organizations.

Another resource for information about nonprofit insurance availability and coverage is the California Association of Nonprofits (CAN) (http://www.canonprofits.org/).

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.69 G. Establishing Relationship With Broker or Agent

§13.69 G. Establishing Relationship With Broker or Agent

To secure appropriate insurance, the client should establish a relationship with an agent or a broker in whom the client has confidence. An experienced, trustworthy agent or broker assesses the organization's risks and locates the best policies to respond to these risks at the best possible prices. The agent or broker can also help the client tailor its policies so it has no more or less coverage than it needs.

An independent agent or broker may be better suited to a nonprofit corporation's needs than one who is limited to selling a particular insurance company's policies.

PRACTICE TIP: Because most attorneys are not familiar with available insurance products and pricing, counsel should recommend that the client consult an agent or a broker before purchasing insurance.

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§13.70 H. Insurance Crisis: Strategies for Relief

In certain industries, such as health care and senior care, CGL and professional liability premiums rose dramatically in recent history, causing several insurers to stop writing such policies in California. This crisis drove some nonprofit corporations out of business (or out of California) and caused those that remained to adopt various strategies for relief, including self-insuring and risk-pooling; increasing their self-insured retention (see §13.68) and insuring only against catastrophes; aggressively managing risk; and abandoning higher-risk aspects of their operations.

More recently, insurers have re-entered the California market and insurance premiums have softened considerably. In such markets, the above strategies may be less critical.

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§13.71 I. Importance of Risk Management

Although increases in premiums for one or more types of insurance may cause insureds to adopt more rigorous risk management practices, care in this area is warranted in both good markets and bad. Insurance is no substitute for adherence to high standards of operation and careful employment practices.

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VI. BANKING

A. Establishing Bank Account

§13.72 1. Selecting Bank

To pay its employees and suppliers and to deposit donations, grants, and other revenues, a nonprofit organization needs to establish one or more bank accounts almost immediately on incorporation. The corporation should consider several factors before selecting a bank.

Fees. Some banks' fees are significant, depending on the balances in the accounts and the anticipated level of activity, including check-writing frequency. Credit unions and savings and loans associations may be more affordable than commercial banks. If the corporation intends to establish more than one account (*e.g.,* checking, savings, or money market), to secure a corporate credit card, or to purchase a certificate of deposit, it may be able to negotiate a waiver of or reduction in fees by placing all accounts with one institution.

FDIC insurance. It may be necessary to open accounts at more than one financial institution to ensure that the nonprofit's deposits remain within the $250,000 per depositor/per depository institution FDIC insurance limits. This is particularly critical in economically volatile periods.

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§13.73 2. Comparing Rates

Directors should compare various yields on money market accounts, certificates of deposit, and other investment vehicles, and balance these yields against the risks inherent in these investments (and holding periods). In addition, the person dealing with the bank should ascertain whether it will waive or reduce its fees for nonprofits. The boards of California nonprofit corporations may be required to make comparisons in order to fulfill their fiduciary duties to the corporation. See Corp C §§5231, 7231, 9241. Nonprofit public benefit corporations might also be required to do so because their assets are deemed to be held in charitable trust for the benefit of the public. See Corp C §5250.

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§13.74 3. Selecting Signatories

The organization's bylaws or the minutes of the first meeting of its directors should specify the person authorized to open bank accounts, sign checks, and make withdrawals from the accounts. See §5.23. Although it often is advisable to require that at least two individuals sign all checks in excess of a specified dollar threshold, this threshold varies considerably from organization to organization, based on its revenues, its operations, its degree of fiscal conservatism, and the relationships among its directors, officers, and staff.

PRACTICE TIP: Account signatories should be officers or executive staff who are routinely available at the organization's place of business.

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§13.75 B. Borrowing Funds

Any nonprofit corporation that borrows funds should shop around for the best interest rate and loan fees. A bank with which the organization or one of its officers or directors already enjoys a significant relationship might offer the most favorable rates, but the board should not assume that this relationship will result in more favorable rates.

Nonprofit public benefit corporations must take precautions not to pay any more than fair market value for any loan they secure because their funds are subject to a charitable trust. Corp C §5250. The fair market value analysis should consider not only the interest rate and loan fees but also the security required and other terms (such as acceleration and prepayment provisions). Charities organized under IRC §501(c)(3) or §501(c)(4) have an enhanced obligation to perform this analysis in order to meet the conditions of their federal and state tax exemptions.

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§13.76 VII. LEASES

Virtually every nonprofit corporation (other than organizations that operate out of an officer's or director's home or business) needs to lease or purchase real property to operate its corporate office, if not also to conduct its exempt purposes (*e.g.,* to operate a hospital or a home for the disabled). New nonprofit organizations typically lease rather than own real property. Likewise, many nonprofits lease equipment, including computers and photocopiers. Although a full discussion of real property or equipment leases is beyond the scope of this volume, a few issues do merit discussion. See §§13.77-13.78. For more information on leases, see Office Leasing: Drafting and Negotiating the Lease (Cal CEB 1996). See also Contino, Negotiating Business Equipment Leases (1995); Equipment Leasing (PLI 1995).

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§13.77 A. Fair Market Considerations

All nonprofit public benefit corporations need to take precautions not to permit an excessive financial benefit to a lessor or lessee, because their corporate assets are subject to a charitable trust. This is particularly important for IRC §§501(c)(3)-(4), (6)-(7), (9), (11), and (13) organizations, which are also subject to the private inurement prohibition, and for IRC §501(c)(3) organizations that are subject to the private benefit proscription.

When the nonprofit corporation is the lessee, it must satisfy itself that the lease is a "fair market" lease. To do so, the corporation should review not only the rent but also other lease terms, such as responsibility for taxes and repairs and its duties in the event of substantial damage to the premises or equipment. A local realtor can help gather comparable rent data.

Any rent formula that includes a rent component based on a percentage of the organization's gross revenues should be scrutinized to ensure that the total rent represents fair market value. Such "participating leases" can also raise unrelated business taxable income (UBTI) issues. See chap 17.

When the nonprofit corporation is the lessor, it is equally important that a lessee pay the nonprofit organization *at least* fair market value to use the premises or equipment.

PRACTICE TIP: "Fair market value" is a dynamic concept. Particularly in volatile economic markets, a nonprofit should not assume that "market" rents determined 6 months ago are market rents today. To protect itself from overpayment or legal challenge, a nonprofit must assure that its market data are current and reliable.

PRACTICE TIP: In a declining real estate market, a prospective nonprofit tenant may be able to reduce its monthly outlay by subletting from a tenant that vacates its space before its lease term expires.

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§13.78 B. Nonprofit Corporation as Lessor; Property Tax Issues

Nonprofit corporations that are entitled to a welfare exemption from property taxes (Cal Const art XIII, §4(b)) must not lease or sublease space to organizations unless they are tax-exempt under IRC §501(c)(3) and meet several other specific criteria. On the welfare exemption and the rules governing leases of property entitled to the exemption, see chap 11.

NOTE: An exemption from real property taxes requires (among other things) that the entity own the real property. However, lessees may be entitled to a property tax exemption based on their *personal* property holdings (such as business machines). See chap 11.

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§13.79 VIII. INTELLECTUAL PROPERTY RIGHTS

Although intellectual property rights are historically considered the domain of for-profit organizations, nonprofit corporations should also be concerned with protecting these valuable rights. It may not be essential or even appropriate to secure these rights at the organization's inception; however, counsel should educate clients about the nature of their intellectual property rights. The primary forms of intellectual property are discussed briefly in §§13.80-13.94. For more detailed information, see Intellectual Property in Business Transactions (Cal CEB 2008); California Business Litigation (Cal CEB 2002); Trade Secrets Practice in California (2d ed Cal CEB 1996).

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§13.80 A. Trademarks and Service Marks

A trademark is a word, a design, or a combination of the two that a manufacturer or merchant uses to identify its goods and distinguish them from others' goods. A service mark is a word, a design, or a combination of the two used by a merchant to identify services and to distinguish them from others' services. Sounds, colors, and even scents can also function and be registered as trademarks or service marks, if they serve to distinguish one's goods or services.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.81 1. Reasons for Seeking Trademark or Service Mark Protection

§13.81 1. Reasons for Seeking Trademark or Service Mark Protection

A nonprofit corporation may seek trademark or service mark protection to

- Prevent public confusion over the origin of its goods or services;
- Prevent competing organizations from adopting confusingly similar names/marks;
- Control, through licensing, the use of these marks and protect the organization's good reputation; and
- Earn a little extra revenue from licensing fees it collects.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.82 2. Federal Marks

§13.82 2. Federal Marks

An entity need not register a trademark or a service mark to have exclusive rights in it, but first use is essential for unregistered trademark and service mark protection. An owner can acquire common law rights in the mark in its geographic area of use simply by using or displaying a mark on or in connection with goods or services in that area. However, an owner can stake out nationwide protection by applying for registration with the United States Patent and Trademark Office and stating that it has a bona fide intention to use the mark in interstate commerce. 15 USC §1051(b).

Although federal registration of a mark is not mandatory, various additional rights accrue to the owner of a federally registered trademark or service mark on the Principal Register, including the following:

- Nationwide priority rights that are effective on the filing date (15 USC §1115);
- Prima facie evidence of the validity, registration, and ownership of the mark, and the owner's exclusive right to use the mark in connection with the specified goods and services (15 USC §1057(b));
- A rebuttable presumption of exclusive ownership of the mark (15 USC §1115);
- The right under the plans convention to register the mark abroad based on the U.S. Registration;
- Federal court jurisdiction to hear claims of infringement of the mark, counterfeiting, and related claims of unfair competition under state law (15 USC §1121);
- The right to use the symbol ®, the phrase "Registered in U.S. Patent and Trademark Office," or the abbreviation "Reg. U.S. Pat. & Tm. Off." (15 USC §1111); and
- Enhanced ability to oppose or cancel a mark on the ground that it dilutes the owner's registered mark (15 USC §1125(c)).

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§13.83 3. California Marks

Trademarks and service marks may be registered under California law. Bus & P C §§14200-14272. This procedure is significantly less formal and less thorough than the federal registration process; it is also significantly less valuable. State registration confers some benefits, including the following (see, *e.g.,* Bus & P C §§14215(b), 14245, 14247):

- Availability of protection for businesses that do not engage in interstate commerce;
- Prima facie evidence of ownership of the mark within the state;
- Entitlement to enjoin infringement of the mark;
- Constructive notice of the registrant's claim of ownership throughout the state; and
- Listing of the state mark in search reports.

Trademark and service mark specialists generally urge clients to seek federal protection if they engage in interstate commerce. Federal registration affords the owner greater rights than does state registration, provides nationwide notice of the owner's prior rights, and, despite the greater expense and complexity of the application process, is ultimately far more valuable than state registration.

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§13.84 B. Corporate Names

The California Secretary of State will not incorporate a nonprofit corporation whose name is so close to that of an existing corporation that it tends to deceive the public. See Corp C §§5122(b), 7122(c), 9122(b). As a result, incorporation confers certain prior rights to a corporate name and assures the new corporation that other corporations will not be able to incorporate or conduct business in California under a confusingly similar name.

The Secretary of State attaches a notice to the organization's endorsed, filed articles of incorporation that explicitly advises the corporation that the filing of articles does not authorize the use of a corporate name in violation of the rights of any state or federal trademark or service mark, whether or not registered, or any state fictitious business name or trade name. Bus & P C §14417. Accordingly, a corporate name has only limited value as an intellectual property right.

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Source: Business Law/Advising California Nonprofit Corporations/13 Nonprofit Operations/§13.85 C. Fictitious Business Names

§13.85 C. Fictitious Business Names

A California nonprofit corporation is expressly exempt from filing a fictitious business name statement when it does business in California under a name that is different from its corporate name. Bus & P C §17911.

NOTE: Failure to file could be problematic if an entity wishes to hold real property under its fictitious business name. A title company may refuse to issue a title policy in this instance.

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D. Copyrights

§13.86 1. Definition; Eligible Works

A copyright is an exclusive right in a work of authorship to reproduce the work, distribute reproductions, publicly display and perform the work, prepare derivative works, and authorize others to do any of these things. 17 USC §106. The source of copyright protection is US Const art I, §8. Copyrightable works include (17 USC §102(a)):

- Literary, musical, and dramatic works;
- Pantomimes and choreographic works;
- Pictorial, graphic, and sculptural works (including nonutilitarian design features of useful articles like lamps);
- Motion pictures and other audio-visual works;
- Sound recordings;
- Computer programs; and
- Architectural work.

The copyright law protects only the expression of ideas, not the ideas themselves. To be entitled to protection, a work must be original (*i.e.,* not copied from another source) and fixed in a tangible medium. Certain compilations of works that themselves are not original might be entitled to copyright protection if the selection or arrangement is original. See 1 Nimmer, Nimmer on Copyright, chap 3 (1963).

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§13.87 2. Registration; Copyright Notice

Copyrights, like trademarks, are effective even if unregistered. The owner of a work of authorship automatically enjoys federal copyright protection from the moment the copyrightable work is fixed in a tangible medium. Despite this fact, the use of copyright notices is recommended in order to put the public on notice of the owner's prior rights. An owner can register a copyright of a published or unpublished work by depositing appropriate copies of the work, an application form, and a nominal fee with the Copyright Office. 17 USC §408. The Copyright Office returns the application form, stamped "Certificate of Registration," with a registration number on it. Although an unregistered copyright is valid, registration (17 USC §§410(c), 411-412):

- Is a prerequisite to the right to sue for infringement;
- Entitles the copyright owner to statutory damages and attorney fees;
- Provides prima facie evidence of the validity of the copyright and the facts stated in the certificate; and
- Affords the owner certain other benefits.

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§13.88 3. Application Process; Duration

Unlike the trademark application process, the copyright process is rather simple and inexpensive. The application is approved if the work is entitled to copyright protection and if the form is completed properly. For works created after 1978, the copyright duration is 70 years after the death of the author or 95 years from publication for works made for hire. Any work created by an employee within the scope of his or her employment is considered a work made for life and the copyright vests automatically with the employer. 17 USC §201(b) (defining works made for hire). See 2 Nimmer, Nimmer on Copyright, chap 9 (1963).

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§13.89 4. No State Copyright Law

Although California has no state copyright law, rights in a work of authorship might be vindicated through state laws governing unfair competition, defamation, and breach of contract if the claim is not preempted by federal copyright law. See 1 Nimmer, Nimmer on Copyright §1.01[B] (1963).

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§13.90 5. Value of Copyright to Nonprofits

A nonprofit corporation might copyright various materials that it generates, including newsletters and articles it publishes, computer programs it develops, and manuals and procedures it creates. The value of and need for copyright protection depend largely on the organization's purpose. If it is engaged in the performing or visual arts or literary endeavors, copyright protection is essential.

Some IRC §501(c)(3) charitable organizations engage to a limited extent in unrelated trades or businesses that are essentially commercial enterprises. See IRC §§511-515; chap 17. Their reasons for protecting intellectual property rights related to such enterprises are likely be the same as those of for-profit organizations.

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E. Patents

§13.91 1. Definition; Criteria

A patent is a right the federal government grants to the owner to exclude others from making, using, or selling an invention. The source of patents is US Const art I, §8. An invention must satisfy three stringent criteria to qualify for patent protection (35 USC §§102-103):

- Novelty (*i.e.,* it is not previously known to others or in public use in the United States, or patented or described in any printed publication more than a year before the application filing date);
- Nonobviousness (*i.e.*, it is not obvious to anyone with ordinary skill in the relevant field); and
- Utility (*i.e.*, it has a useful purpose, it actually works, and it is neither frivolous nor immoral).

To avoid limiting an employer to nonexclusive shop rights use of patents developed by employees, an employer should require employees to assign to the employer, in writing, all their rights in their inventions developed on the employer's time using the employer's resources. The assignment should strictly comply with Lab C §2870, which specifies circumstances under which such assignment is permissible. If it does not comply with the statute, the assignment provision will be held void on the ground that it violates public policy.

PRACTICE TIP: The employment agreement or other document containing the assignment requirement should directly quote §2870.

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§13.92 2. Registration; Duration

Like federal trademark and service mark applications, patent applications are filed with the United States Patent and Trademark Office. Patents generally last 14 to 20 years, depending on the type. See 35 USC §§154-156, 173. On patents generally, see Chisum, Chisum on Patents (1978).

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§13.93 F. Trade Secrets

The California Uniform Trade Secrets Act (CC §§3426-3426.11) protects trade secrets from misappropriation. A trade secret is broadly defined under the Act as any information that (1) has economic value because it is not known to others; and (2) the owner has made reasonable efforts to keep secret. CC §3426.1(d).

Trade secrets can include formulas, patterns, compilations, programs, devices, methods, techniques, or processes. See *Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 67 CR 19.

If a nonprofit organization's trade secrets are misappropriated, it may have recourse under both the Act (including, as appropriate, damages, royalties, and attorney fees) and Bus & P C §§17200-17210, California's unfair competition statutes. See Trade Secrets Practice in California (2d ed Cal CEB 1996).

A nonprofit organization, particularly one operating in a technical area, must be careful not to impinge on the trade secret rights of others. The increased mobility of the technical labor force may result in employment of an individual who has access to the trade secrets of the new employer's competitor. Under the doctrine of "inevitable disclosure," courts outside California have enjoined the employment of an employee who had access to key information belonging to the employer's competitor. See, *e.g., PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262; *PepsiCo, Inc. v Redmond* (ND Ill, Dec. 29, 1996, No. 94 C 6838) 1995 US Dist Lexis 19380 (injunction granted). At least one court refused to apply the doctrine, however, stating that "*PepsiCo* is not the law of the State of California or the Ninth Circuit." *Danjaq, LLC v Sony Corp.* (CD Cal 1999) 50 USPQ2d 1638, aff'd (9th Cir 2001) 263 F3d 942.

PRACTICE TIP: Even though the doctrine of "inevitable disclosure" may not apply in California because of a strong public policy favoring free mobility of the workforce, employers should nonetheless implement policies to protect the trade secrets of others.

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§13.94 G. Special Restrictions on Certain Tax-Exempt Entities

There are limits on certain charitable nonprofit organizations' ability to exploit their intellectual property rights. For example, an IRC §501(c)(3) scientific research organization must assure the IRS that the research it performs is conducted for the public interest and not for commercial purposes. The research is deemed conducted for the public interest only if (see Rev Rul 69-526, 1969-2 Cum Bull 115):

- The research results, including intellectual property rights, are made available to the public on a nondiscriminatory basis; and
- The research is performed primarily for the benefit of the public, not for the financial gain of the administrators.

If the research organization retains control or ownership of more than an insubstantial portion of the patents, copyrights, processes, or formulas resulting from its research, the research is *not* deemed to benefit the public. Thus, a scientific research organization's ability to profit financially from intellectual property rights in its research results may be severely curtailed. See also Rev Rul 76-296, 1976-2 Cum Bull 141.

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§13.95 H. E-mail Policies

Like other organizations, nonprofits communicate increasingly via e-mail. It is therefore important for nonprofits to develop comprehensive e-mail policies for their employees to address such issues as inappropriate conduct, discriminatory remarks, and excessive use of e-mail. Likewise, employers must not run afoul of the Electronic Communications Act (18 USC §§2510-2522), which prohibits eavesdropping on employees unless there is a valid business purpose for doing so. If such a purpose does exist, employees must be apprised that their e-mail might be subject to review under certain circumstances. See Privacy Compliance and Litigation in California, chap 8 (Cal CEB 2008).

Employers should also ensure that heightened care is exercised before transmitting sensitive or confidential information by e-mail.

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§13.96 I. The Internet

Both for-profit and nonprofit organizations rely heavily on the Internet to obtain information, advertise products and services, and disseminate information. Such organizations should be advised that basic legal principles, including intellectual property principles, apply to the Internet. For example, copyright laws apply to material on the Internet, and laws governing appropriate use of trademarks are enforced in electronic commerce as they are in ordinary commerce. Furthermore, organizations that sell goods or services though the Internet may unwittingly subject themselves to the jurisdiction of other states under "long-arm statutes" if they engage in misleading advertising or otherwise violate other states' consumer protection laws.

Charitable organizations under IRC §501(c)(3) must also be aware of various hazards of operating a website. For example, a charity might inadvertently trigger unrelated business taxable income, engage in prohibited lobbying, or (in extreme cases) lose its tax-exempt status as a result of hypertext links to other websites that have commercial or political content. Attorneys General nationwide have been scrutinizing fundraising activities conducted on the Internet.

For a discussion of some of the tax issues raised by fundraising and advertising on the Internet, see IRS Continuing Professional Education Exempt Organizations Technical Instruction Program for Fiscal Year 2001, p 161; IRS Continuing Professional Education Exempt Organizations Technical Instruction Program for Fiscal Year 2000, p 119; IRS Announcement 2000-84, 2000-2 Cum Bull 385 (in which the IRS solicits comments about the use of the Internet by exempt organizations). The IRS maintains a website with information on various timely topics affecting charities at http://www.irs.gov.

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§13.97 J. Anti-Spam Law

Nonprofit organizations must take care not to run afoul of the federal anti-spam law, Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act) (15 USC §§7701-7713), when engaging in certain email communications. This law permits commercial e-mail messages only when the sender meets specific criteria. The Federal Trade Commission (FTC) has clarified that "when nonprofit organizations send emails the primary purpose of which is the advertisement or promotion of a commercial product or service, recipients are entitled to the Act's protections." 16 CFR Pt 316, Project No. R411008 (Definitions and Implementation Under the CAN-SPAM Act: Final Rule and Statement of Basis and Purpose).

Although the Act does not give the FTC jurisdiction to enforce the Act against nonprofits, states, other federal agencies, and Internet service providers are entitled to bring actions under the Act. See 15 USC §7706. When a nonprofit sells merchandise or delivers commercial offers from corporate sponsors to donors or members, it is subject to the Act. The organization Independent Sector (http://www.independentsector.org) recommends that nonprofits engage in "good email practices" in all of their internet communications. For detailed discussion of the CAN-SPAM Act, see Privacy Compliance and Litigation in California, chap 5 (Cal CEB 2008).

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§13.98 K. Identity Theft

Nonprofit as victim. Another potential concern with spam is its use to engage in identity theft. Sophisticated "phishers" spoof a brand to entice e-mail recipients to provide confidential financial information, such as credit card, bank account, and Social Security numbers. Although most phishing activity to date has involved e-mails allegedly from banks and financial institutions, nonprofit organizations, particularly those that engage in fundraising, are also vulnerable. The California Office of the Attorney General offers tips to prevent such fraud at http://www.ag.ca.gov/idtheft/tips.php. In addition, suspected cases of "phishing" can be reported to the federal Internet Crime Complaint Center (http://www.ic3.gov). See Privacy Compliance and Litigation in California, chap 10 (Cal CEB 2008).

Nonprofit as creditor. A nonprofit may be subject to the "Red Flags Rule" for identity theft. The Rule refers to patterns, practices, or specific activities ("red flags") that may indicate the existence of identity theft. 16 CFR §681.1(b)(9). An organization subject to the Rule is required to develop and implement a written program designed to detect, prevent, and mitigate identity theft. 16 CFR §681.1(d). An organization is subject to the rule if it falls within the statutory definition of "financial institution" or "creditor" by extending credit through customer accounts. See 16 CFR §681.1(b). For example, cities that operate utilities for which they regularly bill customers or college and universities that make student loans are subject to the Rule. See Federal Trade Commission, The Red Flags Rule: Frequently Asked Questions (FAQs), Question C-1, available on the FTC website at http://www.ftc.gov/redflagsrule. Organizations subject to the Rule must be in compliance with it by June 1, 2010. See http://www.ftc.gov/opa/2009/10/redflags.shtm.

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§13.99 L. Corporate Governance

Nonprofit organizations have received more attention in recent years as the occasional high-profile nonprofit scandal has drawn the scrutiny of the press, consumer advocates, and legislators. As a result of scandals, Independent Sector, a leadership forum for charities, foundations, and corporate giving programs, has recommended areas of regulation for nonprofits and a number of best practices for corporate governance. See http://www.independentsector.org. In addition, trade associations have introduced their own best practices and corporate integrity programs. See, *e.g.,* American Association of Homes and Services for the Aging's "Quality First Program" at http://www.aahsa.org. More than in the past, nonprofits are taking matters into their own hands by conducting regular orientations for their directors, requiring or encouraging board members to attend educational sessions related to the nonprofit's operations, and conducting regular "legal audits" of their articles, bylaws, insurance policies, personnel policies, and key contracts, among other documents. There is a growing "self-governance" movement that is designed to stave off excessive governmental regulation by demonstrating that nonprofits can regulate themselves effectively.

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§13.100 IX. CONTINUING COMPLIANCE

Several of the transactions and relationships described in this chapter cannot be simply consummated or established and then set aside. Licenses must be renewed; regulations must be followed; intellectual property rights must be policed and maintained; and changes in the volatile labor, employment, and benefits laws must be reflected in the organization's personnel policies and benefits plans. In short, these relationships are not static. Nonprofit organizations that can afford to do so would be well served by maintaining an ongoing relationship with legal counsel to monitor their permits, licenses, personnel policies, leases, and other legal relationships. For organizations on a lean budget, counsel's annual audit of these matters would be a sound investment.

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14

Regulation of Fundraising

Frederick R. Vandeveer
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§14.1 I. SCOPE OF CHAPTER

This chapter discusses the federal and state regulation of charitable fundraising. It covers the federal rules on the solicitation of deductible contributions in §§14.2-14.21, and the rules on the solicitation of nondeductible contributions in §§14.22-14.31. Restrictions on the sale of information otherwise available from federal agencies are discussed in §§14.32-14.36. State and local regulations are covered in §§14.37-14.84. More specifically, the solicitation of gifts and sales are discussed in §§14.37-14.58; commercial fundraisers are covered in §§14.59-14.60; solicitations of salvageable personal property are addressed in §§14.61-14.66; and bingo and other games are discussed in §§14.67-14.84. City and county regulations are addressed briefly in §§14.31 and 14.50.

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II. FEDERAL REGULATIONS

§14.2 A. Solicitation of Deductible Contributions

Disclosure and substantiation requirements. Federal law imposes strict disclosure and substantiation requirements on charitable organizations that solicit deductible contributions. The Internal Revenue Code disallows income tax deductions for charitable contributions of $250 or more unless the charitable organization has given the donor a timely written receipt. IRC §170(f)(8); see §§14.3-14.12. Special substantiation and reporting rules apply to donations of vehicles. IRC §170(f)(12); see §§14.8-14.11. Charitable organizations that receive or solicit contributions for a "quid pro quo" benefiting the donors (*i.e.,* if the donor receives goods or services from the donee in exchange for the contribution) must also comply with a separate set of disclosure requirements. IRC §6115; see §§14.13-14.18.

NOTE: Because of the overlap of IRC §§170(f)(8) and 6115, charitable organizations must often contend with the complexities of *both* laws. Both of these statutes specify the requirements for IRC §501(c)(3) charitable organizations in providing solicitation information to donors and prospective donors.

Effect of noncompliance. Failure to provide the required quid pro quo disclosures and, for vehicle donations, the required reports to the IRS, subjects a charitable organization to monetary penalties. However, the more powerful enforcement effect, by far, derives from the potential loss of the *donors'* income tax deductions. No charitable organization would knowingly risk the ill will of donors for whom it fails to provide the proper disclosures and receipts.

NOTE: The IRS issued proposed regulations in August 2008 that provide guidance concerning substantiation, reporting, and appraisal requirements for both cash and noncash contributions. See 73 Fed Reg 45908 (2008). The proposed regulations only affect donors claiming deductions for charitable contributions after the date the regulations become final. They generally follow, but add some clarification and additional requirements to, the existing regulations and code provisions respecting minimum recordkeeping requirements for all contributions, contemporaneous written acknowledgments for contributions of $250 or more, substantiation of certain noncash contributions and vehicle donations worth more than $500, and appraisal requirements for contributions of property worth more than $5000. See Prop Treas Reg §§1.170A-13, 1.170A-15-1.170A-18. Because the proposed regulations are in the public comment period, they are not discussed further in this chapter. For analysis of the tax treatment of charitable contributions, see chap 15.

Telemarketer disclosures. Federal law also imposes disclosure requirements on telemarketers who solicit contributions on behalf of charitable organizations. 15 USC §§6101-6108. See §14.19.

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§14.3 1. Substantiation Requirements—Disclosure and Information to Contributors

Donee requirements. The substantiation requirements for deductible contributions apply to qualified charitable organizations, which are generally those described in IRC §501(c)(3). The donee charitable organization must provide a "contemporaneous written acknowledgment," that is essentially a written substantiation receipt, to each donor who contributes $250 or more in cash or in-kind property. IRC §170(f)(8). Special substantiation requirements, discussed in §§14.8-14.11, apply to vehicle donations. IRC §170(f)(12).

NOTE: The IRS publishes a useful guide for charitable organizations on rules they must follow if they receive donations worth more than $250. See IRS Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements, available online at http://www.irs.gov/pub/irs-pdf/p1771.pdf.

Donor recordkeeping requirements. For all cash, check, or other monetary gift contributions, regardless of amount, the donor must maintain either a bank record, such as a canceled check, or a "written communication" from the donee charitable organization that shows the donee charitable organization's name, together with the date and the amount of the contribution. Failure to fulfill this minimum recordkeeping requirement may result in disallowance of the income tax contribution deduction. IRC §170(f)(17). Moreover, for cash donations of $250 or more, a written substantiation receipt is required; a canceled check is not sufficient. IRC §170(f)(8).

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§14.4 a. Form and Content of Substantiation Receipt

Contents of receipt. Although no specific form of substantiation receipt is prescribed (letters, postcards, e-mails, or computer-generated forms should all be acceptable), the contemporaneous written acknowledgment (other than for vehicle donations, which has more stringent rules (see §§14.8-14.11)) must include the following information to comply with IRC §170(f)(8) and the applicable regulations (Treas Reg §1.170A-13(f)(2); see also Treas Reg §1.170A-13(a)(1)-(b)(1); see form in §14.12):

- The name of the donor and the date of the contribution;
- The amount of cash and a description (but not the value) of any property the donor has contributed;
- A statement of whether the charitable organization has provided or will provide any goods or services (*i.e.,* cash, property, services, benefits, or privileges) in consideration, in whole or part, for the contribution;
- A description and a good faith estimate of the value of any goods or services the charitable organization has provided or will provide to the donor in consideration for the contribution; and
- If the charitable organization did not or will not provide any goods or services other than intangible religious benefits (*i.e.,* admission to a religious service or ceremony or other intangible religious benefit provided by a religious organization and generally not sold in a commercial transaction outside the donative context), a statement to that effect.

Provision of goods and services. A charitable organization will be considered to have provided goods or services to the donor as consideration for the contribution if the donor, at the time of the contribution, receives or *expects* to receive goods or services in exchange for the payment in the current year or another year. Treas Reg §1.170A-13(f)(6). The donor may rely on the good faith estimate of the value of goods or services provided by the charitable organization (without regard to the manner in which the estimate was made) unless the donor knows or should know that the estimate is in error. Treas Reg §1.170A-1(h)(4). Goods or services of "insubstantial value" under the quid pro quo rules can be disregarded altogether. See §14.15.

Multiple contributions. Generally, if a donor makes multiple contributions during the year, each of which is less than $250, no substantiation form is necessary. Nevertheless, the donor must observe the minimum recordkeeping requirements, such as retaining canceled checks or simple receipts, for each separate contribution to be able to deduct the multiple contributions. See §14.3. If a donor makes multiple contributions during the year and more than one is equal to or greater than $250, one substantiation can be used for the total amount. Treas Reg §1.170A-13(f)(1).

Written acknowledgment of donor expenses. Donors who incur out-of-pocket expenses of $250 or more when rendering services to a charitable organization and intend to deduct these expenses must also obtain written acknowledgment from the organization. The acknowledgment for expenses incurred need only describe the services provided by the donor and the value of goods or services provided in return (or a statement that none were provided); it need not include the date of the services. Treas Reg §1.170A-13(f)(10).

EXAMPLE: A youth leader attends an annual youth event, incurs expenses for food, lodging, and travel exceeding $250. To deduct these out-of-pocket expenses, the individual will need a written statement from the youth organization describing the event and the leader's participation.

Split interest trusts; pooled income funds. No substantiation receipt is required for contributions to a charitable lead trust, a charitable remainder annuity trust, or a charitable remainder unitrust. Treas Reg §1.170A-13(f)(13). A modified substantiation receipt *is* required for contributions to a pooled income fund or in exchange for gift annuities. Treas Reg §1.170A-13(f)(13), (16). For descriptions of charitable remainder trusts, pooled income funds, and charitable lead trusts, see §§15.47-15.65.

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§14.5 b. Timing of Disclosure

To properly substantiate a charitable deduction for income tax purposes, a donor must have the required "contemporaneous" receipt in hand on or before the earlier of (1) the date the donor files his or her income tax return for the year of the contribution or (2) the due date (including extensions) of the donor's tax return for the year. Treas Reg §1.170A-13(f)(3). For vehicle donations, the donor must also attach the written acknowledgment to the tax return. IRC §170(f)(12); see §14.10. For noncash contributions of property worth more than $500 (other than vehicles), the donor must also attach a statement describing the property to the tax return. IRC §170(f)(11)(B). For additional appraisal requirements for contributions of property worth more than $5,000, see §14.20.

PRACTICE TIP: The burden is on the donor to obtain the necessary substantiation, not on the charitable organization to provide it. Good public relations, however, would dictate that the charitable organization assist the donor by sending a timely receipt. It is good practice to send the donor a receipt promptly after the contribution is received. For multiple contributions during the year, it may be preferable to send out a consolidated donor receipt no later than January for contributions made during the prior year.

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§14.6 c. Exceptions for Low-Cost Articles and Membership Benefits

When listing benefits given by the charity on a substantiation receipt, the charitable organization may disregard two general categories of benefits provided to donors:

- Certain low-cost articles or other goods or services that have insubstantial value under guidelines promulgated by the Internal Revenue Service (Treas Reg §1.170A-13(f)(8)(i)(A); on the low-cost articles rules, see §14.15); and
- Annual membership benefits offered to a donor in exchange for a contribution of $75 or less, if the benefits include only the following (Treas Reg §1.170A-13(f)(8)(i)(B); on the membership benefits rules, see §14.16):
- Rights or privileges the member can exercise *frequently* during the year, such as free or discounted admission to the charitable organization's events, facilities, free parking, preferred access to goods or services, and discounts on purchases; and
- Admission to members-only events during the year for which the organization reasonably projects that the cost per person of each event is within the limits for low-cost articles.

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§14.7 d. Special Substantiation Rules for Certain Types of Donations

Special substantiation rules apply for the following:

- **Membership benefits provided to employees in recognition of an employer's contribution.** The total of goods or services provided to *all* employees as membership benefits may be disregarded if those provided to *each* employee could be disregarded. Treas Reg §1.170A-13(f)(9).
- **Contributions made by payroll deduction.** The requirements are met if a pay stub, IRS Form W-2, or other document indicates the amount of the contribution withholding and if the charitable organization provides a pledge card or other document stating that no goods or services were provided to the employee for the contribution. Treas Reg §1.170A-13(f)(11).
- **Payments for the right to purchase college athletic event tickets.** The value of the right is treated as being 20 percent of the payment made. Treas Reg §1.170A-13(f)(14).
- **Contributions by a partnership or an S corporation.** The entity, not the partners or shareholders, is treated as the donor and must obtain timely substantiation. Treas Reg §1.170A-13(f)(15).
- **Corporate matching gifts.** Goods or services the donor receives in consideration for the matching gift are treated as provided in consideration of the donor's own payment. Treas Reg §1.170A-13(f)(17).
- **Contributions to donor-advised funds.** Deductions for contributions of cash or other property to a donor-advised fund, as defined in IRC §4966(d)(2) (see §4.4), are allowed for income, gift, and estate tax purposes only if the substantiation receipt, in addition to complying with the rules of IRC §170(f)(8) (see §14.4), contains a statement that the organization sponsoring the donor-advised funds "has exclusive legal control over the assets contributed." IRC §§170(f)(18)(B), 2055(e)(5)(B), 2522(c)(5)(B).

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§14.8 e. Special Substantiation Rules for Vehicle Donations

Stringent substantiation requirements apply to donations of certain vehicles, including used cars and motor vehicles, boats, and airplanes (other than inventory) to charitable organizations. See IRC §170(f)(12). To claim a charitable contribution deduction, a donor making a vehicle donation with a claimed value of more than $500 to a charitable organization must obtain a timely contemporaneous written acknowledgment or substantiation receipt from the organization. Furthermore, the charitable organization must report information concerning the vehicle donation to the IRS. The IRS has provided interim guidance for these rules. See IRS Notice 2006-1, 2006-1 Cum Bull 347, as modified by IRS Notice 2007-70, 2007-40 Int Rev Bull 735; IRS Notice 2005-44, 2005-1 Cum Bull 1287.

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§14.9 (1) Substantiation Receipt Contents

Contents of receipt. At a minimum, the substantiation receipt required for vehicle donations must include the following, which is generally similar to the information required for other kinds of contributions (IRC §170(f)(12)(B)(i)-(iv)):

- The name of the donor and the date of the contribution;
- The donor's taxpayer identification number;
- The vehicle identification number of the donated vehicle; and
- Whether the charitable organization provided goods or services for the donation, and a good faith estimate of the value of the goods or services. (If only intangible religious benefits were provided, a statement to that effect must be included.)

Additional contents regarding charity's use or disposition. More detail is required in the substantiation receipt, depending on the charity's use of the donated vehicle. If the charitable organization sells the vehicle without any significant intervening use or without making any material improvements to the vehicle, then the substantiation receipt must also include the date of sale, a certification the vehicle was sold at arm's length between unrelated parties, the amount of gross proceeds from sale, and a statement that the deductible amount may not exceed the gross proceeds of sale. IRS Notice 2005-44, 2005-1 Cum Bull 1287.

Significant intervening use. If, on the other hand, the charitable organization plans to make significant intervening use of the donated vehicle or materially improve it before selling it, then the substantiation receipt must include a certification and description of the intended use and intended duration of such use, or the intended material improvement, together with a certification that the vehicle will not be sold before the use or improvement. An example of significant intervening use is the charity's use of the vehicle in an extensive meal-delivery program. IRS Notice 2005-44, 2005-1 Cum Bull 1287.

Sale below fair market value. Finally, if the charitable organization sells the donated vehicle at significantly below fair market value to a needy individual, or simply gives the vehicle to an individual in direct furtherance of the organization's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation, the substantiation receipt must so certify. Donated vehicles sold at auction do not qualify as sales to needy individuals. IRS Notice 2005-44, 2005-1 Cum Bull 1287.

NOTE: For vehicle donations with a claimed value of at least $250 but not more than $500, the detailed substantiation receipt contemplated by IRC §170(f)(12) need not be obtained; instead, the regular substantiation receipt provided for in IRC §170(f)(8) will suffice. See §14.4.

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§14.10 (2) Delivering Substantiation Receipt and Filing IRS Form 1098-C

Charity responsible for delivering receipt. The requirements for timely delivery to a donor of a substantiation receipt for a vehicle donation and the penalties for failure to comply are quite different than the general rules for written substantiation of donations of $250 or more set forth in IRC §170(f)(8). With respect to vehicle donations, the burden is expressly on the charitable organization to provide the substantiation receipt. IRC §170(f)(12). To be timely, the form of acknowledgment must be provided to the donor no later than 30 days after the sale of the vehicle, in the case of sales, or not later than 30 days after the contribution, if no sale occurs because of the organization's intended intervening use, material improvement, or transfer to a needy individual.

No format requirements. The substantiation receipt provided to the donor need not follow any particular format, as long as all required information and certifications are included.

Charity reports vehicle donation. In addition to providing the donor with a proper receipt, the charitable organization must report the vehicle contribution to the IRS. The required information is reported to the IRS on IRS Form 1098-C (Contributions of Motor Vehicles, Boats, and Airplanes).

NOTE: All Forms 1098-C, along with IRS Form 1096 (Annual Summary and Transmittal of United States Information Returns), filed after December 31, 2007, must be filed with the Department of the Treasury, Internal Revenue Service Center, at either Kansas City, MO 64999 or Austin, TX 73301. Future changes to the filing location for Form 1098-C will be announced and placed in the instructions to Form 1096.

PRACTICE TIP: According to the IRS, Form 1098-C, which the charitable organization must use to report vehicle donations, may also be used by the charitable organization as the contemporaneous written acknowledgment or substantiation receipt if timely provided to the donor. The form is available online at http://www.irs.gov/pub/irs-pdf/f1098c.pdf.

Notwithstanding the charitable organization's burden, it is still incumbent on the donor to obtain the substantiation receipt on or before the due date of the donor's tax return. Unlike receipts for other kinds of contributions, the substantiation receipt for a vehicle donation must be attached to the donor's income tax return in order for the charitable deduction to be allowed.

PRACTICE TIP: If the charity sells the vehicle *after* the donor files the tax return, the donor may amend the return and attach the proper receipt to claim the deduction. See IRS Notice 2005-44, 2005-1 Cum Bull 1287.

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§14.11 (3) Penalties

Failure to provide receipt. Under the general rules for contemporaneous receipts set forth in IRC §170(f)(8), no penalty falls on the charitable organization for failure to provide the applicable receipt, other than the potential ill will of a donor whose tax deduction is denied. In contrast, for vehicle donations, IRC §§170(f)(12) and 6720 impose substantial penalties directly on the charity for failure to comply.

Failure to provide acknowledgment of vehicle donation. For knowingly failing to furnish a timely, proper written acknowledgment to a donor making a vehicle donation, or for knowingly furnishing a false or fraudulent acknowledgment, the penalty imposed on the charitable organization is the greater of (a) the actual gross proceeds from the sale of the vehicle, or (b) the sales price stated in the acknowledgment multiplied by the highest rate of individual income tax then in force. IRC §6720(1).

Vehicles put to intervening use. For vehicles put to an intervening use, materially improved, or transferred to a needy individual, such that the written acknowledgment need not state the sales price, the penalty is the greater of (1) the donor's claimed value of the vehicle multiplied by the highest rate of individual income tax then in force or (2) $5000. IRC §6720(2).

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§14.12 f. Form: Acknowledgment and Receipt for Charitable Contribution of More Than $250

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

_ _[*Name of charitable organization*]_ _
_ _[*Address of charitable organization*]_ _

_ _[*Date*]_ _

_ _[*Name of donor*]_ _
_ _[*Address of donor*]_ _

Dear _ _[*name of donor*]_ _:

We gratefully acknowledge receipt of your contribution on _ _[*date of contribution*]_ _, of _ _[*dollar amount of cash contribution or description of in-kind property*]_ _ to our organization.

[*Add one of the following alternatives*]

[*Alternative 1: Only token or low-cost items or membership benefits provided]*

We have provided you no goods or services in exchange for your contribution.

[*Alternative 2: Intangible religious benefits only provided]*

We have provided you no goods or services in exchange for your contribution other than intangible religious benefits.

[*Alternative 3: Goods or services provided]*

As our way of saying "thank you" for your contribution, you received _ _[*or will receive*]_ _ from us _ _[*describe goods or services*]_ _. Our good faith estimate of the value of these _ _[*goods/services*]_ _ is _ _[*dollar amount*]_ _.

[*Continue*]

Sincerely,

_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The organization may list the aggregate amount of cash contributions for the year or may separately state the amounts contributed. The good faith estimate of the value of goods or services the organization provides to the donor is the fair market value of the goods or services. If the goods or services actually cost the organization nothing because they were donated, then the estimate of value should be based on the estimated cost the donor would otherwise have paid for those goods or services.

PRACTICE TIP: Charities should consider creating a single form, combining both the acknowledgment of receipt and the quid pro quo statement. See form in §14.18. For vehicle donations, charities should provide donors with a copy of IRS Form 1098-C as reported to the IRS. See §14.10.

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§14.13 2. Quid Pro Quo Contributions—Disclosure and Information to Contributors

Charitable organizations that provide any goods or services to donors or prospective donors in exchange for contributions must comply with specific quid pro quo disclosure requirements. IRC §6115. (These requirements are in addition to the substantiation requirements if both are applicable.) A charitable contribution is measured by the excess of the contribution's amount or value over the value of any benefit, or quid pro quo, the donor received in return. *U.S. v American Bar Endowment* (1986) 477 US 105, 91 L Ed 2d 89, 106 S Ct 2426. To be deductible, the donor must intend that the excess payment be a gift to the charitable organization. Treas Reg §1.170A-1(h). For similar disclosures required under state law, see §§14.38-14.39.

Safe harbors. The regulations provide "safe harbors" for certain quid pro quo benefits having low or nominal value (see §14.15) and for certain benefits given for membership payments of $75 or less (see §14.16). The regulations draw heavily on and refer to rules previously established in Rev Proc 90-12, 1990-1 Cum Bull 471, and Rev Proc 92-49, 1992-1 Cum Bull 987, as modified by Rev Proc 92-102, 1992-2 Cum Bull 579. See also IRS Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements.

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§14.14 a. Form and Content

Although no particular form of disclosure is required, the disclosure must include a good faith estimate of the value of goods or services provided in exchange for the donor's contribution. To meet this requirement, the charitable organization may use any reasonable methodology to estimate fair market value, as long as it is applied in good faith. Treas Reg §1.6115-1(a). For example, the estimate of value might be the average retail price of similar goods or services commercially available in the area. If the goods or services are not commercially available, the organization may make a good faith estimate of value by reference to the value of similar or comparable goods or services, even if they do not have the unique value of the goods or services provided.

EXAMPLES: A dinner event in a museum gallery may be valued by reference to a comparable event in a comparable hotel banquet facility, even though the hotel obviously lacks the unique cultural atmosphere of the museum. Likewise, the value of a golf outing with a celebrity need not be greater than the commercial fees for the golf course just because a celebrity participates.

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§14.15 b. Safe Harbor—Low-Cost Articles

A charitable organization may disregard goods or services having insubstantial value in the quid pro quo disclosure if the fundraising solicitations are part of a "qualified fund-raising campaign," *i.e.,* a campaign in which the charitable organization properly informs donors how much of their contributions are deductible. Treas Reg §1.6115-1(b). The rules for determining whether the value of goods or services is "insubstantial" are in Rev Proc 90-12, 1990-1 Cum Bull 471, and Rev Proc 92-49, 1992-1 Cum Bull 987, as modified by Rev Proc 92-102, 1992-2 Cum Bull 579.

In general, the safe harbor applies (Rev Proc 2009-50, 2009-45 Int Rev Bull 617):

- To items having a fair market value of the lesser of 2 percent of the donor's contribution or $96 for 2010 (this amount is indexed annually for inflation); or
- If the donor's contribution is at least $48 for 2010 (this amount is also indexed annually for inflation) and only token items are received in return.

A "token" item bears the charitable organization's name or logo and costs the organization no more than $9.60 for 2010. Rev Proc 2009-50, 2009-45 Int Rev Bull 617.

Low-cost articles (valued the same as "token" items) distributed by charitable organizations to prospective donors, which they may keep even if they do not contribute, may also be disregarded. Rev Proc 92-49, 1992-1 Cum Bull 987. See also IRC §513(h)(3).

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§14.16 c. Safe Harbor—Membership Benefits

Membership benefits offered in return for a contribution of $75 or less may be disregarded in the quid pro quo disclosure if they consist only of the following (Treas Reg §1.170A-13(f)(8); on the substantiation rules, see §14.6):

- Rights or privileges the member can exercise *frequently* during the year, such as free or discounted admission to the charitable organization's events facilities, free parking, preferred access to goods or services, and discounts on purchases; and
- Admission to members-only events during the year for which the charitable organization reasonably projects that the cost per person (including any allocable overhead) of each event is within the limits for low-cost articles ($9.60 for 2010. Rev Proc 2009-50, 2009-45 Int Rev Bull 617). For example, a museum's annual reception for members, at which light refreshments are served and a guest speaker appears, should qualify under this provision, as long as the cost per person (excluding allocable overhead) is no greater than the amount permitted for low-cost articles.

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§14.17 d. Timing of Disclosure

Written disclosures. The quid pro quo disclosure must be provided in a written statement either as part of the solicitation or as part of the substantiation receipt for charitable contributions. IRC §6115(a). See form in §14.18. See also IRS Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities, available at http://www.irs.gov/pub/irs-pdf/p4221pc.pdf.

Oral disclosures. Although not specifically required by regulations, for telephone, radio, or television broadcast, or in-person solicitations, the disclosure information should be provided orally at the time of solicitation. In such cases, the written disclosure must follow no later than the time the substantiation receipt for the contribution is provided to the donor.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.18 e. Form: Disclosure Statement for Quid Pro Quo Charitable Contributions

§14.18 e. Form: Disclosure Statement for Quid Pro Quo Charitable Contributions

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_ _[*Name of charitable organization*]_ _
_ _[*Address of charitable organization*]_ _

_ _[*Date*]_ _

Dear _ _[*name of donor*]_ _:

Thank you for your generous contribution. As an expression of our gratitude, you received _ _[*or will receive*]_ _ **from us** _ _[*description of goods or services provided*]_ _**.**

[*Add one of the following alternatives*]

[*Alternative 1: Goods and services not of insubstantial value]*

The estimated value of _ _[*description of goods or services provided*]_ _ **is** _ _[*good faith estimate of value of goods or services provided*]_ _**. The tax deductible portion of your contribution is the amount of your contribution reduced by this estimated value, subject to general limitations applicable to your personal circumstances. Please consult your tax adviser.**

[*Alternative 2: Only token or low-cost items or membership benefits provided]*

Under Internal Revenue Service guidelines, the estimated value of the benefits you received _ _[*or will receive*]_ _ **from us is insubstantial. Therefore, the full amount of your contribution is tax deductible, subject to general limitations applicable to your personal circumstances. Please consult your tax adviser.**

[*Continue*]

Sincerely,

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: If the organization is subject to both the quid pro quo disclosure rules of IRC §6115 and the substantiation requirements of IRC §170(f)(8), which would be true for a contribution of $250 or more if the donor receives a gift from the charity in exchange for the contribution, the forms can be combined as appropriate. The combined form would be provided after the contribution is received rather than at the time of solicitation.

PRACTICE TIP: Charities should consider creating a single form, combining both the acknowledgment of receipt (see form in §14.12) and the quid pro quo statement.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.19 3. Telemarketing Disclosures

§14.19 3. Telemarketing Disclosures

Solicitation purpose; organization's name. Certain disclosures must be made by persons soliciting charitable donations by telephone. 15 USC §6102. These persons must disclose clearly at the outset of a telephone solicitation that the purpose of the call is to solicit a donation, and must state the name of the charitable organization. 15 USC §6102(a)(3)(D).

For-profit telemarketers. The Federal Trade Commission (FTC) is empowered to make regulations imposing additional disclosure requirements for telephone solicitations that the FTC deems appropriate. Regulations implementing the telemarketer disclosure requirements for charitable organizations are set forth in 16 CFR pt 310. See also 15 USC §§6151-6155. In discussing the scope of the regulations under 16 CFR §310.1, the FTC takes the position that its enforcement jurisdiction applies only to for-profit telemarketers that solicit charitable contributions on behalf of charitable organizations.

Misrepresentations prohibited. Although a telemarketer is not required to make the following disclosures, the regulations generally prohibit a for-profit telemarketer calling on behalf of a charitable organization from *misrepresenting* any of the following (16 CFR §310.3(d)):

- Nature, purpose, or mission of the charitable organization;
- Tax deductibility of the solicited donation;
- Proposed use of the solicited donation;
- Percentage or amount of the donation that will actually be received by the charitable organization;
- Material aspects of a prize promotion; or
- Endorsement or sponsorship by any person or government agency.

The regulations clarify that a for-profit telemarketer calling on behalf of a charitable organization must disclose "truthfully, promptly, and in a clear and conspicuous manner" the identity of the charitable organization and that the purpose of the call is a charitable solicitation. 16 CFR §310.4(e).

NOTE: The FTC regulations do not exempt solicitation on behalf of religious organizations.

Automated calls. A seller or telemarketer may make prerecorded calls (also known as automated calls or "robo calls") on behalf of a nonprofit charitable organization to solicit contributions from a member of, or a previous donor to, the organization. The following rules apply to such automated calls (16 CFR §310.4(b)(1)(v)(B)):

- The automated call must allow the telephone to ring for at least 15 seconds or 4 rings before disconnecting an unanswered call;
- If answered, within 2 seconds after the recorded greeting plays, the call must play a message that provides the identity of the organization and the purpose of the call, followed by a disclosure that the person called can opt-out at any time by using an automated voice or keypress-activated mechanism to assert a do-not-call request. If the person called invokes the opt-out mechanism, it must:
- Automatically add the number to the caller's entity-specific do-not-call list;
- Immediately disconnect the call; and
- Be available for use any time during the message.

If the prerecorded call could be answered by an answering machine, it must provide the person called a toll-free number to assert a do-not-call request. 16 CFR §310.4(b)(1)(v)(B)(ii)(B).

Do-not-call registry. The Do-Not-Call Implementation Act (Pub L 108-10, 117 Stat 557) authorizes the FTC to implement and enforce a national do-not-call registry for telemarketing. Charitable organizations that are calling on their own behalf are exempt from complying with the national do-not-call registry. 16 CFR §310.6(a). However, the regulations do permit those solicited to request placement on the soliciting organization's entity-specific do-not-call list. 16 CFR §310.4(b)(1)(iii)(A). And, as mentioned above, persons being solicited have similar rights with respect to telemarketers placing automated calls on behalf of charitable organizations.

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§14.20 4. Appraisal and Sale Disclosure for Property Worth More Than $5000

When donor must obtain appraisal. A donor must obtain an appraisal by a qualified appraiser for a contribution of property (other than marketable securities) worth more than $5000 in order to be allowed an income tax charitable deduction. Treas Reg §1.170A-13(c). The donor must file IRS Form 8283 with his or her income tax return to document the contribution and the appraisal. Both the appraiser and the charitable organization must sign that form. Special appraisal rules apply to donations for vehicles, but specific rules and procedures on the appraisal requirements are beyond the scope of this chapter.

Reporting sales within 3 years. If a charitable organization disposes of the contributed property within 3 years after its contribution, the charity must report the sale and the sale price, together with a description of the charitable organization's use of the property and a statement indicating whether the use was "related" to the charitable organization's functions or purposes, on IRS Form 8282. IRC §6050L; Treas Reg §1.6050L-1.

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§14.21 5. Violations and Penalties

Failure to provide substantiation receipt. Except in the case of vehicle donations (see §14.11), the failure to provide a proper and timely substantiation receipt to a donor under IRC §170(f)(8) results in no direct penalty to the donee charitable organization and is not a violation of any statute or regulation, but a severe penalty falls on the donor —disallowance of the income tax deduction for the amount contributed. Through ignorance of the applicable law, administrative oversight, or sheer neglect, a charitable organization can drastically damage its relationship with its donors by failing to provide the necessary disclosures. Sophisticated donors and their advisers ought to be knowledgeable about the substantiation rules for their own protection, but, unfortunately, the absolute loss of all income tax benefits from charitable contributions can cause even the most understanding of donors to question why the donee, which from the donor's perspective is in the *business* of charitable solicitation, did not provide a suitable warning or the necessary receipt.

Failure to give quid pro quo disclosures. Failure to provide proper quid pro quo disclosure to a donor or prospective donor, however, is a statutory violation by the charitable organization that results in monetary penalties. The penalty is $10 *per contribution* for failing to provide the required disclosures, subject to a maximum penalty *per event or mailing* of $5000. IRC §6714. If noncompliance is due to reasonable cause the IRS may waive the penalty. IRC §6714(b). "Reasonable cause" is not defined in statute or regulation.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.22 B. Solicitation of Nondeductible Contributions

§14.22 B. Solicitation of Nondeductible Contributions

Federal law requires many types of tax-exempt organizations (see §14.23) that cannot receive tax-deductible contributions to disclose to donors and prospective donors that their contributions are *not* tax-deductible. IRC §6113. See §§14.26-14.30.

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§14.23 1. Organizations Subject to Disclosure Requirements

Tax-exempt organizations that are subject to the IRC §6113 disclosure rules are organizations described in IRC §501(c) (other than §501(c)(1)) or §501(d)), but they do not include charitable organizations to which donors may make charitable contributions under IRC §170(c). The most common of such organizations subject to the disclosure rules are the following (IRC §6113(b)(1)(A)):

- Social welfare organizations (IRC §501(c)(4));
- Labor unions and agricultural organizations (IRC §501(c)(5));
- Trade associations and business leagues (IRC §501(c)(6)); and
- Social and recreational clubs (IRC §501(c)(7)).

Political action committees and other political organizations described in IRC §527(e) must also disclose to donors and potential donors that contributions are not tax-deductible. IRC §6113(b)(1)(B).

The disclosure requirements also apply to organizations that (1) would have been subject to the disclosure rules at any time within the 5-year period before the solicitation or (2) are successors to organizations that would have been subject to the disclosure rules at any time during the previous 5-year period. IRC §6113(b)(1)(C).

Exemptions from disclosure. Organizations that ordinarily have no more than $100,000 annual gross receipts are exempt from disclosure. IRC §6113(b)(2)(A). See also IRS Notice 88-120, 1988-2 Cum Bull 454. Also, fraternal organizations operating under the lodge system need not provide the disclosure statement for solicitations of contributions from individuals intended exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children. IRC §6113(b)(3). Section 6113 does not apply to solicitations made to other tax-exempt organizations. IRS Notice 88-120, 1988-2 Cum Bull 454.

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§14.24 2. Fundraising Activities Subject to Disclosure Requirements

A fundraising solicitation is any solicitation for contributions, whether written, telephoned, or broadcast. IRC §6113(c). Solicitations for nondeductible contributions to benefit applicable tax-exempt organizations must be accompanied by the required disclosure stating that contributions are *not* tax-deductible, regardless of whether the solicitation is for donations of cash, gifts, membership dues or fees, contributions of assets, or volunteer services. IRC §6113(a). Examples of solicitations covered by the disclosure rules include the following:

- Solicitations for voluntary contributions or attendance at fundraising events;
- Solicitations for contributions to political campaigns or political action committees; and
- Notices or solicitations for payment of membership dues for new or continuing members of a membership organization.

Exemptions from disclosure: certain contacts and billings. Letters or telephone contacts that are not part of a fundraising campaign involving more than ten potential donors during a calendar year are exempt from the disclosure requirements. IRC §6113(c)(2). Similarly, invoicing to suppliers, advertisers, and similar goods and services providers are not subject to the disclosure rules. Examples of solicitations *not* requiring disclosure include the following:

- Billings for attendance at a conference (as distinguished from a testimonial or fundraising event);
- Billings for insurance premiums of an insurance program sponsored by the organization; and
- Billings to members and nonmembers for food and beverages at a social club that do not include charges for dues or fees.

Exemptions from disclosure: membership benefits materials. General material discussing the benefits of membership in an organization need not disclose that contributions are not tax-deductible unless the material requests payment of membership fees or dues. Material discussing, *e.g.,* a potential political candidate need not include disclosure if no specific solicitation is made. IRS Notice 88-120, 1988-2 Cum Bull 454.

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§14.25 3. Disclosure Requirements

Conspicuous and easily recognizable. The disclosure must expressly state, "in a conspicuous and easily recognizable format," that contributions or gifts to the organization are not deductible as charitable contributions for federal income tax purposes. IRC §6113(a). Fine-print disclosures are probably not acceptable.

Safe harbor rules. Although no specific form is required, the IRS has established safe-harbor procedures for compliance with the disclosure requirements. IRS Notice 88-120, 1988-2 Cum Bull 454. See §§14.26-14.30.

NOTE: Even if an organization does not meet the safe-harbor rules, a good faith effort to properly disclose the required information may be sufficient to allow the organization to be in compliance with IRC §6113, subject to the determination of the IRS.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.26 a. Safe-Harbor Procedures for Mail and Other Print Media Solicitations

§14.26 a. Safe-Harbor Procedures for Mail and Other Print Media Solicitations

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For mail and other print media solicitations, the safe-harbor procedures for compliance with disclosure requirements are as follows (IRS Notice 88-120, 1988-2 Cum Bull 454):

- The solicitation must include one of the following statements:

Contributions or gifts to _ _[*name of organization*]**_ _ are not deductible as charitable contributions for Federal income tax purposes.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible as charitable contributions.**

- The statement must be in at least the same size type as the primary message;
- The statement must appear in either the first sentence in a paragraph or a separate paragraph; and
- The statement must be included on the message side of any card or tear-off section that the donor returns with a contribution.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.27 b. Safe-Harbor Procedures for Telephone Solicitations

§14.27 b. Safe-Harbor Procedures for Telephone Solicitations

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For telephone solicitations, the safe-harbor procedures for compliance with disclosure requirements are as follows (IRS Notice 88-120, 1988-2 Cum Bull 454):

- The solicitation must include one of the following statements:

Contributions or gifts to _ _[*name of organization*]**_ _ are not deductible as charitable contributions for Federal income tax purposes.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible as charitable contributions.**

- The statement must be made during the telephone call and in proximity to the request for contributions; and
- Written confirmations or billings mailed to the donor after the call must comply with the safe-harbor rules applicable to print media and mailings. See §14.26.

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§14.28 c. Safe-Harbor Procedures for Television Solicitations

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For television solicitations, the safe-harbor requirements for compliance with disclosure requirements are as follows (IRS Notice 88-120, 1988-2 Cum Bull 454):

- The solicitation must include one of the following statements:

Contributions or gifts to _ _[*name of organization*]**_ _ are not deductible as charitable contributions for Federal income tax purposes.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible as charitable contributions.**

- If the statement is spoken, it must be made in proximity to the request for contributions; if the statement appears on screen, it must be in large, easily readable type and appear for at least five seconds.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.29 d. Safe-Harbor Procedures for Radio Solicitations

§14.29 d. Safe-Harbor Procedures for Radio Solicitations

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For radio solicitations, the safe-harbor requirements are as follows (IRS Notice 88-120, 1988-2 Cum Bull 454):

- The solicitation must include one of the following statements:

Contributions or gifts to _ _[*name of organization*]**_ _ are not deductible as charitable contributions for Federal income tax purposes.**

Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible.**

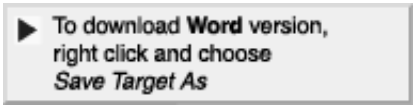
Contributions or gifts to _ _[*name of organization*]**_ _ are not tax deductible as charitable contributions.**

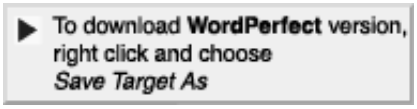
- The statement must be made during the same radio announcement as, and in proximity to, the request for contributions.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.30 e. Safe-Harbor Procedures for Labor or Agricultural Organizations and Business Leagues

§14.30 e. Safe-Harbor Procedures for Labor or Agricultural Organizations and Business Leagues





To come within the IRS safe-harbor rules for compliance with disclosure requirements, membership organizations described in IRC §501(c)(5) (labor or agricultural organizations) or §501(c)(6) (business leagues) that solicit membership dues, normally deductible by donors as business expenses, may substitute one of the following three statements in any type of solicitation (IRS Notice 88-120, 1988-2 Cum Bull 454):

Contributions or gifts to _ _[*name of organization*]_ _ are not tax deductible as charitable contributions. However, they may be tax deductible as ordinary and necessary business expenses.

Contributions or gifts to _ _[*name of organization*]_ _ are not tax deductible as charitable contributions for Federal income tax purposes. However, they may be tax deductible under other provisions of the Internal Revenue Code.

While contributions or gifts to _ _[*name of organization*]_ _ are not tax deductible as charitable contributions for Federal income tax purposes, they may be tax deductible as ordinary and necessary business expenses under other provisions of the Internal Revenue Code.

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§14.31 4. Violations and Penalties

The soliciting organization is subject to a $1000 penalty for failure to provide the disclosure statement in one or more solicitations on any particular day. IRC §6710(a). For example, making ten nondisclosure solicitations during a day results in a $1000 penalty; making 1000 nondisclosure solicitations during another day also results in a $1000 penalty, up to a maximum annual penalty of $10,000. However, no penalty will be imposed if the failure to provide the statement is due to reasonable cause. IRC §6710(b). "Reasonable cause" is not defined in statute or regulation.

An intentional failure to disclose results in a per day penalty of $1000 or 50 percent of the aggregate cost of the solicitations for that day for which no disclosure was made, whichever is greater. There is no maximum penalty for an intentional failure. IRC §6710(c).

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§14.32 C. Sale of Information or Services Otherwise Available From Federal Agency

Most tax-exempt organizations that charge a fee for obtaining information for or providing services to any individual must make a disclosure if the information or services can be obtained free or at nominal charge from a federal agency. IRC §6711(a). For purposes of the disclosure rules, a "nominal charge" imposed by a federal agency for information or services is less than $2.50 (including postage and handling). IRS Notice 88-120, 1988-2 Cum Bull 454.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.33 1. Organizations Subject to Disclosure Requirements

§14.33 1. Organizations Subject to Disclosure Requirements

These disclosure rules apply to organizations exempt from federal income tax that are described in IRC §501(c) or §501(d) and exempt from taxation under IRC §501(a) and to political organizations described in IRC §527(e). IRC §6711(c)(1).

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§14.34 2. Activities Subject to Disclosure Requirements

Offers for sale of information or solicitations for payment for services that are readily available from a federal agency are covered by the disclosure law if the information or services are (IRC §6711(a); IRS Notice 88-120, 1988-2 Cum Bull 454):

- Specifically related to the specific individual being solicited;
- Routinely available; and
- Readily obtainable by the individual.

Thus, an organization may provide services to individuals that are not routinely available for free through a federal agency, such as health care services, without application of the disclosure rules. Information that is not readily available, such as information that can be obtained from a particular federal agency only in person, could also be made available by mail for a fee without disclosure.

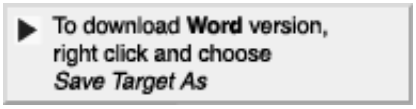
EXAMPLE: An offer to obtain a solicited individual's Social Security earnings record or Social Security identification number for a fee would be subject to the disclosure requirement. This information is related to the specific individual, is routinely available, and is readily obtainable by the individual.

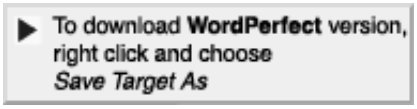
Rules inapplicable re specific individuals. The disclosure rules are not intended to apply to offers to obtain information or services for a fee that are not related to a specific individual.

EXAMPLE: Obtaining or providing, for a fee, copies of newsletters, publications, or other information available to the general public would *not* violate the required disclosure, because it does not relate to a specific individual.

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§14.35 3. Disclosure Requirements





The disclosure required in connection with an offer for the sale of information or services otherwise available from a federal agency must be made in an express statement in a conspicuous and easily recognizable format. A "safe-harbor" disclosure statement is as follows (IRS Notice 88-120, 1988-2 Cum Bull 454):

This material is available free or at nominal charge from _ _[*name of federal agency*]_ _.

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§14.36 4. Violations and Penalties

A charitable organization that *intentionally* fails to disclose the availability of the information or services from the federal agency is subject to a penalty for any day on which that failure occurs equal to $1000 or 50 percent of the aggregate cost of the offers and solicitations for that day, whichever is greater. There is no penalty for an unintentional failure to disclose. IRC §6711(a)-(b).

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III. STATE AND LOCAL REGULATIONS

§14.37 A. Solicitation of Gifts and Sales

California state law regulates charitable solicitations. See Bus & P C §§17510-17510.9. Certain cities and counties have also enacted local ordinances to control and regulate charitable solicitations. These ordinances often impose requirements such as registration, issuance of permits, and financial disclosure. However, the United States Supreme Court case of *Riley v National Fed'n of the Blind* (1988) 487 US 781, 101 L Ed 2d 669, 108 S Ct 2667, draws into question the constitutionality of certain California state and local laws. See §14.39.

PRACTICE TIP: A charitable organization must establish and exercise control over its fundraising activities. This control must include approval of all written agreements related to fundraising and the assurance that fundraising activities are conducted without coercion. Govt C §12599.6(b).

NOTE: Despite the numerous laws and ordinances regulating charitable solicitations, solicitation for contributions by a nonprofit organization does not constitute trade or commerce so as to be subject to the antitrust provisions of the Sherman Act. *Dedication & Everlasting Love to Animals v Humane Soc'y of U.S., Inc.* (9th Cir 1995) 50 F3d 710.

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1. Disclosure and Licensing Requirements

§14.38 a. Timing and Contents of Disclosure

With limited exceptions, a person or an entity who solicits a gift or sale for charitable purposes must make required disclosures under California law. Bus & P C §§17510.3-17510.4. Before making any solicitation for a charitable gift or sale, the solicitor or seller must disclose to the prospective donor or purchaser certain written information about the charitable organization, which may be presented in a properly executed card titled "Solicitation or Sale for Charitable Purposes Card" or any other printed material (such as a brochure). Bus & P C §17510.3(a). In either format, the disclosure must be in at least 10-point type and must include the following (Bus & P C §17510.3(a)(1)-(6)):

- The name and address of each organization, fund, or combined campaign on behalf of which the money collected will be used for charitable purposes;
- If no donee organization or fund, the manner in which the money collected will be used for charitable purposes;
- The nontax-exempt status of the organization or fund, if it does not have a tax exemption under both federal and state law;
- The percentage of the gift or purchase price that may be deducted as a charitable contribution under both federal and state law (similar to federal quid pro quo rules; see §14.13) or, if no portion is deductible, that the contribution is not tax-deductible; and
- If the organization making the solicitation represents any nongovernmental organization by using a name that would reasonably imply that the organization is composed of law enforcement or firefighting personnel or veterans (see Bus & P C §17510.3(a)(6) (veteran exceptions)), the total number of organization members, the number of organization members living or working in the county where the solicitation is made, and, if soliciting advertising for an organization whose name implies that it is composed of law enforcement or firefighting personnel, the statewide circulation of the publication for which the advertising is solicited.

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§14.39 b. Constitutional Challenges to Disclosure and Licensing Requirements

Percentage amount disclosure requirements. Business and Professions Code §17510.3(a) previously required disclosure of the percentage amount of the solicitation to be used for charitable purposes and the estimated amount to be paid for fundraising expenses, but the constitutionality of these disclosure requirements was in question. In *Riley v National Fed'n of the Blind* (1988) 487 US 781, 101 L Ed 2d 669, 108 S Ct 2667, the Supreme Court held that related provisions of North Carolina's charitable solicitation law were unconstitutional because they infringed on an organization's freedom of speech rights. In 2005, Bus & P C §17510.3(a) was amended to remove these unconstitutional disclosure requirements. The *Riley* decision suggests that similar provisions that remain under the California charitable solicitation law may be unconstitutional, but this issue has not been presented squarely to the courts. See §14.59. See also *People v Orange County Charitable Servs.* (1999) 73 CA4th 1054, 87 CR2d 253.

In *Orange County Charitable Servs.,* the court held that a trial court injunction against inaccurate and misleading disclosures by a professional fundraiser in connection with charitable solicitations that required the fundraiser to make certain detailed disclosures as a condition of doing business in California did not infringe on the fundraiser's freedom of speech. 73 CA4th at 1079. Citing *Riley*, the court held that the required disclosure of fundraising expense percentages (but only in response to an inquiry by a prospective donor) was not an undue burden on free speech.

Fraud prosecutions. Even though *Riley* and other previous decisions held that certain charitable solicitation regulations that barred fees in excess of a prescribed level effectively imposed prior restraints on fundraising in violation of the First Amendment, the United States Supreme Court subsequently held that the *Riley* decision did not preclude introducing evidence of high fundraising costs to support a fraud prosecution when the nondisclosure of fundraising costs is accompanied by intentionally misleading statements made by the fundraiser in its charitable solicitations. *Illinois ex rel Madigan v Telemarketing Assocs., Inc.* (2003) 538 US 600, 606, 155 L Ed 2d 793, 123 S Ct 1829 (default rule in criminal prosecutions: mere fact that telemarketer keeps high percentage and does not volunteer that information insufficient for fraud); see also *U.S. v Lyons* (9th Cir 2007) 472 F3d 1055, 1064.

Overly broad or vague licensing requirements. Regulations on fundraising that are overly broad or vague as to the information to be provided by the charitable organization or that give the authorities broad discretion in the issuance of licenses are also likely to be found unconstitutional. See *Gospel Missions v Bennett* (CD Cal 1997) 951 F Supp 1429. In *Gospel Missions*, the court found that Los Angeles ordinances imposed certain registration, licensing, and financial disclosure requirements on charitable solicitations, which were not narrowly tailored to achieve a legitimate objective, and that the requirements therefore violated the First Amendment.

Information cards. After the first *Gospel Missions* case, Los Angeles amended its ordinance to conform, but was again challenged by Gospel Missions. In the subsequent case, the Ninth Circuit remanded to the district court Gospel Missions' challenge concerning provisions of the remaining ordinance that required a person to obtain an "information card" from the police department before soliciting charitable contributions and allowed the police department to endorse a charitable organization on the information card if the organization met certain requirements. The Ninth Circuit asked the district court to determine whether the information card was the functional equivalent of a license and, if so, to consider Gospel Missions' vagueness, overbreadth, and equal protection challenges. *Gospel Missions v City of Los Angeles* (9th Cir 2003) 328 F3d 548. Although the district court concluded that the information card is indeed equivalent to a license, ultimately, the Ninth Circuit rejected GMA's vagueness and overbreadth challenges to the information card requirement. *Gospel Missions of Am. v City of Los Angeles* (9th Cir 2005) 419 F3d 1042.

Door-to-door canvassing permits. In *Watchtower Bible & Tract Soc'y, Inc. v Village of Stratton* (2002) 536 US 150, 153 L Ed 2d 205, 122 S Ct 2080, the United States Supreme Court also found unconstitutional an Ohio local ordinance requiring a permit for door-to-door canvassing. However, because the decision in *Watchtower* might apply only to ordinances regulating door-to-door canvassing in general, it might not be decisive in a case pertaining to the constitutionality of local charitable solicitation ordinances.

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§14.40 2. Organizations and Activities Subject to Disclosure Requirements

Charities subject to disclosure requirements. Charities subject to the disclosure requirements include any person, nonprofit community organization, fraternal, benevolent, educational, philanthropic, service, or governmental employee organization that (a) solicits or obtains contributions solicited from the public for charitable purposes or (b) holds any assets for charitable purposes. Bus & P C §17510.2(d).

Definitions of "solicitation" or "sales" subject to disclosure requirements. Generally, the disclosure requirements apply to any solicitation or sales solicitation for charitable purposes. Bus & P C §17510.3(a). A "solicitation for charitable purposes" is defined as a request for money or property in connection with any of the following (Bus & P C §17510.2(a)):

- An appeal for charitable purposes;
- The use of a charity's name as an inducement to giving;
- A statement that the gift or any part of the gift will be used for charitable purposes; or
- The use of the name of an organization of law enforcement personnel, firefighters, or other persons who protect the public safety as an inducement to giving, unless the only express or implied purpose of the solicitation is for the sole benefit of the active membership of the organization.

A "sales solicitation for charitable purposes" is the sale or attempted sale of any item or service by using any of the means stated above for a solicitation for charitable purposes. Bus & P C §17510.2(b). A "sale" is broadly defined to include any gift made with the hope or expectation of monetary compensation. Bus & P C §17510.1.

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§14.41 3. Timing and Form of Disclosure

Solicitation in person. When a charitable solicitation or sales solicitation is made in person, the written disclosure must be provided before the solicitation is made. Bus & P C §17510.3(a). See §14.38.

Solicitation by other means. If the initial solicitation is not made in person but by radio, television, letter, telephone, or other means (including the Internet), the disclosures must be clearly made but need not be in written form, depending on the method of solicitation. Bus & P C §17510.4. The statute does not mandate when disclosure must be made, but a reasonable standard will probably be applied.

Radio and television solicitations. The disclosure requirement does not apply to any radio or television solicitation of 60 seconds or less unless a gift or sale results from the solicitation; in that event, a solicitation or sale for charitable purposes card must be mailed or delivered to the donor or purchaser. Bus & P C §17510.4. Again, the statute does not specify a time for disclosure, but a reasonable standard will most likely be applied. See form of solicitation or sale for charitable purposes card in §§14.45-14.49.

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4. Exceptions to Disclosure Requirements

§14.42 a. Nonsale Solicitations by Volunteers

If a solicitation is not a sales solicitation *and* it is made by a volunteer who does not receive compensation for the solicitation, the solicitor satisfies the disclosure requirements by providing the prospective donor with the name and address of the charitable organization for which the solicitation is made and the charitable purposes for which the solicitation is made, and by stating that financial information about the organization may be obtained by contacting the organization's office at the address given. If the solicited person requests the financial information, the charitable organization must provide it within 7 days after receiving the request. Bus & P C §17510.3(c). Although the statute does not require that the disclosure be in written form, it is recommended in order to show that the disclosure was made.

NOTE: The charitable organization's financial records must be maintained on the basis of generally accepted accounting principles (GAAP). Bus & P C §17510.5. See chap 21.

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§14.43 b. Solicitations by Minor Volunteers

No disclosure is required if the solicitation is made on behalf of a charitable organization that is tax-exempt under IRC §501(c)(3) by a volunteer who is 18 years of age or younger and who receives no compensation for the solicitation. Bus & P C §17510.3(d).

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§14.44 c. Solicitation of Members or on Organization's Premises; Bingo Games

No disclosure is required if the solicitation for a gift or sale is made to members of the charitable organization or at the organization's regular occupied premises. In addition, no disclosure is required for funds raised from bingo games authorized by Pen C §326.5. Bus & P C §17510.6. For further discussion of bingo games and similar fundraising activities, see §§14.66-14.72.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/ 5. Solicitation or Sale for Charitable Purposes Card for Solicitations by Volunteer/§14.45 a. Form: Title and Nature of Solicitation

5. Solicitation or Sale for Charitable Purposes Card for Solicitations by Volunteer

§14.45 a. Form: Title and Nature of Solicitation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§14.45-14.49.

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SOLICITATION OR SALE FOR CHARITABLE PURPOSES CARD

[*Add one of the following alternatives*]

[*Alternative 1: Soliciting on behalf of organization or fund]*

The _ _[*donation/sale proceeds*]_ _ **will be used to further the charitable purposes of** _ _[*name and address of organization, fund, or combined campaign*]_ _**. The** _ _[*organization or fund*]_ _ _ _[*is/is not*]_ _ **tax exempt under** _ _[*California/federal/California or federal*]_ _ **law.**

[*Alternative 2: Not soliciting on behalf of organization or fund]*

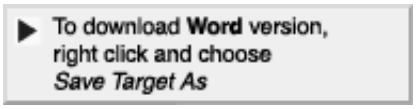
_ _[*Name of solicitor*]_ _ **is requesting a donation of** _ _[*dollar amount/describe property*]_ _**. The** _ _[*donation/sale proceeds*]_ _ **will be used to further the following charitable purposes:** _ _[*state charitable purposes*]_ _**.**

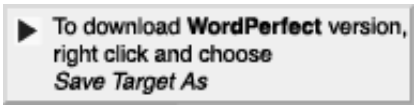
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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.46 b. Form: Deductibility of Contribution

§14.46 b. Form: Deductibility of Contribution

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[*Add one of the following alternatives*]

[*Alternative 1: Gift or purchase price is tax deductible]*

_ _[A*mount of purchase price or gift*]_ _ **is deductible as a charitable contribution on your federal and state income tax returns, subject to general limitations applicable to your personal circumstances. Please consult your tax adviser.**

[*Alternative 2: Gift or purchase price is not tax deductible]*

This contribution is not tax deductible for federal or state income tax purposes.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.47 c. Form: Solicitation for Law Enforcement, Firefighting, or Veterans Organizations

§14.47 c. Form: Solicitation for Law Enforcement, Firefighting, or Veterans Organizations

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[*Add one of the following alternatives*]

[*Alternative 1: Organization has name that implies it is composed of law enforcement or firefighting personnel or veterans]*

This organization has a total of _ _[*number*]**_ _ members, and _ _**[*number in county*]**_ _ of such members reside or work in _ _**[*county of solicitation*]**_ _.**

[*Alternative 2: Soliciting for advertising for organization whose name implies it is law enforcement or firefighting organization]*

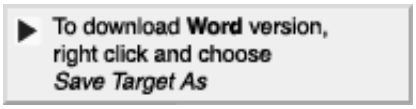
The statewide circulation for the publication in which the solicited ad will appear is _ _[*specify circulation*]**_ _.**

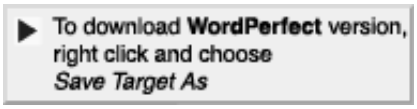
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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.48 d. Form: Whether Soliciting Organization Will Benefit From Contribution

§14.48 d. Form: Whether Soliciting Organization Will Benefit From Contribution

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§14.45-14.49.





[*Add one of the following alternatives*]

[*Alternative 1: Soliciting organization is the organization that will benefit from the contribution]*

The _ _[*name*]**_ _ and _ _**[*address*]**_ _ of the organization that will benefit from your contribution is _ _**[*name and address*]**_ _.**

[*Alternative 2: Soliciting organization is not the organization that will benefit from the contribution]*

The name and address of the soliciting organization is _ _[*name and address*]**_ _.**

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.49 e. Form: Signature Block

§14.49 e. Form: Signature Block

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§14.45-14.49.

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I declare under penalty of perjury that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature of principal, staff member, or officer of soliciting organization*]__
_ _[*Typed name*]_ _

Comment: This form must be in at least 10-point type. For discussion of the requirements for commercial fundraisers, see §§14.58-14.59.

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§14.50 6. Local Ordinances

The state law disclosure requirements are deemed satisfied if a solicitation complies with any city or county ordinance having disclosure requirements substantially similar to and no less restrictive than the state law requirements. Bus & P C §17510.7. For information on city and county ordinances, contact the appropriate city or county office. For a list of addresses and telephone numbers of these offices, see the Appendix to this book.

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§14.51 7. Additional Financial Disclosures by Certain Charities

Annual filing with Attorney General. A charitable organization must annually file certain financial information with the Attorney General if it (Bus & P C §17510.9(a)):

- Collected more than 50 percent of its annual income and received more than $1 million in charitable contributions from donors in California in the previous calendar year; and
- Spent more than 25 percent of its annual income on salaries, fundraising, travel expenses, overhead, and other management and administration expenses.

The financial information required to be filed is set forth in Attorney General Form CT-694 (Annual Financial Solicitation Report), which must be filed in triplicate. The form may be filled in online and printed from the Attorney General's website. See http://www.ag.ca.gov/charities/.

Contents. The following information must be included on Form CT-694 (Bus & P C §17510.9(b)):

- The charity's total revenue and contributions; and
- The dollar amount and percentage of total revenue and charitable contributions allocated to the following:
- Salaries for all of the charity's employees;
- Salaries for the five highest compensated employees;
- Fundraising;
- Travel expenses;
- Programs; and
- Overhead and other management and administrative expenses.

Nonprofit must provide copy on request. The charitable organization must make a copy of Form CT-694 available to anyone who requests it in person, by telephone, or by mail. The person requesting the information must supply a stamped, self-addressed envelope. Bus & P C §17510.9(c).

Public review. Copies of completed forms are available for public review at the Registrar of Charitable Trusts in Sacramento and in the San Francisco and Los Angeles offices of the Attorney General. Bus & P C §17510.9(d).

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§14.52 8. Prohibited Acts and Practices

Misrepresentation. Charitable organizations and commercial fundraisers may not misrepresent the purpose of the charitable organization or the nature, purpose, or beneficiary of a solicitation. Misrepresentation may be accomplished by words, conduct, or failure to disclose a material fact. Govt C §12599.6(a).

Acts prohibited regardless of injury. Regardless of injury, the following acts and practices are prohibited in the planning, conduct, or execution of any solicitation or charitable sales promotion (Govt C §12599.6(f)):

- Operating in violation of, or failing to comply with, the requirements of the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7) or orders of the Attorney General, or operating after registration with the Attorney General is no longer valid;
- Using any unfair or deceptive acts or practices or any fraudulent conduct that creates a likelihood of confusion or misunderstanding;
- Using any name, symbol, emblem, statement, or other material that would mislead a reasonable person as to the identity of charitable beneficiary;
- Misrepresenting or misleading anyone to believe that:
- The solicitation or sale is being conducted for a charitable organization or for a charitable purpose when it is not;
- Another person sponsors, endorses, or approves a charitable solicitation or sale when that person has not given written consent to using that person's name for these purposes;
- The goods or services have the endorsement, sponsorship, approval, characteristics, ingredients, uses, benefits, or qualities that they do not have or that a person has the endorsement, sponsorship, approval, status, or affiliation that the person does not have;
- Misleading any person to believe that the registration with the Attorney General constitutes an endorsement or approval by the Attorney General;

NOTE: The Attorney General provides a sample statement that is not prohibited (see Govt C §12599.6(f)(7)):

> "The official registration and financial information regarding (insert the legal name of the charity as registered with the Registry of Charitable Trusts) can be obtained from the Attorney General's Web site at http://www.caag.state.ca.us/charities/. Registration does not imply endorsement."

- Representing that a charitable organization will receive an amount greater than the actual net proceeds reasonably estimated to be retained by the charity;
- In connection with solicitations by commercial fundraisers on behalf of law enforcement personnel, firefighters, or other persons who protect the public safety, the distribution of honorary membership cards, courtesy cards, stickers, emblems, plates, or other items that could be used for display on a motor vehicle that suggest affiliation with or endorsement by any public safety personnel;
- Solicitation for advertising to appear in a for-profit publication that relates to or could reasonably be construed to relate to any charitable purpose without making the following disclosures at the time of solicitation:
- That the publication is a for-profit, commercial enterprise;
- The true name of the solicitor and that the solicitor is a professional fundraiser; and
- That the publication is not affiliated with or sponsored by any charitable organization;
- Representing that the contribution solicited by a charitable organization will be given to a second charitable organization unless that second organization has provided written consent to the use of its name, signed by an authorized officer, director, or trustee, before the solicitation; and
- Representing that tickets to events will be donated for use by another, unless the following requirements have been met:
- The soliciting organization has written commitments from charitable organizations stating that they will accept

donated tickets and specifying the number of tickets they are willing to accept; and

- The donated tickets will not, when combined with other ticket donations, exceed either the number of ticket commitments received from charitable organizations or the total attendance capacity at the site of the event.

NOTE: A ticket commitment from a charitable organization alone does not constitute written consent to use the organization's name in a solicitation campaign. Govt C §12599.6(g).

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§14.53 9. Violations and Penalties

Violation of state disclosure requirements may result in civil and criminal penalties and remedies (see §§14.54-14.57), which are cumulative to each other and to any other penalties and remedies under California law. Bus & P C §17534.5. The penalties are enforceable against the solicitor and the charitable organization; technically, they are also enforceable against volunteer solicitors. The Attorney General has broad powers to carry out its charitable trust enforcement responsibilities.

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§14.54 a. Monetary Penalty

Violation of disclosure rules. The Attorney General or a district attorney, county counsel, or city attorney may file a civil action for violation of the disclosure requirements, which may result in a civil penalty up to $2500 for each violation. Bus & P C §17536. Each solicitation in violation of the requirements is a separate violation.

Violation of Uniform Act. The Attorney General may file an action for violation of the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7), which may result in a civil penalty ranging up to $10,000, depending on the violation. Govt C §12591.1.

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§14.55 b. Injunction

Violation of disclosure rules. The Attorney General or a district attorney, county counsel, city attorney, city prosecutor, or any person who has suffered injury or loss may bring an action to enjoin a violation or proposed violation of the disclosure requirements. Bus & P C §17535. The maximum penalty for each intentional violation is $6000, and each day of violative conduct is a separate violation. Bus & P C §17535.5.

Violation of Uniform Act. The Attorney General may institute appropriate action to secure compliance with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). Govt C §12591.

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§14.56 c. Criminal Enforcement

A violation of the disclosure requirements of Bus & P C §17510.3 is a misdemeanor. See Bus & P C §17534. Unless otherwise provided, the maximum penalty is $1000, 6 months' confinement, or both. Pen C §19.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.57 d. Penalty for False Representations

§14.57 d. Penalty for False Representations

It is unlawful for a person who is soliciting or receiving money for charitable purposes to make a false statement about the purposes or organization for which the solicitation is made, the cost of solicitation, or how the solicited property will be used. Anyone who willfully or negligently makes such false statement is guilty of a misdemeanor. The maximum penalty for such an offense is $5000, 1 year's imprisonment, or both. Pen C §532d(a). The offense must be proved by the testimony of at least one witness and corroborating circumstances. Pen C §532d(b).

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B. Commercial Fundraisers

§14.58 1. Required Disclosures

Prior or contemporaneous disclosure required. In addition to the disclosures required by Bus & P C §17510.3, any person, corporation, or entity that receives compensation for charitable solicitations must disclose that the solicitation is being conducted by a commercial fundraiser for charitable purposes and the name of that fundraiser. These additional disclosures must be made before any oral solicitation is made by personal contact, radio, television, telephone, or over the Internet, or at the same time that a written solicitation is made. Bus & P C §17510.85.

NOTE: These disclosures are not applicable to any person who is an employee of the charitable corporation. Govt C §12599(a).

Registration with Attorney General before solicitation. A commercial fundraiser also has specific registration, reporting, deposit, and records requirements. See Govt C §§12599-12599.7. Commercial fundraisers (and fundraising counsel) must register with the Attorney General's Registry of Charitable Trusts before beginning soliciting. Govt C §12599(b). A charitable organization may not contract with any commercial fundraiser that has not registered with the Attorney General or, if not registered, has not agreed to register before commencing any solicitation. Govt C §12599.6(c). A contract between a charitable organization and a commercial fundraiser is voidable by the charitable organization if the commercial fundraiser is not so registered. Govt C §12599.3(a).

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§14.59 2. Limit on Commercial Fundraiser's Fees

Fifty-percent limit. A commercial fundraiser is prohibited from charging a fee higher than 50 percent of the net proceeds collected by that fundraiser. This limitation does not apply to a flat fee associated with the design and development of a solicitation or marketing campaign agreed to before the initiation of the direct solicitation. Bus & P C §17510.87. Violation of the fee limitation is not a crime, but the fundraiser is subject to a civil penalty in the amount of the excess fee. Bus & P C §17510.87.

NOTE: The constitutionality of this fee limitation became questionable after *Riley v National Fed'n of the Blind* (1988) 487 US 781, 101 L Ed 2d 669, 108 S Ct 2667. See §14.38.

Individual contracts required; inspection. The charitable organization must enter into a written contract for each solicitation, campaign, event, or service employing a commercial fundraiser. The contract must be signed by an authorized official of both the charitable organization and the commercial fundraiser. Govt C §12599(i). The contract must be available for inspection by the Attorney General and must contain certain mandatory provisions set forth in Govt C §12599(i)(1)-(13).

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C. Solicitations of Salvageable Personal Property

§14.60 1. Organizations and Activities Subject to Regulation

No organization may directly or indirectly solicit donations of salvageable personal property or sell the property so received unless it is an organization exempt under Rev & T C §23701d or §23701f. Welf & I C §148.3. "Salvageable personal property" is any type of new or used corporeal personalty, other than money or evidences of debt. Welf & I C §148(b). The term "solicit" is broadly defined to include nearly all forms of communication. Welf & I C §148(a).

Exemptions from regulation. However, the following solicitations and sales are exempt from these regulations (Welf & I C §148.1):

- Solicitation of salvageable personal property from the organization's members;
- Sales of salvageable personal property solicited from members;
- Solicitations and sales of personal property by fraternal, social, political, or service organizations for occasional rummage sales or bazaars, as long as the sales and bazaars are not conducted as part of the organization's permanent or continuous operation and are not a major part of its activities; and
- Solicitations by a qualifying organization that has a membership composed of persons with physical, mental, or developmental disabilities and whose primary purpose is to provide services to persons with those disabilities.

Use of independent contractor barred. Qualifying organizations (organizations exempt under Rev & T C §23701d or §23701f) may solicit or sell salvageable personal property but may not use an independent contractor to do so. Welf & I C §148.4. Thus, a charitable organization cannot use a commercial fundraiser to solicit or sell salvageable personal property. The solicitation or sale must be made by the organization's officer or an agent (who is *not* an independent contractor) appointed by an officer of the organization. See Welf & I C §§148.4-148.5.

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§14.61 2. Receipts and Accounting

Accurate records of sale proceeds. Every organization qualified under Welf & I C §148.3 to solicit donations of salvageable personal property must keep accurate books and records setting out the proceeds of these sales and the amounts devoted directly to charitable uses. Welf & I C §148.6.

PRACTICE TIP: Qualifying organizations must keep these books and records open for the inspection by peace officers. Welf & I C §148.6.

Charitable percentage calculated annually. If a nonprofit organization engages in any solicitation of personal property or sales solicitation for charitable purposes that may be deductible under Rev & T C §17201, and states in writing or verbally the percentage that will be used for charitable purposes, then the percentage must be calculated on an annual basis based on the gross amount received from the disposition of the property and the net amount received by the charity for its programs. The net amount is calculated by subtracting from the gross amount received from the disposition of the property (1) the costs incurred by the nonprofit organization or any other entity acting on behalf of the nonprofit organization to solicit, acquire, modify, and dispose of the property, and (2) any net income retained by any entity acting on behalf of the nonprofit organization. Bus & P C §22930(a).

NOTE: If a commercial fundraiser solicits the donation of personal property for charitable purposes that may be deductible under Rev & T C §17201, and states in writing or verbally the percentage that will be used for charitable purposes, then the percentage must also be calculated as set forth above. Bus & P C §22930(a).

CAUTION: Despite the implied authorization for the use of commercial fundraisers under Bus & P C §22930(a), it is unlawful for an organization exempt under Rev & T C §23701d or §23701f to use an independent contractor to solicit or sell salvageable personal property. Welf & I C §148.4. See §14.60. Before resolution of this discrepancy by the legislature, the conservative advice is not to use commercial fundraisers to solicit or sell salvageable personal property.

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.62 a. Motor Vehicle, Aircraft, and Vessel Donations

§14.62 a. Motor Vehicle, Aircraft, and Vessel Donations

A nonprofit organization or commercial fundraiser must provide a receipt to any person who donates a motor vehicle, aircraft, or vessel that may be deductible under Rev & T C §17201 within 90 days from the date of donation. The receipt must state the date the donation was made and describe the donated property in the following manner (Bus & P C §22930(b)):

- The model;
- The age;
- The level of use, including but not limited to the mileage and condition;
- Whether a visual inspection by the nonprofit organization, the commercial fundraiser, or their representative indicated there were any readily apparent defects that would materially reduce the value of the property; and
- Whether the property was operable at the time of the donation.

PRACTICE TIP: The nonprofit organization or commercial fundraiser must retain a copy of the receipt for its records. Bus & P C §22930(d).

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.63 b. When Property Is Sold

§14.63 b. When Property Is Sold

Additional information required for pre-receipt sales. If the donated property is sold before the receipt is issued, the following information must be included in addition to the information described in §14.62 (Bus & P C §22930(c)):

- The date the property was sold;
- If the property was sold to a dismantler, the amount received for the sale; and
- If the property was altered subsequent to the donation and the alteration affected the value of the property, a statement that the property was altered and whether the alteration increased or decreased the value of the property.

Receipt to purchaser required. When salvageable personal property is sold, a qualifying organization must provide a receipt to the purchaser of the donated property, stating the price paid for it. Welf & I C §148.6. A qualifying organization must also comply with the following requirements (Welf & I C §§148.2, 148.6):

- The organization must maintain separate bank accounts and records for solicitations or sales of salvageable personal property and must not commingle the proceeds from such solicitations or sales with other organization assets. The accounts and records must show the proceeds of sales and the amounts devoted directly to charitable uses.
- The accounts and records must be open to inspection by any peace officer.
- The organization must comply with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7).

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§14.64 3. Required Identification Card

In addition to the disclosures required under Bus & P C §17510.3 (see §§14.37-14.49), a qualifying organization must provide an identification card to each officer or agent soliciting salvageable personal property. The card must be exhibited at the request of a peace officer or anyone being solicited and must contain the following information (Welf & I C §148.6):

- The solicitor's name and address;
- The name of the qualifying organization for whom he or she is soliciting;
- The fact that he or she has been appointed by the qualifying organization to be a solicitor; and
- The signature of the person who appointed the solicitor.

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§14.65 4. Violations

Anyone who violates any provision regulating the solicitation of salvageable personal property or who solicits donations of salvageable personal property but uses an identification card that does not comply with Welf & I C §148.6 (see §14.64) is guilty of a misdemeanor. Welf & I C §148.8. Unless otherwise provided, the maximum penalty is $1000, 6 months' imprisonment, or both. Pen C §19.

NOTE: Cities and counties can impose additional requirements on soliciting and selling salvageable personal property. Welf & I C §148.9.

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§14.66 D. Bingo and Similar Games

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Exception to gambling ban. For-profit casino-type gambling is generally prohibited in California, but a limited exception has been created for bingo games conducted for charitable purposes. Cities and counties can adopt ordinances permitting certain organizations (see §14.67) to hold bingo games for charitable purposes if certain requirements are met. Pen C §326.5; Cal Const art IV, §19.

"Bingo" defined. The Penal Code defines bingo, for fundraising purposes, as "a game of chance in which prizes are awarded on the basis of designated numbers or symbols that are marked or covered by the player on a tangible card in the player's possession and that conform to numbers or symbols, selected at random and announced by a live caller." Pen C §326.5(o).

NOTE: The game of bingo includes tangible cards having numbers or symbols that are concealed and preprinted in a manner providing for distribution of prizes. Electronics or video displays may not be used in connection with the game of bingo, except in connection with the caller's drawing of numbers or symbols and the public display of that drawing, and except as provided in Pen C §326.5(p), which authorizes the use of card-minding devices.

No person playing or operating the bingo game may know which are the winning cards in advance of the game. Only a covered or marked tangible card possessed by a player and presented to an attendant may be used to claim a prize. All preprinted bingo cards used in fundraising bingo games must include the following legend (Pen C §326.5(o)):

For sale or use only in a bingo game authorized under California law and pursuant to local ordinance.

Remote call bingo. The California Remote Caller Bingo Act (Stats 2008, ch 748) permits cities and counties to authorize remote caller bingo games, *i.e.,* bingo games in which the organization conducting the game uses audio or video technology to link electronically any of its in-state facilities for the purpose of the remote calling of a game from a single location to multiple locations owned, leased, or rented by that organization or pursuant to specified agreements. Bus & PC §§19850.5-19850.6; Pen C §326.3; see Pen C §326.3(u)(1) (definition). Only the organizations listed in §14.67 that have been incorporated or in existence for at least 3 years may operate remote caller bingo games, and they must be licensed under Pen C §326.5(*l*). Pen C §326.3(b)(1)-(3). Other rules prohibit the value of prizes from exceeding 37 percent of the gross receipts for that game, and require that all prize money exceeding state and federal exemption limits on prize money be subject to income tax reporting and withholding requirements. Pen C §326.3(p).

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.67 1. Organizations Authorized to Conduct Bingo Games

§14.67 1. Organizations Authorized to Conduct Bingo Games

City and county ordinances may authorize the following organizations to conduct bingo games as long as the proceeds from these games are used only for charitable purposes (Pen C §326.5(a)):

- Mobilehome park associations, senior citizen organizations, and charitable organizations affiliated with school districts; and
- Organizations that are exempt from bank and corporate taxes under the following Revenue and Taxation Code sections:
- §23701 (exempt organizations);
- §23701a (labor, agricultural, or horticultural organizations);
- §23701b (fraternal order described in IRC §501(c)(8));
- §23701d (religious, charitable, scientific, literary, educational, amateur sports, or humanitarian corporations);
- §23701e (business leagues, chambers of commerce, real estate or trade boards described in IRC §501(c)(6));
- §23701f (civic leagues, social welfare organizations, or employee organizations described in IRC §501(c)(4));
- §23701g (social organizations described in IRC §501(c)(7));
- §23701k (religious or apostolic corporations described in IRC §501(d)); and
- §23701w (veterans organizations described in IRC §501(c)(19)).

No person or organization other than the organization authorized to conduct the bingo game may have any financial interest in the bingo game. Pen C §326.5(i).

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§14.68 2. Location and Conduct of Bingo Games

Qualified property. An organization authorized to conduct a bingo game can conduct the games only on property owned, leased, or donated to the organization; the property must be used by the organization as an office or for purposes for which the organization was formed. However, the property need not be used or leased *exclusively by* or donated *exclusively to* the organization. Pen C §326.5(f).

Staffing. The bingo game can be staffed and operated only by members of the authorized organization, none of whom may receive compensation from the game. However, the authorized organization may employ and compensate security personnel who are not members of the authorized organization for a bingo game. Pen C §326.5(h).

Participation. Although the bingo game must be open to the public (Pen C §326.5(g)), no minors may participate (Pen C §326.5(e)). Anyone who participates in a bingo game must be physically present at the time and place it is being conducted. Pen C §326.5(m).

Prize limit. The total value of prizes awarded for each bingo game cannot exceed $500. Pen C §326.5(n).

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§14.69 3. License and Other Fees

License and cost-of-enforcement fees. A city or county may impose a license fee on an organization that it authorizes to conduct bingo games. A city or county may also impose an additional fee to cover the actual costs of law enforcement and public safety costs directly related to the game. Pen C §326.5(*l*). In addition, a city or county may require a license before it authorizes an organization to conduct remote caller bingo. Pen C §326.3(c).

Fees based on gross receipts. A city or county may not impose a fee based on the gross receipts derived from bingo games. *Arden Carmichael, Inc. v County of Sacramento* (2000) 79 CA4th 1070, 94 CR2d 673. This is because Cal Const art XIII, §26(d) provides that a tax-exempt organization is exempt from any city or county business license tax or fee based on income or gross receipts. After the county changed its fee structure to one based on a percentage of the prize payouts, the court held that the new fee structure did not violate the constitution, because the new structure was not necessarily a fee based on income or gross receipts. *Arden Carmichael, Inc. v County of Sacramento* (2001) 93 CA4th 507, 113 CR2d 248. Rather, the court held that the prize payouts were "an expense of the bingo operations." 93 CA4th at 510.

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§14.70 4. Accounting and Use of Proceeds

An organization exempt from tax under Rev & T C §23701d must keep all profits from bingo games in a separate fund or account that cannot be commingled with any other fund or account, and must use the profits for charitable purposes only. Pen C §326.5(j).

Any other authorized organization must also keep all proceeds from bingo games in a separate fund or account, which cannot be commingled with any other fund or account. The proceeds must be used for charitable purposes or in the following manner (Pen C §326.5(k)):

- The proceeds may be used for prizes;
- A portion of the proceeds (not to exceed 20 percent before deduction for prizes or $2000 per month, whichever is less) may be used to rent the property and for overhead expenses, including the purchase of bingo equipment, administrative expenses, security equipment, and security personnel (but see Pen C §326.5(k)(2)(B)); and
- The proceeds may be used to pay license fees.

Gross receipts over $5000. For an organization with monthly gross receipts from bingo games in excess of $5000, a city or county may enact ordinances to limit the amount of the proceeds that the organization may use for noncharitable purposes. Pen C §326.5(k)(4).

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5. Lotteries, Casino Games, and Raffles

§14.71 a. Lotteries

Except for the California state lottery, it is generally illegal to conduct lottery games in California. A lottery is defined under Pen C §319 as

> any scheme for the disposal or distribution of property by chance, among persons who have paid or promised to pay any valuable consideration for the chance of obtaining such property or portion of it, or for any share or any interest in such property, upon an agreement, understanding, or expectations that it is to be distributed or disposed of by lot or chance.

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§14.72 b. Casino Games

"Controlled games." Qualified tax-exempt organizations may conduct fundraisers using controlled games as a funding mechanism to further their purposes and missions. Bus & P C §19986. A "controlled game" is defined as any poker or Pai Gow game, and any other game played with cards or tiles, or both, and approved by the Department of Justice, and any game of chance, including any gambling device, played for any thing of value that is not prohibited and made unlawful by statute or local ordinance. Pen C §337j(e)(1). The controlled game fundraiser may not be conducted by any gaming machine, apparatus, or device that meets the definition of a slot machine as defined in Pen C §330b or §330.1. Bus & P C §19986(k).

Prizes. No cash prizes may be awarded to participants of the controlled game fundraiser. However, the winner of each controlled game may be awarded a prize donated to the fundraiser, provided the value of an individual prize does not exceed $500, and the total value of all prizes awarded does not exceed $5000. Bus & P C §19986(c).

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§14.73 (1) Operating Limitations

A controlled game fundraiser may only be conducted by an organization that has been qualified to conduct business in California for at least 3 years before conducting controlled games and is tax-exempt under Rev & T C §23701a, §23701b, §23701d, §23701e, §23701f, §23701g, §23701k, §23701*l*, or §23701w. Bus & P C §19986(e), (h). A tax-exempt organization may only hold one controlled game fundraiser per year; if the organization has multiple chapters, each chapter may hold one controlled game fundraiser each year. Controlled game fundraisers must be preapproved by the Department of Justice and cannot exceed 5 consecutive hours. Bus & P C §19986(b). With the exception of certain rural areas, no more than four controlled game fundraisers can be conducted at the same location in a given year, even if the fundraisers are sponsored by different qualified organizations. Bus & P C §19986(*l*). No person under age 21 is permitted to participate in a controlled game fundraiser. Bus & P C §19986(n). In addition, no controlled game fundraiser may be operated or conducted over the Internet. Bus & P C §19986(o).

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§14.74 (2) Revenue Restrictions

At least 90 percent of the revenue from the fundraiser must go directly to the tax-exempt organization and no more than 10 percent of the gross receipts of the fundraiser can be paid as compensation to the party conducting the fundraiser for the qualified organization, excluding any facility rental fees. Bus & P C §19986(d). An eligible organization can use funds from other sources to pay for the administration or other costs of conducting the controlled game fundraiser. Bus & P C §19986(d).

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.75 (3) Registration and Recordkeeping

§14.75 (3) Registration and Recordkeeping

Registration with Department of Justice. An eligible organization may conduct a controlled game fundraiser only if it registers with the Department of Justice. The department will provide the registration form to eligible organizations. Bus & P C §19986(e).

Recordkeeping. An eligible organization needs to maintain records of the following information for each controlled game fundraiser (Bus & P C §19986(g)):

- An itemized list of gross receipts for the fundraiser;
- An itemized list of recipients of the net profit of the fundraiser, including the name, address, and purpose for which fundraiser proceeds are to be used;
- The number of participants in the fundraiser;
- An itemized list of the direct costs for each fundraiser;
- A list of all prizes awarded for each fundraiser; and
- The date, hours, and location for each fundraiser.

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§14.76 c. Raffles

Qualified tax-exempt organizations may conduct raffles under Pen C §320.5. Under the statute, only organizations that have been qualified to conduct business in California for at least 1 year and that are tax-exempt under Rev & T C §23701a, §23701b, §23701d, §23701e, §23701f, §23701g, §23701k, §23701*l*, §23701t, or §23701w may conduct raffles. Pen C §320.5(c).

"Raffle" defined. For purposes of Pen C §320.5, a raffle is defined as a scheme for the distribution of prizes by chance among persons who paid money for paper tickets that provide the opportunity to win those prizes, and that meets all of the following requirements (Pen C §320.5(b)):

- Each ticket is sold with a detachable coupon or stub, and both the ticket and its associated coupon or stub are marked with a unique and matching identifier.
- Winners of the prizes are determined by draw from among the coupons or stubs.
- The draw is conducted in California under the supervision of a natural person who is 18 years of age or older.
- At least 90 percent of the gross receipts generated from the sale of raffle tickets for any given draw are used by the eligible organization conducting the raffle to benefit or provide support for beneficial or charitable purposes; alternatively, the organization may use those revenues to benefit another private, nonprofit organization, provided that an organization receiving these funds is itself an eligible organization under the statute. In no event may funds raised by raffles be used to fund any beneficial, charitable, or other purpose outside of California.

NOTE: With regard to the 90 percent of gross receipts distribution requirement, Pen C §320.5(b)(4)(A) provides that an eligible organization may use funds from sources other than the sale of raffle tickets to pay for the administration or other costs of conducting a raffle. Therefore, it appears that the statute permits an eligible organization to use its funds to cover raffle expenses as long as 90 percent of the gross revenue from the raffle is used for charitable or beneficial purposes. Penal Code §320.5 was enacted as enabling legislation for Cal Const art IV, §19(f), which provides that at least 90 percent of the gross receipts from the raffle shall be used for beneficial or charitable purposes in California, but is silent on the issue of the eligible organization using other resources to cover the expenses of the raffle. It is thus uncertain whether Pen C §320.5, as enacted, extended the parameters of a legal raffle as prescribed by Cal Const art IV, §19(f).

Revenue restrictions. The eligible organization must use the raffle funds for directly supporting a beneficial or a charitable purpose in California. Pen C §320.5(a).

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§14.77 (1) Operating Limitations

Only an employee of the eligible organization is entitled to receive compensation in connection with the operation of a raffle; however, no compensation may be paid from revenues required to be dedicated to beneficial or charitable purposes. Pen C §320.5(d). No raffle may be conducted by any gaming machine, apparatus, or device. Pen C §320.5(e). No raffle may be conducted, and no tickets may be sold, within an operating satellite wagering facility or race track. A raffle may not be advertised, operated, or conducted in any manner over the Internet, and no raffle tickets may be sold, traded, or redeemed over the Internet; "advertisement," however, does not include the announcement of a raffle on the website of the eligible organization. Pen C §320.5(f). No individual, corporation, partnership, or other legal entity, besides the eligible organization, may have a financial interest in the conduct of a raffle. Pen C §320.5(g).

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.78 (2) Registration and Recordkeeping

§14.78 (2) Registration and Recordkeeping

Registration with Department of Justice. An eligible organization may conduct a raffle only if it registers annually with the Department of Justice and completes the necessary registration forms provided by the Department of Justice. Pen C §320.5(h). Further, once registered, an eligible organization must annually provide the Department of Justice with the following information on a form provided by the Department of Justice (Pen C §320.5(h)(6)-(7)):

- The aggregate gross receipts from the operation of raffles;
- The aggregate direct costs incurred by the eligible organization from the operation of raffles; and
- The charitable or beneficial purposes for which proceeds of the raffles were used, or the identity of the eligible recipient organization to which proceeds were directed, and the amount of those proceeds.

Annual filing. The registration form, Form CT-NRP-1, is prescribed by the California Attorney General. A completed registration form and a filing fee must be submitted by September 1 of each year (*i.e.*, September 1 through August 31) during which a raffle is expected to be conducted. If registration is not made by September, an eligible organization must submit the registration form and fee at least 90 days before the raffle is held. 11 Cal Code Regs §420. Every registered eligible organization must also file a nonprofit raffle report each year on or before September 1 on Form CT-NRP-2. The Forms CT-NRP-1 and CT-NRP-2 can be found at the Attorney General's website: http://www.caag.state.ca.us/charities/forms.htm.

Exemption from registration and reporting. The registration and reporting requirements do not apply to a religious corporation, a charitable corporation organized primarily as an educational institution or a hospital, a health care service plan licensed under Health & S C §1349, or a cemetery corporation regulated under Chapter 19 of Division 3 of the Business and Professions Code. Pen C §320.5(h)(7).

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Source: Business Law/Advising California Nonprofit Corporations/14 Regulation of Fundraising/§14.79 (3) Raffles Exempt From Governing Statute

§14.79 (3) Raffles Exempt From Governing Statute

A raffle is exempt from the requirements of Pen C §320.5 if it satisfies all of the following requirements (Pen C §320.5(m)):

- It involves a general and indiscriminate distribution of the tickets;
- The tickets are offered on the same terms and conditions as the tickets for which a donation is given; and
- The scheme does not require any of the participants to pay for a chance to win.

These requirements for exempting a raffle from Pen C §320.5 are consistent with the factors previously used by the Attorney General in determining the illegality of raffles before the enactment of Pen C §320.5.

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d. Other Relevant Law

§14.80 (1) Avoiding Illegal Lotteries

Previous Attorney General rulings on raffles or casino nights. Even before the passage of Cal Const art IV, §19(f) and the enactment of Pen C §320.5 and Bus & P C §19986, many exempt organizations did conduct raffles or casino nights to raise funds. Previously, the Attorney General applied California's lottery law in determining the illegality of those raffles and casino nights and held that the three elements of an illegal lottery are consideration, chance, and a prize. 82 Ops Cal Atty Gen 12 (1999). If any one of these three elements is missing, the activity is not an illegal lottery.

The Attorney General, in examining the element of consideration, had previously ruled that there was no consideration if there was a "general and indiscriminate" distribution of free chances to win. There was consideration if a donation had to be given to enter a contest. 82 Ops Cal Atty Gen 12 (1999). In that opinion, the Attorney General held that a charitable organization that offered raffle tickets at $100 each or $500 for six tickets, and also allowed each participant to obtain one free raffle ticket, was conducting an illegal lottery because some participants paid valuable consideration to increase their chances to win.

Therefore, an exempt organization can request a donation for a raffle ticket or casino night chips, but must disclose that participants are not required to make a donation in order to be eligible to win. In addition, the organization must provide for the indiscriminate distribution of free raffle tickets or chips to eliminate the element of consideration.

CAUTION: Apparently, if an exempt organization can conduct its raffle by (a) providing a general and indiscriminate distribution of free chances to win; (b) offering free tickets on the same terms and conditions as the tickets for which a donation is given; and (c) not requiring any participant to pay for a chance to win, the organization may be able to avoid the classification of its raffle as an illegal lottery, and also avoid the requirements of Pen C §320.5. However, this is an untested theory and it would be advisable for an organization to consult with legal counsel, enforcement agencies (such as office of the Attorney General or the local district attorney), or both, before proceeding in this manner.

Avoiding possibility that someone wins without making any donation. In practice, if a charitable organization discloses that a donation is not required in order to be eligible to win, the distribution of free chances could lead someone to demand several free chances, and thus possibly win the prize without making any donation. To avoid this result, the organization could limit the number of chances a person could receive, whether free or by donation. (It appears from 82 Ops Cal Atty Gen 12 (1999) and Pen C §320.5(m) that the organization cannot limit the number of free chances to a number lower than that provided to the largest donor.)

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§14.81 (2) Charitable Deduction for Raffle Tickets or Casino Chips

The amount paid to the charitable organization for the purchase of raffle tickets or casino chips is not deductible as a charitable contribution by the purchaser. Rev Rul 83-130, 1983-2 Cum Bull 148. In addition, if the raffle or casino night is structured in such a way that no consideration or wager was required for a chance to win, then the organization is not required to withhold the tax it would otherwise be required to withhold for gambling winnings under IRC §3402(q). See Treas Reg §31.3402(q)-1(d), Example 10.

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§14.82 (3) Mailing Lottery Information or Lottery Tickets

Federal law generally prohibits the broadcasting of lottery information and the mailing of lottery information and lottery tickets. See 18 USC §§1302, 1304. However, 18 USC §1307(a)(2) provides that §§1302 and 1304 shall not apply to any advertisement, list of prizes, or other information concerning a lottery conducted by a nonprofit organization that is not otherwise prohibited by state law. Accordingly, a nonprofit organization that conducts a raffle under Pen C §320.5 or a controlled game fundraiser under Bus & P C §19986 should fall within the exception created by 18 USC §1307(a)(2). However, it does not appear that 18 USC §1307(a)(2) provides an exception for the mailing of lottery tickets. A lottery has been similarly defined under federal law to be a scheme consisting of three essential elements: (1) the distribution of prizes; (2) according to chance; and (3) for a consideration. *FCC v American Broadcasting Co.* (1954) 347 US 284, 290, 98 L Ed 699, 74 S Ct 593. In *American Broadcasting*, the court held that a scheme that does not require the contestant to furnish the necessary consideration does not constitute a lottery. (The court was construing the definition of "lottery" for purposes of 18 USC §1304.) Accordingly, if the raffle is structured in such a way that no consideration is required to be furnished, then the prohibition against mailing lottery (raffle) tickets under 18 USC §1302 should not apply.

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§14.83 6. Violations and Penalties

A violation of the charitable bingo game law is a misdemeanor. Pen C §326.5(c). Generally, a misdemeanor carries with it a fine of $1000, 6 months' imprisonment, or both. Pen C §19. If the violation is that of a person (other than security personnel) receiving compensation from the bingo game, the violation is punishable by a fine up to $10,000. Pen C §326.5(c). Any violation related to unauthorized bingo games, raffles, or casino games is also a misdemeanor, and the prizes are forfeited to the state. See Pen C §§321, 325, 330.

The Department of Justice is authorized to take legal action against an exempt organization that has violated Pen C §320.5, Bus & P C §19986, or any regulations under those sections. Bus & P C §19986(i); Pen C §320.5(i). The city or county that enacted the bingo game ordinance may also bring an action to enjoin a violation. Pen C §326.5(d).

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§14.84 E. City and County Regulations

Many cities and counties have enacted local ordinances regulating charitable solicitations. A charitable organization that plans to solicit in a particular city or county should consult local authorities for applicable local ordinances. The addresses and telephone numbers of many city and county offices where information on local charitable solicitation ordinances can be obtained are listed in the Appendix.

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15

Charitable Giving

Jeffrey D. Davine

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§15.1 I. SCOPE OF CHAPTER

California and federal tax policy underlying tax subsidies for charitable giving encourages the transfer of private funds for public purposes. Advisers representing prospective donors or California nonprofit charitable organizations must understand various aspects of these tax benefits to maximize the benefit of charitable giving for private clients who make these contributions and the charities that receive them.

To this end, the chapter discusses income, estate, and gift tax deductions (see §§15.2-15.5), the timing of those deductions (see §§15.6-15.13), and the applicable limitations (see §§15.14-15.33). The chapter also covers appraisal requirements (see §§15.34-15.39), briefly touches on private foundations (see §15.40), and discusses gifts of partial interests (see §§15.41-15.46). In addition, the chapter addresses split interest trusts (see §§15.47-15.65), charitable contributions for disaster relief (see §15.66), and California conformity to federal law on charitable giving (see §15.67).

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II. INCOME, ESTATE, AND GIFT TAX DEDUCTIONS

A. Income Tax Incentives

§15.2 1. Charitable Contribution Income Tax Deduction

The principal tax incentive for charitable giving is the charitable contribution income tax deduction. The federal rules for this deduction are contained in IRC §170 and in a considerable volume of Treasury Regulations, pronouncements by the Internal Revenue Service, and relevant case law. For many donors, it is important to maximize the charitable income tax deduction because the tax saving arising from this deduction lowers the effective cost to the donor of making a charitable gift. For example, if a dollar of income that is used to fund a charitable gift would have been subject to California and federal taxes totaling 40 cents, the true cost to the donor of making the charitable gift is only 60 cents instead of a dollar if the contribution qualifies as both a state and a federal charitable income tax deduction. Although this general concept is simple, the practitioner must understand a number of refinements and special rules to be sure that the cost of philanthropy is reduced for the client in this manner.

For discussion of fundraising regulations and federal and state law requirements imposed on charitable organizations, see chap 14.

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§15.3 2. Gifts of Appreciated Property

Double tax benefit. The second major income tax subsidy, and thus incentive, for charitable giving applies to gifts of appreciated assets to charity. See IRC §170(e)(1). As a general rule, the appreciation in the asset will not be subject to California or federal income taxation. Moreover, a donor who contributes certain assets may be able to claim deduction equal to the fair market value of those assets, depending on the type of charity to which the assets are conveyed. This results in a double tax benefit for the donor—the untaxed appreciation avoids tax, and the deduction (equal to the fair market value of the property) reduces the tax on the donor's other income. See §15.2. This double subsidy can effectively reduce the cost of a dollar of the charitable gift to 40 cents or less. Thus, appreciated assets that would generate long-term capital gain if sold are the assets that may be contributed during life at the lowest after-tax cost to the donor.

EXAMPLE: The effective combined California and federal income tax rate on a particular donor's ordinary income is 40 percent, but the donor would pay a combined rate of 20 percent on recognized capital gain. If he or she makes a charitable contribution of $100, the charitable deduction results in tax savings of $40, reducing the after-tax cost of the gift to $60. If the donor instead makes a charitable gift valued at $100 by transferring appreciated securities with that value and a tax basis of $20, he or she will not only benefit from the tax savings of $40 resulting from the charitable deduction but will avoid the capital gains tax of $16 (value of $100 minus basis of $20, or $80, multiplied by the 20-percent capital gains tax rate), further reducing the after-tax cost of making the gift with appreciated securities to $44.

Assignment of income doctrine. When using an appreciated asset to make a charitable gift it is important to keep in mind the "assignment of income" doctrine. A commonly used technique for avoiding capital gains tax on an asset that is about to be sold is to contribute the asset to a charitable entity near the time that the sale is to occur and then let the charity complete the sale. If properly carried out, the donor is not treated as the seller of the asset and, therefore, pays no tax. In addition, because the charity is exempt from tax, it is not required to recognize gain or pay the resulting tax. Depending on the type of property contributed, the donor may be able to claim a charitable contribution deduction equal to the property's fair market value.

WARNING: It is extremely important that the donor's advisor ensure that the sale negotiations have not progressed to the point where the asset has ripened into a fixed right to receive cash or other property before the asset is contributed to the charity. It is not unusual for a donor to want to allow a transaction to progress to the point at which it is virtually certain that the sale will occur before contributing the property to charity. If this occurs, the donor may be considered to be the seller of the asset (and, therefore, responsible for paying the resulting income tax on the gain) and to have merely contributed the proceeds of the sale to the charity. See *Ferguson v Commissioner* (9th Cir 1999) 174 F3d 997.

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§15.4 3. Contributions by Estates and Trusts

The income tax treatment of charitable contributions by estates and trusts are governed by IRC §642(c), not IRC §170. One principal feature of the income tax deduction for estates and trusts is that the limitations on charitable income tax deductions for individuals (see §§15.14-15.31) do not apply. On the other hand, IRC §642(c) has its own special rules that must be navigated by the practitioner within the overall geography of Subchapter J of the Internal Revenue Code (IRC §§641-692). For discussion of the tax treatment of charitable contributions by estates and trusts, see California Estate Planning §§13.11-13.14 (Cal CEB 2002); Ferguson, Freeland & Ascher, Federal Income Taxation of Estates and Beneficiaries, chap 5 (3d ed 1998).

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§15.5 B. Gift and Estate Tax Deductions

Tax incentives for charitable giving are available not just to reduce income taxes, but also to reduce transfer taxes. Specific charitable deductions for estate and gift taxes are in IRC §§2055 and 2522, respectively. For discussion of gift and estate tax deductions, see Hopkins, The Tax Law of Charitable Giving, chap 8 (3d ed 2005). The estate and gift tax deduction provisions do not, like IRC §170(c)(2), limit the deductions to transfers to entities organized in the United States and its possessions. A separate estate tax deduction provision for conservation easements is found in IRC §2031(c), but it is more limited than the income tax provision.

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§15.6 III. TIMING OF DEDUCTIONS

The donor must establish when a contribution was made in order to identify the taxable year in which the deduction may be claimed. The time that the contribution was made also fixes the value of the contribution for tax purposes, which is an important consideration if the donated assets fluctuate in value. Further, the gift date can be important in ascertaining whether the contribution is long-term or short-term capital gain property.

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§15.7 A. No Deduction Until Payment Made

A donor may not claim a charitable contribution income tax deduction until "payment" is made to a charitable donee. IRC §170(a)(1). Payment is deemed to be made when the asset to be transferred is actually delivered with the intent that it be given to the charity (Treas Reg §1.170A-1(b)), which is deemed to occur when the donor has relinquished all dominion and control over the asset.

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§15.8 B. Conditional Gifts

A conditional gift is one that is subject to conditions precedent or subsequent. If at the time a gift is made it is conditioned on some precedent act or event, the donor may not claim a deduction unless the possibility that the transfer will *not* become effective is so remote as to be negligible. Treas Reg §1.170A-1(e). Otherwise, a charitable contribution income tax deduction is allowed only when the contingency is eliminated. Rev Rul 79-249, 1979-2 Cum Bull 104. Alternatively, if property passes to charity but could be thwarted by a subsequent act or event, a deduction may be claimed only when the possibility of an occurrence of this act or event appears to be so remote as to be negligible. Treas Reg §1.170A-1(e).

EXAMPLE: A donor transfers land to a city for as long as the city uses the land as a public park. If, on the date the gift is made, the city plans to use the land for a park and the possibility that it will not be used for a public park is so remote as to be negligible, the donor may claim a deduction under IRC §170 for the gift. Treas Reg §1.170A-1(e). See *Mitzi S. Briggs* (1979) 72 TC 646, aff'd (9th Cir 1981) 665 F2d 1051.

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§15.9 C. Gifts by Check

Gifts generally made when delivered or mailed. A charitable contribution by check is generally deemed made in the year in which the check is delivered or mailed to the charity, even if the charity does not receive the check (or the funds) until the following year. Treas Reg §1.170A-1(b).

EXAMPLE: If a donor mails a check on December 31, the donor is entitled to claim a charitable contribution income tax deduction in the year the check was mailed, even though the charity receives the check and the funds are removed from the donor's account in the subsequent year. See *Estate of Modie J. Spiegel* (1949) 12 TC 524, acq 1949-2 Cum Bull 3; Rev Rul 54-465, 1954-2 Cum Bull 93.

No conditions or postdating. For the mailing of a check to constitute delivery, the donor may neither place conditions on the time or manner of its payment nor postdate the check, and it must be honored when presented to the bank by the charity. If the check is not honored because of insufficient funds, for example, the gift will be deemed to have been made only when funds are actually transferred. Treas Reg §1.170A-1(b). See *Brooks Griffin* (1967) 49 TC 253.

NOTE: It appears that these rules also may apply for estate tax purposes, despite the more general estate and gift tax rule that a gift by check is not complete until the check clears the donor's bank. *Estate of Ella M. Belcher* (1984) 83 TC 227.

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§15.10 D. Gifts by Credit Card

Charitable contributions made by credit card are deductible as of the date that the donor charges the contribution to the credit card, regardless of when the credit card bill is actually paid. The IRS views the use of a credit card as making a charitable contribution with borrowed funds. As a result, "repayment" by the donor to the credit card company is irrelevant for purposes of determining when the contribution is made. See Rev Rul 78-38, 1978-1 Cum Bull 67.

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§15.11 E. Gifts of Securities

When gift completed. If a donor unconditionally delivers or mails a properly endorsed stock certificate to a charity or to the charity's broker or agent, the gift is deemed to be complete on the date of delivery or, if the certificate is received in the ordinary course of the mails, on the date of mailing. However, if the donor delivers the stock certificate to the donor's broker or agent, or to the issuing corporation or its agent, with instructions to transfer the shares on the corporation's books to the donee, the gift is completed on the date that the transfer is made on the corporation's books. Treas Reg §1.170A-1(b).

For stock that is held in "street name," a contribution is deemed made when the donor's broker actually transfers the stock to the donee's account. In addition, if the charity maintains an account with the same broker as the donor, the gift would appear to be complete when the broker charges the donor's account and correspondingly credits the donee's account with the shares of the contributed stock. Until that time, the donor could regain control of the stock and prevent the gift from being made. See *Roger B. Morrison*, TC Memo 1987-112.

All rights transferred. To avoid running afoul of the partial interest rules (see §§15.41-15.46), the donor must transfer all rights in the stock to the charity when making a gift of stock. Retention of any substantial rights in the stock, such as the right to vote the stock, will preclude the donor from claiming a charitable income tax deduction. See Rev Rul 81-282, 1981-2 Cum Bull 78.

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§15.12 F. Gifts of Real Property

State law generally establishes when real property is deemed delivered for tax purposes. California law provides that recording a deed is not required to effectively transfer real property; the transfer is deemed to occur when the donor delivers a properly executed deed to the donee. CC §1054. If a deed was duly executed by a donor, a presumption arises that it was delivered as of the date on the deed (see CC §1055). However, the IRS may rebut this presumption. See *Joseph L. Alioto*, TC Memo 1980-360, aff'd (9th Cir 1982) 50 AFTR2d 82-6016. If an executed deed is delivered to an agent for the donee, it is deemed to be delivered to the donee. CC §1059(2).

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Source: Business Law/Advising California Nonprofit Corporations/15 Charitable Giving/§15.13 G. Pledges and Other Promises

§15.13 G. Pledges and Other Promises

"Pledge" defined. A charitable pledge is a promise made by a donor to make a contribution to a charity in the future. A pledge is typically made by a donor pursuant to a written statement whereby the donor covenants to transfer money or property to the charity at a future date.

Enforceability requires consideration or reliance. For the donor's pledge to be enforceable, California courts generally require either that consideration be provided by the charity to the donor or that the charity show that it acted in reliance on the pledge. The type or amount of consideration provided or the degree of detrimental reliance by the charity is not material. For example, agreeing to name a new wing of a hospital after a donor who has made a pledge should be sufficient consideration to make the pledge enforceable. Alternatively, mutual promises by multiple donors have been determined to constitute adequate consideration. In other words, each donor's promise to make a contribution constitutes the necessary consideration for each other donor's promise. See *Christian College v Hendley* (1874) 49 C 347; *Board of Home Missions v Manley* (1933) 129 CA 541, 19 P2d 21; *University of S. Cal. v Bryson* (1929) 103 CA 39, 283 P 949. Without one of these two elements being present, it is uncertain whether a California court would enforce a donor's promise. See *First Sav. Bank v Coe College* (1935) 8 CA2d 195, 47 P2d 481.

NOTE: In determining whether a pledge can be enforced by the charity, tension exists between conventional contract law (which ordinarily requires that consideration flow to the promisor or that the promisee acted in reliance on the promise) and the public policy (which favors charitable giving even though no consideration has been provided or reliance has occurred). Because of these competing considerations, the law in this area is not uniform from state to state.

To bolster a charity's ability to enforce a pledge (should enforcement action become necessary), a pledge agreement should satisfy certain criteria. As a threshold matter, a pledge should be reduced to writing and the writing should contain certain basic provisions. These provisions include the following:

- A recitation of the consideration provided by the charity to the donor (even if this consideration is de minimis) or any reliance by the charity on the donor's pledge;
- A provision stating that the donor intends that it should be binding on the donor, the donor's executors, administrators, heirs, successors, and assigns, and the personal representative of the donor's estate;
- An acknowledgment by the charity that it accepts the pledge; and
- A place for the donor's signature (and, if applicable, the signature of the donor's spouse) and that of a representative of the charity.

For example, if the charity has agreed to install a plaque on a building honoring the donor as a result of the pledge, this fact should be set forth in the agreement. Alternatively, if the charity will recognize the donor's pledge in reaching its campaign goals and will publicize the gift to induce other donors to contribute, these facts should be recited in the agreement. Moreover, if one or more other donors has promised to make a contribution because of the donor's pledge, this fact should be set forth in the agreement.

Deductibility. A donor's pledge is not deductible for income tax purposes until the pledge is actually fulfilled by payment, although the pledge is deductible for gift tax purposes when it becomes enforceable. Treas Reg §§1.170A-1(a), 25.2522(a)-1; Rev Rul 81-110, 1981-1 Cum Bull 479; Rev Rul 55-410, 1955-1 Cum Bull 297. Similarly, a gift of a donor's own promissory note is considered to be a promise to make a contribution in the future and is usually not deductible for income tax purposes until the payment is made. See Rev Rul 68-174, 1968-1 Cum Bull 81. If a donor gives a promissory note from a third party that he or she holds as a creditor, however, the donor may claim a charitable deduction equal to the note's fair market value in the year of the gift. See *F. Robert Woodward*, TC Memo 1978-163. If a donor takes an enforceable promissory note from a charity and forgives individual payments on the note as each payment becomes due, the donor may deduct the amount forgiven in each year. See *Nelson Story III* (1962) 38 TC 936, acq 1965-2 Cum Bull 6.

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§15.14 IV. LIMITATIONS ON DEDUCTIONS

The calculation of the charitable contribution income tax deduction that may be claimed by an individual donor making a charitable gift begins with the amount of cash or the fair market value of property contributed to the charity. This figure may be reduced, depending on the type of property transferred to the charity, whether the donor received anything of value in return, and the character of the donee. The portion of the allowable deduction that the donor may claim in the year of the gift may be further limited by the donor's adjusted gross income.

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A. Reduction Rules

§15.15 1. Ordinary Income Property

Reduced deduction for appreciated property. The income tax deduction is generally reduced for a contribution of property that, if sold by the donor at its fair market value at the time of the gift, would have given rise to ordinary income or short-term capital gain by an amount equal to that ordinary income or gain (unless ordinary income or capital gain is recognized in the same taxable year in which the contribution is made). IRC §170(e)(1)(A); Treas Reg §1.170A-4(a)-(b). Assets that would generate ordinary income if sold include inventory assets held by a taxpayer for sale to customers in the ordinary course of a business.

NOTE: The general rule that a contribution of an inventory item may not result in a deduction in excess of the item's cost basis is modified for corporate donors by the two exceptions discussed in §§15.16-15.17.

Depreciable property. Gifts of many types of depreciable property are also subject to this reduction rule to the extent that a sale of that property results in the recapture of depreciation as ordinary income.

Other ordinary income property. The reduction rules also cover other ordinary income property, including the following:

- Accounts or notes receivable (IRC §1221(a)(4));
- Copyrights and similar intellectual property, when held by their creator or someone with a tax basis carried over from the creator (IRC §1221(a)(3));
- Original issue discount debt instruments (IRC §1271);
- Certain stock acquired in a tax-free transaction, the sale of which would generate ordinary income treated as a dividend (IRC §306);
- Partnership interests, the sale of which would generate ordinary income under the partnership tax rules (IRC §751); and
- Stock in certain foreign corporations (IRC §1248).

Short-term capital gain. The reduction rules also apply to a gift of a capital asset if the sale of that asset would have resulted in short-term capital gain. This would occur if the donor has not held the capital asset for the holding period required for long-term capital gain, generally more than 1 year. See IRC §1222(3).

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§15.16 a. Special Rule for Qualified Contributions of Inventory

Notwithstanding the general rule applicable to ordinary income property described in §15.15, a C corporation that contributes inventory property to a public charity that will use the property for the care of the ill, the needy, or infants may claim an enhanced charitable contribution deduction, *i.e.,* a deduction that exceeds its basis in the property. IRC §170(e)(3)(A). The deduction is equal to the lesser of (IRC §170(e)(3)(B)):

- The corporation's basis in the property plus one-half of the ordinary income that the corporation would have been required to recognize if the property were sold for fair market value; or
- Twice the value of the corporation's basis in the property.

EXAMPLE: If a corporation's basis in inventory property is $20,000 and the fair market value of the inventory is $32,000, the corporation's deduction will be $26,000, reflecting its $20,000 basis plus one-half of the $12,000 excess of the inventory's value over its basis. If, however, the corporation's basis in the inventory is $10,000 and the value of the inventory is $32,000, the deduction will be $20,000, twice the value of the corporation's basis.

NOTE: The IRS has announced that it is studying the computation of the deductible amount and adjustments to the cost of goods sold for charitable contributions of inventory property. For a particular qualified contribution of inventory property under IRC §170(e)(3) that otherwise satisfies the requirements of IRC §170 and the relevant regulations, the IRS will not challenge a taxpayer's computation of the deductible amount and the required adjustment to cost of goods sold under (1) IRC §170(e)(3) and Treas Reg §1.170A-4A(c) or (2) IRC §170(e)(1) and Treas Reg §1.170A-1(c). Taxpayers may rely on this notice unless and until further guidance is issued. Notice 2008-90, 2008-43 Int rev Bull 1000.

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§15.17 b. Scientific Property Used for Research

The same rule for calculating the deduction arising from qualified contributions of inventory (see §15.16) also applies to gifts by corporations (other than S corporations, personal holding companies, or service organizations) of scientific equipment made by the donor to educational institutions or scientific research institutions. See IRC §170(e)(4).

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§15.18 2. Tangible Personal Property

Deduction reduced if unrelated to charitable purpose. The deduction for gifts of tangible personal property is reduced even if the sale of that property by the taxpayer would have resulted in long-term capital gain, if the use to which the charity will put the property is unrelated to the donee's charitable purpose. See IRC §170(e)(1)(B)(i). The allowable contribution deduction is reduced by the amount of gain that would have been long-term capital gain had the property been sold at its fair market value.

No reduction if reasonable belief of use for exempt purpose. The donor must ascertain whether the charity will put the tangible personal property to a use related to its tax-exempt purpose. No reduction is required if it is reasonable to anticipate at the time of the gift that the property will not be put to an unrelated use. Treas Reg §1.170A-4(b)(3)(ii)(b).

EXAMPLE: Donor contributes a painting to a museum and receives a letter acknowledging the gift and stating that the museum plans to include the painting in its permanent collection. It is reasonable for the donor to anticipate, lacking any actual knowledge to the contrary, that the painting will not be put to an unrelated use, whether or not the painting is later sold by the museum.

NOTE: If the charity sells an item of donated property, that property is deemed to have not been put to a use related to the tax-exempt purpose of the charity, even if the proceeds of sale are used to support the charitable purposes of the donee.

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§15.19 3. Capital Gain Property Donated to Private Foundations; Qualified Appreciated Stock

Deduction limited to basis. If a donor makes a charitable gift of capital gain property to a private foundation, the amount of the deduction must be reduced by the amount of gain that would have been long-term capital gain had the property had been sold by the donor at fair market value at the time of the gift. In other words, the donor's deduction will be limited to his or her tax basis in the property. See IRC §170(e)(1)(B)(ii).

Exception for qualified appreciated stock. Gifts of "qualified appreciated stock" to private foundations are excepted from this general rule. This exception allows a deduction for the full market value of publicly traded stock contributed to a private foundation if the stock would have generated long-term capital gain had it been sold by the donor. See IRC §170(e)(5).

NOTE: The deduction for qualified stock, which in the past had been allowed to "sunset," is now permanent. IRC §170(e)(5) (amended by the Tax and Trade Relief Extension Act of 1998) (Pub L 105-277, §1004(a)(1), 112 Stat 2681-888).

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§15.20 B. Quid Pro Quo Gifts

If a donor transfers property and receives something in return (a quid pro quo for the gift), the charitable income tax deduction is limited to the amount by which the value of the property transferred to the charity exceeds the value of the items received in return. *Hernandez v Commissioner* (1989) 490 US 680, 688, 104 L Ed 2d 766, 109 S Ct 2136 (sine qua non of charitable contribution is transfer of money or property without adequate consideration; rejecting taxpayers' argument that quid pro quo analysis is inappropriate when the payments resulted in receipt of a purely religious benefit); *U.S. v American Bar Endowment* (1986) 477 US 105, 118, 91 L Ed 2d 89, 106 S Ct 2426; see Treas Reg §1.170A-1(h).

Tuition not deductible. Tuition payments to parochial schools, which are made with the expectation of a substantial benefit, or quid pro quo, have long been held not to be charitable contributions under IRC §170. *Sklar v Commissioner* (9th Cir 2008) 549 F3d 1252 (*Hernandez* decision forecloses argument that exception exists for payments for which one receives purely religious benefits); *Hernandez*, 490 US at 693 (payments to church of scientology for religious instruction not deductible); see *DeJong v Commissioner* (9th Cir 1962) 309 F2d 373, 376 (law is well settled that tuition paid for education of taxpayer's children is family expense, not charitable contribution to educating institution). In *Sklar*, the Ninth Circuit reaffirmed the continued efficacy of the *Hernandez* holding. The court rejected the notion that the 1993 amendments to IRC §§170(f)(8) and 6115 overruled the *Hernandez* holding, concluding that neither the plain language of the 1993 amendments nor the accompanying legislative history indicates any substantive change to the *Hernandez* holding that payment for religious education to religious organizations is not deductible.

IRC §6115 disclosure requirements. Any organization that receives a quid pro quo contribution greater than $75 must provide the donor with a written statement explaining that the donor will receive a tax deduction only for the amount of his or her donation above the value of any goods or services received in return for the donation. IRC §6115(a). Further, the donee organization must provide a good faith estimate of the value of any goods or services given donors. However, for this purpose, the term "quid pro quo contribution" means a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization. A quid pro quo contribution does not include any payment made to an organization, organized exclusively for religious purposes, in return for which the taxpayer receives "solely an intangible religious benefit" that generally is not sold in a commercial transaction outside the donative context. IRC §6115(b).

NOTE: The *Sklar* court also rejected the notion that a portion of the tuition payments were deductible under the "dual payment" analysis, that permits the partial deduction of payments to organizations that bear the "dual character" of a purchase and a contribution. *U.S. v American Bar Endowment* (1986) 477 US 105, 116, 91 L Ed 2d 89, 106 S Ct 2426. Revenue Ruling 67-246, 1967-2 CB 104 sets forth a two-part test for determining the extent to which dual payments are deductible: (1) the payment is deductible only if and to the extent it exceeds the market value of the benefit received; and (2) the excess payment must be made with the intention of making a gift.

For discussion of the rules on the required disclosure by charities of the value of property, services, benefits, and privileges transferred to a donor (see, *e.g.,* IRC §170(f)(8)), see §§14.13-14.18.

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§15.21 1. Token Benefits

The value of some benefits received from charities by donors is so small that it will not be taken into account to reduce the deduction. Under this de minimis rule, the full charitable gift is deductible if either (see Treas Reg §1.170A-13(f)(8)(i); Rev Proc 2009-50, §3.25, 2009-45 Int Rev Bull 617):

- The fair market value of all benefits received by the donor is no more than 2 percent of the gift or $95 (adjusted for inflation with respect to tax year 2009), whichever is less, or $96 (adjusted for inflation with respect to tax year 2010), whichever is less; or
- The donor's payment is $47.50 or more (adjusted for inflation with respect to tax year 2009) or $48 or more (adjusted for inflation with respect to tax year 2010) and the only benefits received are token items (*e.g.,* coffee mug, T-shirt) bearing the charity's name or logo and having a total cost of no more than $9.50 (adjusted for inflation with respect to tax year 2009) or no more than $9.60 (adjusted for inflation with respect to tax year 2010).

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§15.22 2. Charity Auctions

Purchases at a charity auction are deductible only if, and to the extent that, the taxpayer intends to make a gift and the fair market value of the property purchased is less than the amount paid by the taxpayer. IRC §170(c). See also *Murray F. Hardesty,* TC Memo 1993-225.

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§15.23 3. Raffle Tickets

No charitable deduction. The Sixth Circuit Court of Appeals has held that the cost of a raffle ticket purchased from a charity is not deductible as a charitable contribution unless the value of the opportunity to participate in the raffle was worth less than the price of the ticket. *Goldman v Commissioner* (6th Cir 1967) 388 F2d 476. *Goldman* was cited by the IRS in Rev Rul 83-130, 1983-2 Cum Bull 148, ruling that the purchaser of a ticket for a charitable raffle was not entitled to a deduction.

Generally illegal in California. Except as described in the next paragraph, it is generally illegal in California for charities to sell the right to participate in a raffle. Pen C §320. For a raffle to be legal, the element of consideration must be missing. The organization must make a general and indiscriminate distribution of raffle tickets free of charge to any persons asking for a ticket and must permit those persons to participate and claim the prize if they win. Because a ticket for a charity raffle conducted in this manner is available without payment, any donation made in connection with a raffle legally conducted by a charity in California should be fully deductible.

Exception; Attorney General guidance. An exception to the general California prohibition on raffles allows raffles by certain "qualified" tax-exempt organizations under Pen C §320.5. The California Attorney General has published guidance for charities that contemplate conducting a raffle. This guidance can be found at http://www.ag.ca.gov/charities/raffles.php. See also §§14.76-14.79.

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§15.24 4. Bargain Sales

Part gift, part sale. In a quid pro quo situation in which property transferred to the charity is appreciated property, the transfer is a bargain sale treated for tax purposes as part gift and part sale. As with other quid pro quo gifts, the amount deductible by the donor is the excess of the fair market value of the property less the payment or the value of the property, services, or benefits the donor receives.

Allocation of basis. The sale portion of the bargain sale transaction must be examined to determine whether and to what extent the donor will recognize capital gain as a result of the bargain sale. In making this determination, the donor's tax basis must be allocated between the gift and sale portions of the transaction. The basis allocated to the sale portion of the transaction bears the same relationship to the total basis in the property that the amount realized in the transaction bears to the fair market value of the property transferred. See IRC §1011(b).

EXAMPLE: A donor transfers stock valued at $400, with a basis of $100, to charity for a payment at $300. The charitable deduction is the net gift, or $100. The basis allocated to the sales portion of the transfer is:

$$\text{Basis allocated to sale portion} = \frac{\text{Amount Realized} \times \text{Total Basis}}{\text{Fair market value}} = \frac{300 \times 100}{400} = 75$$

The donor realizes capital gain of $300 less $75 (the basis allocated to the sales portion), or $225.

Gifts of encumbered property. If property transferred to a charity is subject to a mortgage or other encumbrance, the total amount of the debt is included in the amount realized for purposes of the bargain sale rules, whether or not the charity agrees to assume the indebtedness. Treas Reg §1.1011-2(a)(3).

EXAMPLE: Donor transfers real property to charity, with a value of $1000, subject to a mortgage of $300. The charitable deduction is equal to the net gift of $700, and the mortgage of $300 is the amount realized under the bargain sale rules.

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§15.25 C. Percentage Limitations

Taxpayer's contribution base. The charitable contribution income tax deduction (calculated after taking into account the reduction rules; see §§15.15-15.19) that an individual may claim in each year is limited to 50 percent of the taxpayer's contribution base (*i.e.,* adjusted gross income without regard to any net operating loss carryback to the year). Within this general limitation, separate limitations apply, depending on the type of property contributed and the type of charitable organization to which it is given.

IRA distributions. The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) contains a special rule with respect to contributions of proceeds from an individual retirement account directly to charity. Before the enactment of this rule, a taxpayer could not exclude from income a distribution from the taxpayer's individual retirement account even if the distribution was made directly from the IRA to charity. As a result of the passage of the PPA, a taxpayer was able to exclude up to $100,000 from gross income for distributions made directly from the taxpayer's IRA (either a Roth IRA or a traditional IRA) to a public charity in 2006 or 2007. See IRC §408(d)(8). This exclusion was available only to IRA owners who had reached age 70½ at the time the distribution was made. IRC §408(d)(8)(B)(ii). A distribution made to a donor advised fund or to a supporting organization did not qualify for the exclusion. If the charitable IRA rollover rule is extended to tax years after 2009 (see HR 1250, 11th Cong, 1st Sess (2009)), in order to be able to accept direct IRA distributions, a supporting organization described in IRC §509(a)(3) should consider submitting a request to the IRS to change its public charity classification to that of an entity described in IRC §509(a)(1) or IRC §509(a)(2). Guidance on requesting a change of public charity classification can be found in Announcement 2009-62, 2009-33 Int Rev Bull 247.

EXAMPLE: A taxpayer who has adjusted gross income in 2006 of $50,000 wants to make a substantial charitable contribution in that year. The principal source of available funds is the taxpayer's IRA. Before passage of the PPA, if the taxpayer made a charitable gift from IRA funds the taxpayer would have the following tax consequences:

AGI (pre-gift)	$50,000
IRA Distribution	$100,000
AGI (post-gift)	$150,000
Charitable deduction (50% of AGI)	($75,000)
Taxable Income	$75,000

Because the taxpayer's taxable income after the gift, $75,000, is greater than it would have been had the taxpayer not made the gift, making the gift increased the taxpayer's 2006 tax liability by the amount of tax on the excess taxable income of $25,000.

As a result of the change made by the Pension Protection Act of 2006, the taxpayer's IRA distribution of $100,000 made directly to charity is excluded from the taxpayer's income. Therefore, the taxpayer's taxable income, $50,000, is not increased as a result of making the gift.

NOTE: The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Pub L 110-343, 122 Stat 3765) amended IRC §408(d)(8)(F) and extended application of the charitable IRA rollover rule for two additional tax years, 2008 and 2009.

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1. Contributions by Individuals of Property That Is Not Capital Gain Property

§15.26 a. Gifts to Public Charities

Examples of public charities. The most generous percentage limitation applies to a gift by an individual of property that is not capital gain property to a charity described in IRC §170(b)(1)(A). These organizations are not private foundations. Examples include the following:

- Churches;
- Schools;
- Hospitals;
- Foundations supporting state colleges or universities;
- Governmental units;
- Certain other publicly supported charities, including organizations described in IRC §509(a)(2); and
- Supporting organizations described in IRC §509(a)(3).

Private foundations treated as public charities. In addition, three types of private foundation are treated as public charities under IRC §170(b)(1)(F):

- Private operating foundations (*e.g.,* a privately funded nonprofit clinic);
- "Conduit foundations," which distribute all contributions received during a taxable year within 2½ months after the close of that year; and
- Donor-directed funds in which a donor contributes to a foundation but retains the right to designate public charities to which the contributions are eventually distributed.

Deduction limited to 50 percent of contribution base. An individual donor may deduct gifts of certain assets to these charities in an amount up to 50 percent of the donor's contribution base. Qualifying assets include cash, property that if sold would generate either ordinary income or short-term capital gain (after application of the reduction rules; see §§15.15-15.19), and long-term capital gain property for which the deduction has been reduced under IRC §170(e)(1) by the amount of unrealized gain (*e.g.,* a gift of appreciated tangible personal property to a public charity, the use of which is unrelated to that charity's exempt purpose). IRC §170(d)(1)(A).

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§15.27 b. Gifts to Private Foundations

Deductibility of an individual's contributions to private foundations of assets that would not produce long-term capital gain if sold is generally limited to 30 percent of the taxpayer's contribution base. IRC §170(b)(1)(B)(i). Deductions actually allowed for this category of gift must be coordinated with the limitation for gifts to public charities so that the amount of gifts to private foundations that are actually deductible, when added to the amount of gifts of these assets to public charities that are actually deductible, does not exceed 50 percent of the contribution base. IRC §170(b)(1)(B)(ii).

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2. Contributions by Individuals of Property That Is Capital Gain Property

§15.28 a. Gifts to Public Charities

Contributions of capital gain property to public charities or organizations treated under IRC §170(b)(1)(A) as public charities (see §15.26) are generally deductible up to 30 percent of the contribution base. IRC §170(b)(1)(C)(i).

Donors may elect to reduce the amount of the claimed deduction from the fair market value of the contributed property (which would otherwise be the amount of the charitable deduction) by the amount that would have been long-term capital gain had the property been sold. The election, if made, applies to all capital gain property contributed to public charities or organizations treated under IRC §170(b)(1)(A) as public charities during the year. The result is that the 30-percent limitation does not apply to these assets; they will instead be included in the general 50-percent limitation. See §15.26.

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§15.29 b. Gifts to Private Foundations

Deductibility of contributions of capital gain property to a private foundation is limited to 20 percent of the donor's contribution base as long as the amount deductible for contribution of those assets to private foundations plus the amount deductible for contribution of those assets to public charities does not exceed 30 percent of the contribution base. IRC §170(b)(1)(D).

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§15.30 3. Ordering Rules

For any year in which an individual has made gifts of different types of assets to different types of charitable organizations, the limitations are applied in the following order to find the amount deductible:

STEP 1: Calculate 50 percent of the contribution base, *i.e.,* adjusted gross income computed without regard to any net operating loss carryback to the taxable year. IRC §170(b)(1)(G). See §15.25.

STEP 2: Deduct the amount of contributions of property other than capital gain property to 50-percent-type charities. See §15.26. If these contributions exceed 50 percent of the contribution base, there is no need to proceed further.

STEP 3: Deduct gifts of property other than capital gain property to private foundations, up to 30 percent of the contribution base. See §15.27. If contributions in this category exceed the balance of the maximum deduction, there is no need to proceed further.

STEP 4: Deduct contributions of long-term capital gain property to 50-percent-type charities, up to 30 percent of the contribution base. See §15.28. If contributions in this category exceed the balance of the maximum deduction, there is no need to proceed further.

STEP 5: Deduct the amount of contributions of long-term capital gain property to private foundations, up to the lesser of 20 percent of the contribution base or the excess of 30 percent of the contribution base over the amount of contributions of capital gain property to public charities. See §15.29.

EXAMPLE: A donor has a contribution base of $100,000 and makes the following contributions: (1) $30,000 to 50-percent-type charities, of which $10,000 is cash and $20,000 is long-term capital gain property; and (2) $105,000 to a private foundation, of which $5000 is cash and $100,000 is long-term capital gain property (publicly traded stock). The amount deductible is calculated as follows:

1. Fifty percent of the contribution base, or $50,000, is the maximum charitable deduction.
2. Deduct cash contribution of $10,000 to public charities, leaving available $40,000 of contribution limit.
3. Deduct cash contribution of $5000 to private foundation, leaving $35,000 of overall limit and $25,000 of 30-percent limit.
4. Deduct the $20,000 capital gain gift to public charities, leaving $15,000 of the overall limit and $5000 of the 30-percent limit.
5. The stock gift to the private foundation of $100,000 may be deducted only up to $5000—the amount remaining in the 30-percent limit—even though $15,000 remains in the overall limit. The unused deduction of $95,000 is available for carryover.

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§15.31 4. Carryover of Excess Contributions

Contributions that exceed the relevant percentage limitation are carried forward for up to 5 additional tax years, subject to the same percentage limitations for each category of gift in each of those 5 years. In each carryforward year, contributions made during that year are deductible *before* any carryover contributions. IRC §170(d)(1)(A).

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§15.32 5. Corporation Donors

Much less generous limitations apply to corporations. Corporations may not deduct charitable contributions exceeding 10 percent of taxable income, regardless of the type of property contributed or the character of the organization contributed to, without taking into account the charitable deduction and net operating loss and capital loss carrybacks. IRC §170(b)(2)(A), (d)(2)(A).

Amounts over the 10-percent limitation may be carried forward for the 5 succeeding tax years. IRC §170(b)(2)(A), (d)(2)(A).

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§15.33 6. Estates and Trusts Donors

The percentage limitations applicable to individuals (see §§15.26-15.29) do not apply to estates and trusts. For the charitable contribution deduction for estates and trusts, see IRC §642(c). For further discussion of gifts contributed by estates and trusts, see §15.4.

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§15.34 V. APPRAISAL REQUIREMENTS

To claim a charitable contribution deduction for certain types of property under Treas Reg §1.170A-13(c)(2)(i) (see §§15.35-15.36), a donor must do the following:

- Obtain a "qualified appraisal" (see §15.37) from a "qualified appraiser" (see §15.39);
- Include an "appraisal summary" (see §15.38) with the tax return in which the deduction is claimed; and
- Maintain records that contain the information required by Treas Reg §1.170A-13(b)(2)(ii).

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Source: Business Law/Advising California Nonprofit Corporations/15 Charitable Giving/ A. Contributions Subject to Appraisal Requirements/§15.35 1. Property Valued at Over $5000

A. Contributions Subject to Appraisal Requirements

§15.35 1. Property Valued at Over $5000

Qualified appraisal and summary. If an individual, corporation, or partnership claims a deduction for property (other than cash or publicly traded securities) with a value that exceeds $5000, the donor must obtain a "qualified appraisal" for the property and attach a fully completed "appraisal summary" to the income tax return on which the deduction is claimed for each donee. Treas Reg §1.170A-13(c)(2)(i). These requirements, which must be met to claim a charitable contribution income tax deduction, are in addition to the substantiation requirements applicable to contributions of cash or property of $250 or more. See §§14.2-14.12. For the time limit on the appraisal, see §15.37.

Similar items aggregated. In applying the $5000 contribution threshold, all similar items contributed in the same year are aggregated, regardless of whether the property is contributed to the same donee. Reg §1.170A-13(c)(1)(i). Items of property are similar if they are within the same generic category or type, such as stamp collections, paintings, or jewelry. Treas Reg §1.170A-13(c)(7)(iii).

EXAMPLE: A donor claims a deduction of $2000 for books donated to College A, $2500 for books donated to College B, and $900 for books donated to College C. Because the books are all similar items of property, their fair market values must be aggregated. Added together, their total value is $5400, more than the $5000 threshold. Therefore, the donor must obtain a qualified appraisal and attach three appraisal summaries (one for each donee) to his or her tax return reporting the contribution of books.

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§15.36 2. Certain Securities

Eased documentation rules—nonpublicly traded stock. Charitable contributions of nonpublicly traded stock that has a value between $5000 and $10,000 is subject to a somewhat less burdensome rule than that discussed in §15.35. For such stock, a donor need submit only a partially completed appraisal summary form with his or her return. Treas Reg §1.170A-13(c)(2)(ii)(B)(1).

Publicly traded stock; C corporation gifts. In addition, only a partially completed appraisal summary form is required when certain publicly traded securities are given to a charitable donee. Treas Reg §1.170A-13(c)(2)(ii)(B)(2). To be eligible for this rule, Treas Reg §1.170A-13(c)(7)(xi)(B) requires that

- The securities contributed must comprise a stock issue (1) that is regularly traded in a market reflected by the existence of an interdealer quotation system and (2) for which the issuer or agent computes the average trading price;
- The average trading price and the total volume of the issue must be published in newspapers;
- The issuer must keep books and records listing each transaction; and
- The IRS must have access to the issuer's books and records.

The contribution of property made by a C corporation other than a closely held corporation or a personal service corporation also qualifies for this special rule. Treas Reg §1.170A-13(c)(2)(ii)(B)(3).

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§15.37 B. Qualified Appraisal

General requirements. A qualified appraisal is a document that:

- Relates to an appraisal that is made no earlier than 60 days before the date of contribution of the appraised property and no later than the due date (including extensions) of the return on which the deduction is first claimed or, if the deduction is first claimed on an amended return, the date on which the amended return is filed (see Treas Reg §1.170A-13(c)(3)(iv)(B));
- Is prepared, signed, and dated by a "qualified appraiser" (see §15.39); and
- Does not involve an appraisal fee that is based on a percentage of the appraised value of the property (except for an appraisal fee paid to a nonprofit association that is generally recognized as regulating appraisers, as long as the association does not pay any compensation to the appraiser for the appraisal and the fee is not based on the amount of the deduction allowed by the IRS) (see Treas Reg §1.170A-13(c)(6)).

Content requirements. The following information must be included in a qualified appraisal (Treas Reg §1.170A-13(c)(3)(ii)):

- A detailed description of the property;
- For tangible property, a description of its physical condition;
- The date (or expected date) of the property's contribution;
- The terms of any agreement entered into by the donor or the donee regarding the property's use, sale, or disposition;
- Identification of the qualified appraiser and the business that employs or engages the appraiser;
- A description of the appraiser's qualifications;
- A statement that the appraisal was prepared for income tax purposes;
- The date (or dates) that the property was appraised;
- The appraised fair market value of the property as of the date of contribution;
- The method of valuation used to calculate the property's fair market value; and
- The specific basis for the valuation.

The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780) revised the rules concerning qualified appraisals. IRC §170(f)(11)(E)(i) now provides that the term "qualified appraisal" means an appraisal that is "(i) treated… as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and (ii) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary."

Continued reliance on Notice 2006-96. Because regulations under the PPA are not yet final, taxpayers should still be able to rely on the guidance contained in Notice 2006-96, 2006-46 Int Rev Bull 902. Notice 2006-96 contains transitional guidance relating to the revised definitions of "qualified appraisal" and "qualified appraiser" and is effective for appraisals prepared for returns that are filed after August 17, 2006. Notice 2006-96 provides that an appraisal will be treated as a qualified appraisal for purposes of IRC §170(f)(11)(E) if the appraisal complies with all of the requirements of existing Treas Reg §1.170A-13(c) (except to the extent that it is inconsistent with IRC §170(f)(11) as amended) and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. For the definition of a "qualified appraiser," see §15.39.

Generally accepted appraisal standards. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of IRC §170(f)(11)(E) if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP), as developed by the Appraisal Standards Board of the Appraisal Foundation. Additional information is available from the Appraisal Foundation at http://www.appraisalfoundation.org.

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§15.38 C. Appraisal Summary

Appraisal summary required. A donor must include an appraisal summary with the tax return for the year in which the contribution of property is made and the deduction is claimed. Treas Reg §1.170A-13(c)(2)(i)(B). An appraisal summary is a summary of a qualified appraisal made on IRS Form 8283 (available at http://www.irs.gov/formspubs/index.html?portlet=3), signed and dated by the *donee* and by the qualified appraiser who prepared the qualified appraisal.

Contents. The appraisal summary must contain the following information (Treas Reg §1.170A-13(c)(4)(ii)):

- The donor's name and taxpayer identification number;
- A detailed description of the property;
- For tangible property, a brief summary of its physical condition at the time it was donated;
- The manner and date of the donor's acquisition of the property or, if the donor created or produced the property, a statement indicating this fact and the approximate date on which the property was substantially completed;
- The donor's adjusted basis in the property;
- The donee's name, address, and taxpayer identification number;
- The date on which the donee received (or will receive) the property;
- A statement indicating whether the contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;
- Identification of the qualified appraiser who signed the appraisal summary;
- Identification of the business that employs or engages the appraiser (see Treas Reg §1.170A-13(c)(3)(ii)(E));
- The property's appraised fair market value as of the contribution date;
- The appraiser's declaration of qualifications and knowledge of the effect of a fraudulent appraisal (see Treas Reg §1.170A-13(c)(5)(i));
- The appraiser's declaration that the fee arrangement was not a prohibited fee arrangement (see Treas Reg §1.170A-13(c)(6)) and that the appraisal prepared by the appraiser is not being disregarded under 31 USC §330(c) as of the date that the appraisal summary is signed; and
- Any additional information that the IRS requires as stated in the instructions to IRS Form 8283.

Separate summary for each property item. A separate appraisal summary is required for each item of property contributed by the donor. If similar items are contributed during one tax year to more than one donee, a separate appraisal summary is required for each donee. See Treas Reg §1.170A-13(c)(4)(iv)(B).

PRACTICE TIP: A single appraisal summary can be used for all similar items contributed during one taxable year to the same donee. See Treas Reg §1.170A-13(c)(4)(iv)(B).

Partnerships and S corporations. If the donor is a partnership or an S corporation, it must provide a copy of the appraisal summary to each partner or shareholder who receives an allocation of the charitable contribution deduction attributable to the appraised property. Each partner or shareholder must attach a copy of the appraisal summary to his or her tax return on which the contribution is claimed. See Treas Reg §1.170A-13(c)(4)(iv)(F)-(G).

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Source: Business Law/Advising California Nonprofit Corporations/15 Charitable Giving/§15.39 D. Qualified Appraiser

§15.39 D. Qualified Appraiser

Qualifications. A qualified appraiser is an individual who makes certain required declarations on the appraisal summary (Treas Reg §1.170A-13(c)(5)(i)):

- The appraiser holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;
- The appraiser is qualified to make appraisals of the type of property being valued because of his or her qualifications as described in the appraisal;
- The appraiser does not fall within any category of excluded persons as described below; and
- The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property can subject him or her to a civil penalty for aiding and abetting an understatement of tax liability and that he or she may have other appraisals disregarded under federal law.

NOTE: An individual is not a qualified appraiser with respect to a particular donation, even if the appraisal summary contains the requisite declaration (see Treas Reg §1.170A-13(c)(5)(i)), if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property. For example, the appraiser is not qualified if the appraiser and the donor make an agreement concerning the amount at which the property will be valued and the donor knows that the agreed amount exceeds the fair market value of the property. Treas Reg §1.170A-13(c)(5)(ii).

Ineligible persons. The following persons, however, are ineligible to serve as qualified appraisers (Treas Reg §1.170A-13(c)(5)(iv)):

- The taxpayer claiming the deduction;
- A party to the transaction in which the donor acquired the property unless it is donated within 2 months after its acquisition and its appraised value does not exceed its acquisition price;
- The donee;
- Any person regularly employed by any person listed in the first three items;
- Any person related or married to any person listed in the first three items; or
- An appraiser who is regularly used by any person described in the first three items and who does not perform a majority of his or her appraisals for other persons.

EXAMPLE: A donor purchases a sculpture from a dealer and 2 years later gives the sculpture to a museum. At the time of the contribution, the sculpture's fair market value is $25,000. Neither the donor, the dealer, the museum, nor anyone employed by the donor, the dealer, or the museum, may serve as a qualified appraiser of the sculpture.

Additional qualifications under PPA. The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) added certain requirements that a qualified appraiser must meet. Specifically, an appraiser must have (1) earned an appraisal designation from a recognized professional appraiser organization, and (2) must have met certain minimum education and experience requirements. See IRC §170(f)(11)(E)(ii).

- **Appraisal designation.** An appraiser will be treated as having earned a recognized appraisal designation within the meaning of IRC §170(f)(11)(E)(ii) if the designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed. Notice 2006-96, §3.03(1), 2006-46 Int Rev Bull 902.
- **Education and experience requirements.** An appraiser will be treated as having met the PPA's minimum education and experience requirements for appraising real property if he or she is licensed for the type of property being appraised in the state where the property is located. For property other than real property, he or she must have successfully completed coursework relevant to the property being valued, have 2 years of experience buying, selling, or valuing the type of property, and must describe in the appraisal his or her

education and experience. Notice 2006-96, §3.03(3), 2006-46 Int Rev Bull 902.

- **Verifiable education and experience.** Further, an individual will not be treated as a qualified appraiser with respect to any specific appraisal unless he or she (1) demonstrates his or her verifiable education and experience in valuing the type of property being appraised, and (2) has not been prohibited from practicing before the IRS at any time during the 3-year period ending on the date of the appraisal. IRC §170(f)(11)(E)(iii). An appraiser will be treated as having satisfied the first requirement if he or she makes a declaration in the appraisal that he or she is qualified to make appraisals because of background, experience, education, and membership in professional associations. Notice 2006-96, §3.03(2).

Proposed Treasury Regulation §1.170A-17, which provides guidance regarding qualified appraisers, incorporates many of the requirements contained in the current regulations. The proposed regulation, however, also modifies certain of the provisions of the current regulations. For example, the appraiser declarations required in the appraisal and on IRS Form 8283 have been modified. In addition, the proposed regulations contain several new terms implementing the Pension Protection Act requirements of a qualified appraiser pursuant to IRC §170(f)(11)(E)(ii)-(iii).

For returns filed after February 16, 2007, the declaration required under Treas Reg §1.170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under IRC §6695A. Notice 2006-96, §3.04(2).

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§15.40 VI. PRIVATE FOUNDATIONS

Some donors prefer to contribute to a privately funded organization—often a private foundation—rather than to a public charity. Although private foundations provide certain advantages to the donor that are not available from public charities, they also have disadvantages that can lead donors and their advisers to examine alternatives. On the advantages and disadvantages of private foundations, see §4.23-4.24. For a detailed discussion of tax considerations in planning for a private foundation, see §§4.25-4.55. On alternatives to private foundations, such as donor funds and supporting organizations, see §§4.3-4.422, 4.56-4.80.

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§15.41 VII. GIFTS OF PARTIAL INTERESTS

Generally, no charitable contribution income tax deduction is allowed for a contribution, not made by a transfer in trust, of an interest in property that is less than the donor's entire interest in that property. IRC §170(f)(3).

This general rule has a few very specific exceptions. See §§15.42-15.46.

For further discussion, see Hopkins, The Tax Law of Charitable Giving, chap 8 (3d ed 2005).

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§15.42 A. Exception If Donor's Entire Interest Is Partial Interest

The rule disallowing a charitable deduction does not apply to a gift of a partial interest in property if that interest is the donor's entire interest in the property; *e.g.,* an income interest. Treas Reg §1.170A-7(a)(2).

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§15.43 B. Exception for Undivided Portion of Donor's Entire Interest

The rule disallowing a charitable deduction does not apply to a gift of an undivided portion of the donor's entire interest in the property if that portion consists of a fraction of each interest owned by the donor; *e.g.,* an undivided one-half interest in a piece of real estate. IRC §170(b)(1).

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§15.44 C. Remainder in Residence or Farm

A deduction is allowed for a gift of a personal residence or a farm in which the donor retains a life estate for himself or herself or for someone else. See IRC §170(f)(3)(B)(i). For this purpose, "personal residence" need not be the donor's principal residence; a second home or even a vacation residence qualifies for a charitable income tax deduction. Treas Reg §1.170A-7(b)(3).

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§15.45 D. Qualified Conservation Contribution

A deduction is allowed for a gift of a "qualified conservation contribution," which includes certain property interests given to a government agency, a public charity, or certain entities controlled by those organizations as long as the contribution is restricted to conservation purposes (including preservation of historic land or buildings). IRC §§170(f)(3)(B)(iii), 170(h).

A somewhat more limited federal estate tax-qualified conservation easement deduction is allowed by IRC §2031(c).

NOTE: These deductions can be particularly useful for families desiring to preserve open space. For further discussion, see California Estate Planning §§23.42-23.47 (Cal CEB 2002).

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§15.46 E. Gift Annuities

A charitable gift annuity, defined in IRC §501(m)(5), is a popular form of charitable gift in which the donor transfers property to a charity in exchange for the charity's obligation to pay an annuity to the donor or another party for the recipient's life. This type of gift is frequently lumped together with gifts of partial interest, not in trust, even though it is more properly analyzed as a quid pro quo gift. See §§15.20-15.24.

NOTE: A charity issuing a gift annuity to a resident of California must obtain a Certificate of Authority as a Grants and Annuities Society from the California Department of Insurance. Ins C §11520.5.

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Source: Business Law/Advising California Nonprofit Corporations/15 Charitable Giving/§15.47 VIII. SPLIT-INTEREST TRUSTS

§15.47 VIII. SPLIT-INTEREST TRUSTS

Special rules apply for charitable contributions to trusts that have both charitable and noncharitable beneficiaries. These rules establish the taxation of trust income and distributions and the calculation of the charitable contribution deduction, if any, allowed for transfers to these trusts. Split-interest trusts take one of three forms:

- Charitable remainder trusts (see §§15.48-15.54);
- Pooled income fund (see §15.55); and
- Charitable lead trusts (see §§15.56-15.58).

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§15.48 A. Charitable Remainder Trusts

A charitable remainder trust (CRT) is an irrevocable trust to which a donor contributes property and that provides for distributions, set by formulas, to one or more noncharitable beneficiaries during its term, with the remainder (the "charitable remainder") payable to one or more charitable organizations when the term expires. The rules on qualifying as a charitable remainder trust are contained in IRC §664 and related regulations.

For a CRT to qualify for an income tax deduction, the actuarial value of the charitable remainder must equal at least 10 percent of each contribution to the trust. IRC §664(d)(1)(D), (2)(D). In addition, in the case of a charitable remainder annuity trust, the probability that the trust assets will be exhausted before the remainder can be paid to charity cannot exceed 5 percent. Rev Rul 77-374, 1977-2 Cum Bull 329. Additional requirements are described in §§15.50-15.54. For a more detailed discussion of CRTs, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

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§15.49 1. Charitable Remainder Trust Spousal Waivers

All inter vivos charitable remainder trusts (CRTs) created on or after June 28, 2005, must comply with the spousal waiver provisions contained in Rev Proc 2005-24, 2005-1 Cum Bull 909. This revenue procedure provides that, in many states (other than most community property states, such as California), a surviving spouse has a statutory right to elect to receive a specified share of a deceased spouse's estate in lieu of other provisions that the deceased spouse may have made for the survivor. Historically, the elective share of the surviving spouse was limited to the probate estate and, therefore, would not extend to assets that avoid probate through, for example, lifetime transfers in trust. Many states, however, have expanded the rights of a surviving spouse to claim an elective share against an "augmented estate" that may include assets transferred to a trust created during life, such as a charitable remainder trust. A surviving spouse exercising this right could cause the charitable remainder trust to make a payment to the surviving spouse that would not be a qualifying annuity or unitrust payment and would, therefore, invalidate the charitable remainder trust.

Safe harbor. Revenue Procedure 2005-24 provides for a "safe harbor" to ensure that a charitable remainder trust does not fail to qualify as such as a result of a surviving spouse's ability to claim an elective share against the deceased spouse's augmented estate. The safe harbor requires that the charitable remainder trust's governing instrument provide that the spouse irrevocably waives the right of election with regard to the assets of the charitable remainder trust to ensure that no part of the trust can ever be used to satisfy the elective share that the spouse may otherwise have under state law. The waiver must be in writing and must be signed by the waiving spouse. Because the law of some states requires a spouse's signature on this type of waiver to be notarized, this should be done on all charitable remainder trusts. For charitable remainder trusts created on or after June 28, 2005, the waiver must be completed before the date that is 6 months after the due date of the CRT tax return for the year in which the later of the following occurs:

- The creation of the trust;
- The date of the donor's marriage to the spouse;
- The date the donor becomes domiciled in a state that provides spousal elective rights; or
- The effective date of state law creating spousal elective rights.

Sample language. Use of the following sample language should comply with the requirements of Rev Proc 2005-24:

> The undersigned spouse of the donor of this trust hereby irrevocably waives any right that he or she may now have or acquire in the future to claim any or all assets of this trust by reason of any spousal right of election or other such law of any jurisdiction. This waiver shall not affect assets other than those of this trust, nor shall it affect the right, if any, of such spouse to receive distributions from this trust according to its terms.

NOTE: In Notice 2006-15, 2006-1 Cum Bull 501, the IRS announced that it is reconsidering the approach set forth in Rev Proc 2005-24. As a result, until further guidance is issued by the IRS, a spousal waiver is *not* required to be included in a charitable remainder trust in order for it to satisfy IRC §664.

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§15.50 2. Tax Aspects

UBTI taxed. A charitable remainder trust (CRT) is exempt from tax, unless it has unrelated business taxable income (UBTI) within the meaning of IRC §512. (For discussion of UBTI, see chap 17.) Before passage of the Tax Relief and Health Care Act of 2006 (Pub L 109-432, 120 Stat 2922), if a CRT had any UBTI in a tax year, all of the income earned by the CRT in that year was deemed to be UBTI. For tax years beginning after December 31, 2006, if a CRT has UBTI, a 100-percent excise tax is imposed on the CRT equal to the amount of the UBTI. Pub L 109-432, §424, 120 Stat 2922 (amending IRC §664(c)).

NOTE: Although imposition of this excise tax can result in a significant tax liability for the CRT, it may be a less harsh result than if all of the CRT's income is deemed to be UBTI and subject to tax.

Income tax deduction. A donor making a gift to a CRT generally is entitled to a charitable contribution *income tax* deduction equal to the actuarially determined present value of the charitable remainder, determined as of the date of the gift. IRC §170(f)(2)(A). No current income tax deduction is allowed if a trust is funded with tangible personal property. IRC §170(a)(3).

Gift tax deduction. The donor is similarly entitled to a charitable contribution *gift tax* deduction equal to the present value of the charitable remainder. IRC §2522(c). In some cases a transfer to a split-interest trust results in both a charitable gift and a noncharitable gift. This is particularly common when the initial annuity is first paid to the donor and may later be paid to a second noncharitable beneficiary if that second noncharitable beneficiary survives the donor.

PRACTICE TIP: To avoid current gift tax on the transfer of the interest to the second noncharitable beneficiary, the grantor should specifically reserve in the CRT the right to revoke the noncharitable income interest in his or her will. This provision makes the initial transfer to the second beneficiary "incomplete" for gift tax purposes, as permitted by Treas Reg §1.664-2(a)(4).

Ten percent rule. To qualify as a CRT, the present value of the charitable remainder interest must be at least 10 percent of the value of property transferred to the CRT. IRC §664(d)(1)(D), (2)(D).

Four tiers. Distributions from a CRT are characterized as made in order from four tiers, regardless as to when the income comprising that tier was earned by the CRT (IRC §664(b)):

(1) Ordinary income of the CRT for the year and the CRT's undistributed ordinary income for prior years.

(2) Capital gain of the CRT for the year and undistributed capital gain from prior years.

(3) Other income, including tax-exempt income, of the CRT for the year and undistributed income in this category from prior years.

(4) The CRT's corpus.

The IRS provides guidance on how capital gains are distributed from a CRT. The IRS has issued final regulations that address the tier rules applicable to distributions from a CRT. Treasury Regulation §1.664-1(d) applies the "first in, first out" policy of the four-tier structure both among tiers and among categories of income within tiers. For example, within the capital gain tier, short-term capital gains are deemed to be distributed first and long-term capital gains that are subject to higher federal income tax rates are deemed to be distributed before long-term capital gains that are subject to lower federal income tax rates. Therefore, distributions of long-term capital gains are treated as made first out of 28-percent gains, second out of 25-percent gains, and third out of 15-percent gains.

Sprinkling power. The trust instrument may give the trustee the power to sprinkle distributions from the CRT among noncharitable beneficiaries as long as the power would not cause the trust to be treated as a grantor trust under IRC §§671-679. See Rev Rul 77-285, 1977-2 Cum Bull 213.

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§15.51 3. Term

A charitable remainder trust (CRT) may be established for (1) a fixed term of years (not to exceed 20) or (2) the life or lives of one or more individuals living when the CRT is created. IRC §664(d)(1)(A), (2)(A). These two choices may be combined as long as the term does not extend beyond either allowable alternative.

EXAMPLE: A CRT may provide for distributions to A for his life and then to B for her life, or for a term of 20 years, whichever is shorter, as long as A and B are both living at the time the CRT is created, because it is not possible for the period to last longer than the lives of A and B. However, the CRT may *not* provide for distributions to A for his life and then to B for a term of years, because it would be possible for such a period to last longer than either the lives of the individuals or a 20-year period. Treas Reg §1.664-2(a)(5).

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4. Formulas for Distribution of Charitable Remainder Trusts

§15.52 a. Annuity Trust

One formula that may be used to calculate annual distributions to the noncharitable beneficiary of a CRT is a sum certain (not less than 5 nor more than 50 percent of the initial fair market value of the property placed in trust). IRC §664(d)(1)(A). This amount may be stated as a fixed dollar amount or as a fraction or percentage of the initial fair market value of the property irrevocably passing in trust, as finally determined for federal tax purposes.

No charitable deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If the probability exceeds 5 percent that the noncharitable income beneficiary will outlive the trust corpus, the probability that the charitable transfer will *not* become effective is not so remote as to be negligible, and the deduction will be denied. Rev Rul 77-374, 1977-2 Cum Bull 329; Rev Rul 70-452, 1970-2 Cum Bull 199. The IRS has issued sample forms for eight different types of charitable remainder annuity trusts. Rev Proc 2003-53—2003-60, 2003-31 Int Rev Bull 230, 236, 242, 249, 257, 262, 268, and 274.

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§15.53 b. Unitrust

The other formula for annual distributions to the noncharitable beneficiaries of a CRT is a fixed percentage (between 5 and 50 percent) of the net fair market value of the trust assets, *valued annually;* this is the unitrust amount. IRC §664(d)(2)(A). Whereas the income beneficiary of a charitable remainder annuity trust receives fixed annual payments each year, the income beneficiary of a charitable remainder unitrust receives distributions that may increase or decrease each year depending on whether the net value of assets held within trust increases or decreases each year. The net income charitable remainder unitrust may incorporate a "makeup" feature, providing that, in any year in which trust income exceeds the unitrust amount, the trustee will distribute the excess to the income beneficiary to the extent that distributions in earlier years have been less than the unitrust amount as a result of the net income restriction. IRC §664(d)(3)(B). This net income feature is not available for a charitable remainder annuity trust. In addition, a charitable remainder unitrust can initially be a net income unitrust (with or without a makeup provision) and then convert or "flip" to a "standard" charitable remainder unitrust, that is, a charitable remainder unitrust without a net income limitation. Treas Reg §1.664-3(a)(1)(i)(c). The IRS has issued sample forms for eight different types of charitable remainder unitrusts. Rev Proc 2005-52—2005-59, 2005-34 Int Rev Bull 326, 339, 353, 367, 383, 392, 402, and 412.

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§15.54 c. Net Income Unitrust

The trust document may limit distributions to the noncharitable beneficiary to the lesser of the unitrust amount or trust income. IRC §664(d)(3)(A). For this purpose, trust income is, in general, fiduciary accounting income determined under the governing instrument and applicable local law. IRC §643(b).

EXAMPLE: In preparation for retirement, H is planning to sell his business, which has a zero basis, for approximately $1 million. H and W would like to benefit their community through a charitable gift, but their primary financial planning objective is to enhance their retirement income during their combined life expectancy of 20 years. They compare a stream of annual income they could expect from the after-tax proceeds from selling the business with the distributions they might expect from a charitable remainder trust funded with the appreciated asset, following by a sale of the business by the trust, as follows:

Sale of Appreciated Asset	
Proceeds from sale of business	$1,000,000
Capital gains tax (California and federal)	(200,000)
After-tax proceeds	800,000
Annual retirement income @ 5% of trust assets	40,000

Sale of Appreciated Asset With Charitable Remainder Trust	
Federal and state income tax deduction (IRC §7520 interest rate @ 5%)	$376,890
Capital gains tax	0
Annual retirement income @ 5% of trust assets	50,000
Eventual charitable gift	1,000,000

Although H and W may achieve their principal financial objective of increasing retirement income, two important differences between the two scenarios arise because assets have been irrevocably set aside for the eventual benefit of the charitable remainderman. First, H and W receive only the formula distribution from the charitable remainder trust; they are denied access to the corpus of the trust even if an emergency arises. Second, if H and W have a common secondary financial planning objective of benefiting their children with an inheritance, a charitable remainder trust would not work; the children would not receive anything. In the first scenario, the children would receive the after-tax proceeds from the sale of the business, $800,000, reduced by estate taxes, which H and W estimate will be about half of that amount.

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§15.55 B. Pooled Income Funds

Definition. A pooled income fund is a trust to which a donor transfers property, retains an income interest for the life of one or more beneficiaries, and contributes an irrevocable remainder interest to a charitable organization. IRC §642(c)(5). The property transferred by each donor is commingled with property transferred by other donors and may not be invested in tax-exempt securities. Each noncharitable beneficiary receives income equal to a prorata share of the income earned by the pooled income fund. The pooled income fund must be maintained by the organization to which the remainder interest is contributed.

NOTE: No donor or beneficiary may be a trustee.

Income, estate, and gift tax deductions are allowed for the value of property transferred to the pooled income fund, less the present value of the life income interest. Treas Reg §1.642(c)-6(a).

Not exempt from tax. Unlike the charitable remainder trust, the pooled income fund is not exempt from tax. Instead, it is subject to the normal rules for computing trust income in Subchapter J of the Internal Revenue Code (IRC §§641-692), including the deduction for distributions to beneficiaries. See IRC §651. The pooled income fund is allowed a deduction for capital gain, which, under the governing instrument, is permanently set aside for charitable purposes. IRC §642(c)(3). The combination of these two deductions effectively avoids income tax in most pooled income funds.

The income beneficiary includes in income his or her distributions from the trust, the character of which is passed through from the trust. IRC §662(b). These distributions are normally ordinary income because the pooled income fund may not invest in tax-exempt securities. Treas Reg §1.642(c)-5(b)(7). Capital gain is customarily allocated to corpus. Treas Reg §1.643(a)-3.

CAUTION: Because of the complexity and expense of developing a charitable remainder trust, many charitable organizations have a minimum gift level, below which they will not actively participate in planning, drafting, or funding other charitable remainder trusts. The traditional use of a pooled income fund provides a deferred giving vehicle for smaller contributors and allows the donor's contribution to be pooled with that of other small donors. However, inept management of pooled income funds by some sponsoring charities, and the disappointing deals that resulted from those funds, has caused the pooled income fund to become less attractive as a vehicle for smaller life income gifts, with a corresponding increase in the popularity of charitable gift annuities, in which the income stream to the noncharitable beneficiary does not depend on investment results.

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§15.56 C. Charitable Lead Trusts

The charitable lead trust is a mirror image of a charitable remainder trust (CRT). It is a split-interest trust with annual or more frequent payments made to a charitable organization, either for a fixed term of years or for the life or lives of designated individuals, with the remainder passing to noncharitable beneficiaries. IRC §170(f)(2)(B). Lead trusts are frequently used by planners to minimize estate and gift tax consequences of passing assets to a younger generation. For discussion of estate planning issues and forms, see Drafting California Irrevocable Trusts, chap 18A (3d ed Cal CEB 1997).

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§15.57 1. Distributions

The distributions from a charitable lead trust to one or more charitable beneficiaries must be in the form of a guaranteed annuity or a unitrust amount equal to a fixed percentage of the fair market value of trust assets, determined annually. Unlike charitable remainder trusts under IRC §170(f)(2)(A), no net income limitation for unitrust distributions is allowed and there is no minimum percentage payout rate. Treas Reg §25.2522(c)-3(c)(2)(vii). See §15.53.

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§15.58 2. Tax Consequences

Donor has no income tax deduction unless grantor trust. In general, the grantor of a charitable lead trust may not claim an income tax deduction for the funding of the trust unless the trust is treated as a grantor trust. Distributions to charity from a trust not treated as a grantor trust are excluded from the gross income of the donor, effectively resulting in a charitable income tax deduction that could exceed the limitation, based on the percentage of the taxpayer's contribution base, to which the donor would otherwise be subject. IRC §170(b)(1).

Grantor trust deduction rules. However, if the grantor is treated as the owner of the trust under the grantor trust rules (IRC §§671-679), the grantor receives a charitable contribution deduction equal to the discounted present value of the formula distributions to be made to charities (IRC §170(f)(2)(B)). If the trust ceases to be a grantor trust, the grantor will recapture income in an amount equal to the amount of the original charitable income tax deduction less the discounted value of the income previously earned by the trust and taxed to him or her under the grantor trust rules. IRC §170(f)(2)(B). The recapture amount is discounted to the date of contribution. All income of the charitable lead trust structured as a grantor trust will be taxable to the grantor, and no further charitable income tax deduction will be allowed to offset that income, either by the trust or by the grantor.

Nongrantor trust income computed as ordinary trust. The majority of charitable lead trusts are structured as nongrantor trusts. (This results in no income tax deduction, but avoids having future income taxed to the grantor. See Drafting California Irrevocable Trusts §§18A.1-18A.3 (3d ed Cal CEB 1997).) Because these trusts are not tax-exempt, their taxable income is computed under the normal trust rules of Subchapter J of the Internal Revenue Code (IRC §§641-692). Income of the trust in excess of the deductible charitable distribution is taxed to the trust. The deduction otherwise allowable under IRC §642(c) for payment of the charitable income interest may be reduced or eliminated if the distribution is from unrelated business taxable income of the trust. IRC §681.

Gift tax deduction. Under either the grantor or nongrantor trust format, the donor is allowed a charitable gift tax deduction based on the present value of the charitable income interest. This deduction is the crucial calculation when using the lead trust to pass assets to a younger generation. Similarly, the estate of a deceased donor will receive a charitable estate tax deduction for a testamentary charitable lead trust equal to the present value of the distributions to be made to charity. See IRC §§2055(e), 2522(c); Treas Reg §25.2522(c)-3(c)(2)(vi)-(vii).

EXAMPLE: H and W own commercial real estate currently valued at $3 million, subject to a long-term net lease generating $200,000 a year. They transfer the property to a charitable lead trust to pay 6 percent, or $180,000, per year to a group of charities for a term of 15 years, when the trust will terminate and distribute the real estate to their grandchildren who, by that time, will be adults.

Initial value of trust assets	$3,000,000
Charitable gift tax deduction (IRC §7520 interest rate @ 5%)	(1,870,000)
Taxable transfer	1,130,000

H and W have adequate unified credit and generation-skipping transfer tax exemption to offset the entire $1,130,000 present value of the gift to the grandchildren. The grandchildren will receive the property without diminution by transfer taxes, and the charities will receive distributions totaling $2,700,000 during the term of the trust.

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§15.59 D. Possible Liability in Connection With Split-Interest Gifts

The use of planned giving for marketing commercial products, *e.g.,* life insurance, annuities, and financial services, has become widespread. One result has been that people who might formerly have thought of themselves as donors have begun to think of themselves more as consumers, whether the planned gift is being promoted by an insurance company or by a charity. In a number of situations when a planned gift did not work out exactly as planned, donors have sued their advisers or the charity involved in the planned gift, or both.

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§15.60 1. Fiduciary Duties to Donors

Duties to donors can arise under several theories. A fiduciary is "[a] person having duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking." Black's Law Dictionary (8th ed 2004). An agent owes a fiduciary duty to a principal with whom a relationship of trust and confidence has been created. The principal either entrusts the agent with his or her property or relies on the agent's purported superior knowledge and expertise. Frequently, planned giving officers who work for charities see their job as building a relationship of trust and confidence between themselves and potential donors; this relationship can create a fiduciary duty that can place the planned giving officer in a situation of conflicting duties to the donor and the charity. In addition, most planned giving officers and most charities subscribe to one or more fundraising codes of ethics, such as those prescribed by the National Conference on Planned Giving and the National Society of Fundraising Executives. Finally, Bus & P C §17510.8 also imposes such a duty:

> Notwithstanding any other provision of this article, there exists a fiduciary relationship between a charity or any person soliciting on behalf of a charity, and the person from whom a charitable contribution is being solicited.

PRACTICE TIP: Counsel should acquaint clients with the potentially conflicting duties to help them develop a way of complying with any applicable duties and preventing the creation of unintended or unrecognized fiduciary duties to potential donors.

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§15.61 a. Overstatement of Expertise

Planned giving gift solicitation materials may stress the benefits to be derived from consulting with the charity's planned giving officers in the area of estate planning. It is easy to overstate the officers' expertise and scope of advice, resulting in unexpected liabilities from conflicts of interest and failure to adequately advise donors of facts they need to make an informed decision.

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§15.62 b. Charities Serving as Trustees of Charitable Split-Interest Trusts

Substantial charities that have active planned giving programs commonly offer to serve as trustees of split-interest trusts. Often, donors seek a charity that is willing to serve as trustee without charging a fee, on the theory (which is not necessarily well founded) that their benefits from the trust will be greater. But the extent to which charities can serve as trustees, with or without compensation, is limited. In general, no organization can engage in a trust business in California without satisfying the requirements of the California trust company law. Fin C §§1500-1591. However, a nonprofit corporation may "[a]ct as trustee under any trust incidental to the principal objects of the corporation." Corp C §§5140(k), 7140(k), 9140(k).

The charity that engages in the practice of serving as trustee should consider whether it must disclose to the donor the manner in which the trust will be operated. All such disclosures should be documented, including the treatment of all expenses incurred by the trust.

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§15.63 2. Other Bases of Liability

A disgruntled donor may sue a charitable organization on a variety of bases other than a breach of fiduciary duty, *e.g.,* undue influence, negligence, misrepresentation or fraud, or breach of contract.

Undue influence. All that is required to prove undue influence is the establishment of a confidential relationship, a participation in the procurement of the gift, and a substantial benefit. CC §1575. When a charity has cultivated a relationship with a donor, and especially if the donor was not represented by competent independent counsel in a transaction, a presumption of undue influence can easily arise that will provide the donor or any disgruntled relatives with a legal basis for undoing the gift and seeking damages.

PRACTICE TIP: Planned giving officers are often reluctant to insist that a donor be represented by counsel for fear of jeopardizing the gift. The attorney representing the charity should counsel the client to consider thoughtfully and adopt a policy in this area to avoid unpleasant surprises in the future.

Negligence. A donor may allege that representatives of the charity who purported to advise the donor with respect to a planned gift assumed a duty to do so competently and breached that duty either by misinforming him or her or failing to provide full information on all the facts relevant to the donor's informed decision making.

Misrepresentation; fraud. Misrepresentation of material facts and fraud support the rescission of a gift. CC §§1571-1573. The client should document in writing the representations and limitations communicated to the potential donor.

Breach of contract. The donor may allege that the charity promised certain benefits to the donor that failed to materialize.

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§15.64 3. Damages

A donor who successfully proves breach of contract, undue influence, negligence, misrepresentation, or fraud arising from the planned giving activities of a charitable organization that resulted in the donor's making a gift can seek remedies, which may include rescission of the gift, compensatory damages, or even punitive damages. A donor's heirs may seek compensatory damages for the loss of tax benefits, the loss of life insurance benefits from a failure to receive from a remainder trust sufficient income to continue to pay for insurance coverage purchased as part of the overall transaction, or out-of-pocket expenditures such as attorney or accountant fees. In egregious situations, punitive damages may be awarded. CC §3294.

NOTE: In addition to equitable and legal penalties, a lawsuit, regardless of the outcome, may cause the loss of the favorable public image that a charity with an active fundraising program is endeavoring to create.

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§15.65 4. Invalidity of Gift to Person Who Drafts Transfer Instrument

Charities are often involved in drafting instruments that result in gifts to them. However, Prob C §21350(a), with certain exceptions, invalidates donative transfers to any person who drafted the instrument or specified persons related to or associated with the drafter. One exception is if the transferee is "an entity that qualifies for an exemption from taxation under §501(c)(3) or §501(c)(19) of the Internal Revenue Code, or a trust holding an interest for this entity, but only to the extent of the interest of the entity, or the trustee of this trust." Prob C §21351(f).

NOTE: Probate Code §21351(f) does not necessarily remove all transfers that partially benefit a charity from the reach of the statute. For example, if an attorney unrelated to the donor client drafts a charitable remainder trust benefiting a relative of the attorney, the fact that the remainderman is a charity will not prevent the transaction from being voidable as to the interest of the relative. Prob C §§21350, 21351(f).

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§15.66 IX. DISASTER RELIEF

The IRS provides guidance for new and existing charitable organizations that seek to assist disaster victims. In addition, special tax provisions relating to disaster relief may be available to victims of disasters in certain designated areas. Donors may also be eligible for special tax incentives for contributions. See IRS Publication 3833. See also http://www.irs.gov/charities/charitable/article/0,,id=149938,00.html.

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§15.67 X. CALIFORNIA CONFORMITY

With certain modifications, California law generally conforms to federal law on the requirements applicable to charitable giving. See Rev & T C §§17201, 24357-24359.1.

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16

Management of Charitable Funds

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§16.1 I. SCOPE OF CHAPTER

This chapter is an introduction to the management of assets that nonprofit corporations hold to fund their charitable activities. For convenience, the authors refer to these assets collectively as "institutional funds."

Because the terminology used by commentators, practitioners, and laypersons with respect to institutional funds can cause confusion, this chapter begins with clarification of the term "institutional fund." See §§16.2-16.6. Following that is an analysis of the applicable law (see §§16.7-16.19); the provisions that govern expenditure, investment, and use of such funds (see §§16.20-16.37); related litigation issues (see §§16.38-16.53); and the effect of bankruptcy and receivership on such funds (see §§16.54-16.66).

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II. CHARACTERIZING INSTITUTIONAL FUNDS

§16.2 A. Terminology

In this chapter, the term "institutional fund" refers to all assets that are held by a nonprofit corporation and that are expended or invested to advance the charitable purpose(s) for which the corporation was formed. Practitioners, commentators, and laypersons refer to these funds by various labels, none of which have standardized and well-defined meanings. For example, institutional funds are often referred to as "endowment funds," "quasi-endowments," "annual funds," or "capital funds." By using different terms for institutional funds, speakers often intend to convey different types of spending restrictions attached to the funds and the uses to which funds are dedicated.

PRACTICE TIP: The California statutes that apply to institutional funds omit many of the terms mentioned in this section. The terms used in the statutes may carry somewhat different meanings than those attached by laypeople; the practitioner should be aware of this potential discrepancy when collecting information from clients. On the definition of "institutional fund" and other key definitions under the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510), see §16.13. See also Dostart, Rosen & Sternal, *UPMIFA: New Law Affects Lawyers Advising (and Serving on) Charity Boards in California*, 18 Cal Tax Lawyer 25 (Fall 2009).

Rather than attempting to delve into the meanings attached to the various labels, however, this chapter is concerned with identifying and analyzing the legal distinctions recognized under California law. It also reviews the implications those distinctions may have for the management of a specific fund.

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B. Types of Endowments

§16.3 1. True Endowment

The term "true endowment" generally refers to a permanent institutional fund whose principal must be preserved in perpetuity as a condition imposed by the contributor of the funds.

NOTE: This contrasts with the provisions of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510), under which the definition of "endowment funds" has no "perpetuity" requirement. See §16.13.

The contributor to a true endowment may or may not impose restrictions on the expenditure of the income earned from the principal, and the law requires the trustee of the fund to adhere to any such restrictions. See Prob C §16000; Bus & Prof C §17510.8. Organizations generally prefer to receive unrestricted contributions to maximize flexibility in spending, whereas contributors may wish to impose restrictions on the spending of gifts to ensure the gift will be used for designated charitable purposes in the future.

NOTE: The type of restrictions imposed by the original contributor is extremely important, because subsequent contributions by other entities to the endowed fund take on both the primary characteristics of the fund and any restrictions on the expenditure of income.

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§16.4 2. Term Endowment

A "term endowment" is created when a contributor imposes restrictions on the expenditure of principal or income for a fixed period of time or until the occurrence of a specific event. For example, a contributor to a city-owned museum may direct that while he or she is alive, only the income be used to support a specific purpose, *e.g.,* museum grounds beautification, but that at the contributor's death, both the principal and income be used for the unrestricted purposes of the museum. In this example, the term expires on the death of the contributor, and the museum may only invade the principal after that event occurs. During the contributor's lifetime, the endowment provisions of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) apply to the gifted assets. At all times during the contributor's lifetime and as long thereafter as assets from the gift remain, the institutional fund investment provisions of UPMIFA apply to the gifted assets.

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§16.5 3. Quasi-Endowment

The term "quasi-endowment" refers to a fund in which the organization itself either

- Places a restriction on future use of an unrestricted contribution; or
- Sets aside unrestricted surplus revenues or other funds, voluntarily imposing some or all of the features of a true or term endowment on the fund.

In either situation, subsequent additions to a quasi-endowment assume the characteristics of the original fund.

When the principal of a quasi-endowment is expendable because the original contributor has stated that the principal is available to be spent, spending still may be limited by the organization to support the purposes for which the quasi-endowment was created. When an organization has decided to retain income from an endowment fund as principal and utilize the earnings from this fund in a manner similar to that of a true endowment, the organization may freely direct the use of the income and principal.

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§16.6 C. Nonendowed Funds

Endowments are distinguishable in the following ways from annual and capital funds:

- Annual funds are available in full and without restriction to satisfy the needs of the organization for the current year.
- Capital funds are available to revitalize and expand facilities and provide for new equipment.

These distinctions are important for conceptualizing the special role of endowments in the funding of nonprofit organizations. Endowments are a key ingredient in providing future funds for the organization's ongoing programs.

Quasi-endowments (see §16.5) are not subject to UPMIFA's endowment restrictions, but are subject to UPMIFA's investment standards (assuming such amounts are "institutional funds").

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§16.7 III. APPLICABLE LAW

Both the Corporations Code and the laws applicable to trusts (see Prob C §§15000-19403) contain provisions that govern the expenditure and investment of institutional funds. Practitioners may find the dichotomy perplexing: Why would expenditure and investment of the assets of a fund held by a corporation, even a nonprofit corporation committed to charitable purposes, be subject to the rules governing trusts? For an explanation, see the discussion of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) in §§16.11-16.17.

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§16.8 A. Legal Basis for Charitable Trust Principle

California case law establishes that all assets of a charitable corporation are impressed with a charitable trust by virtue of the express declaration of the corporation's purposes, even when those who contribute such assets fail to expressly declare the purposes for which the assets are contributed. *Pacific Home v County of Los Angeles* (1953) 41 C2d 844, 852, 264 P2d 539.

A similar principle is echoed in California statutory law (Bus & P C §17510.8):

> The acceptance of charitable contributions by a charity or any person soliciting on behalf of a charity establishes a charitable trust and a duty on the part of the charity and the person soliciting on behalf of the charity to use those charitable contributions for the declared charitable purposes for which they are sought.

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§16.9 1. Coordination of Nonprofit Corporation Law and Trust Law

The Legislature has imperfectly coordinated the application of the various provisions of the Nonprofit Corporation Law (Corp C §§5000-10841) and the Trust Law (Prob C §§15000-19403) that govern funds held by nonprofit corporations. Several isolated provisions exist that either exempt nonprofit corporations from compliance with specified sections of the Trust Law or attempt to harmonize provisions of the Nonprofit Corporation Law with provisions of the Trust Law and with the charitable trust provisions of the Govt C §§12580-12599.7 (Supervision of Trustees and Fundraisers for Charitable Purposes Act). Generally, however, no guidance addresses which law controls.

For example, although Corp C §5240 (in the Nonprofit Corporation Law) can be read as requiring separate prudency attention to each investment in a particular institutional or endowment fund, that section refers to "funds" (see §5240(b)(1)-(2)), which might be interpreted to mean all funds held for investment in their totality. Conversely, Corp C §5240 does not articulate a total portfolio concept for application of prudency, an omission that might be interpreted to infer the negative, because Prob C §18503(e) (in the Trust Law) so clearly states a "total portfolio" approach. The authors are of the view that conforming the investment standard in Corp C §5240 to the investment standard specified in Prob C §18503(e) is desirable.

PRACTICE TIP: Because this area of the law is somewhat unsettled, the safest course for the practitioner is to try to comply with the provisions of both the Nonprofit Corporation Law and the Trust Law. This chapter points out potential conflicts and suggests solutions when applicable.

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§16.10 2. Laws Relating to Religious Nonprofits

At least one provision of the Nonprofit Religious Corporation Law (Corp C §§9110-9690) deals with charitable trusts. Corporations Code §9142(c) expressly precludes assets held by a religious corporation from being impressed with any trust unless one of the following exceptions applies:

- The corporation made an express commitment through a resolution of the board of directors to hold those assets in trust;
- The governing documents of a superior religious body or general church of which the corporation is a member so expressly provide (or, perhaps, provided at the time of the gift); or
- The donor expressly imposed a trust in writing at the time of the donation.

If the local church intends to hold property in trust for the benefit of itself and any applicable general church, nothing in §9142 prevents the local church from revoking the trust as its settlor unless the trust was expressly made irrevocable. See *California-Nevada Annual Conf. of United Methodist Church v St. Luke's United Methodist Church* (2004) 121 CA4th 754, 757, 17 CR3d 442, disapproved in *Episcopal Church Cases* (2009) 45 C4th 467, 87 CR3d 275. In *Episcopal Church Cases*, the court held that a general church can create a trust interest for itself in local church property by issuing a rule declaring that such a trust exists, if its governing instruments so provide. In this case, the local church had agreed to be bound by the greater church's governing instruments that clarified the local parish owned local church property in trust for the greater church. The court was required to defer to the general church's determination that it acted properly under its own rules when it adopted a canon stating that parish property was to be held in trust for the general church.

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B. The Uniform Prudent Management of Institutional Funds Act (UPMIFA)

§16.11 1. Application of UPMIFA

Perhaps the most significant consequence of the rule that assets contributed to a charitable corporation are impressed with a charitable trust (see §16.10) is that funds held by nonprofit corporations may be governed by the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510), effective January 1, 2009, which has replaced the Uniform Management of Institutional Funds Act. Generally speaking, UPMIFA governs spending and investment of "institutional funds" and includes special provisions for the expenditure of "endowment funds."

The UPMIFA provides for diversification and pooling of assets, total return investment, and whole portfolio management. In addition, UPMIFA introduces well-developed and accepted concepts of prudent investment that effectively allow for better returns with less risk. More specifically, the Act:

- Updates the rules on prudent investing of all funds managed by charities (funds held as trusts with a corporate trustee or an individual trustee are excluded);
- Changes the rules on spending from endowment funds; and
- Clarifies that the trust law rules of cy pres and deviation can be used to modify restrictions imposed on institutional funds.

The UPMIFA does not alter the status of governing boards or the duties and liabilities of directors as governed by other provisions of California law. Corp C §5240(e). On delegation of management or investment functions, see Prob C §18505.

NOTE: An interesting, and probably unintended, discrepancy in UPMIFA coverage is the difference between UPMIFA's application to entities formed under the Nonprofit Public Benefit Corporation Law (Corp C §§5110-6910) and those formed under the Nonprofit Religious Corporation Law (Corp C §§9110-9690). Specifically, Corp C §5240(e) harmonizes Prob C §18501-18510 with the Nonprofit Public Benefit Corporation Law, but there is no such harmonizing cross-reference in Corp C §9250 for corporations formed under the Religious Corporation Law. This omission may not matter because the Attorney General generally has no jurisdiction under the Religious Corporation Law. See Corp C §9230(a). A theoretical consequence of this inconsistency may arise in a litigation between private litigants, *e.g.,* two members of a church's governing board, when the conduct that is the subject of the litigation is permitted or proscribed under UPMIFA but the opposite treatment applies under Corp C §9241. On coordination of applicable laws, see §16.9.

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§16.12 2. Contrast to Former Spending Rule for Endowments

The biggest change from former law to the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) is in the spending rule for endowment funds. Under the old rule, a charity could spend appreciation above the dollars contributed (termed historic dollar value) in amounts the charity determined to be prudent. Under the new rule, historic dollar value is no longer identified as an amount that cannot be spent and charities may spend the amount that is prudent, after considering the factors listed in the statute. Prob C §18504.

PRACTICE TIP: For most charities with endowments, the rule change will not alter how they spend from their endowments. Most charities develop spending rates based on economic conditions and their particular circumstances. A charity with a prudent system for reviewing and managing its spending rate should be able to use that system under UPMIFA.

See also Dostart, Rosen & Sternal, *UPMIFA: New Law Affects Lawyers Advising (and Serving on) Charity Boards in California*, 18 Cal Tax Lawyer 25 (Fall 2009).

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§16.13 3. Definitions

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) contains some key definitions that facilitate an understanding of the Act.

"Institutional fund." A fund held by an institution exclusively for charitable purposes is defined as an "institutional fund." The term does *not* include (Prob C §18502(e)):

- Program-related assets;
- A fund held for an institution by a trustee that is not an institution; or
- A fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise on violation or failure of the purposes of the fund.

Thus, a bank's trust company that holds and manages assets for a charitable organization is not holding an institutional fund.

PRACTICE TIP: If a charitable fund does not qualify as an institutional fund under UPMIFA, it is not governed by the Act and the practitioner must look to the laws governing nonprofit corporations and institutional funds generally.

"Endowment fund." This is defined as an "institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use." Prob C §18502(b). The key element of this definition is that the fund may not be currently spent in its entirety. Thus, a donor cover letter specifying that a gift not be spent for 2 years renders that gift an "endowment fund" for those 2 years.

"Gift instrument." A "gift instrument" refers to the documents governing property transferred to or held by an institution as an institutional fund. Prob C §18502(c). The gift instrument may be a letter from the donor accompanying the gift, a solicitation from the charity to which the donor responds, or a gift instrument entered into by the donor and the charity.

"Program-related asset." This means an asset held by an institution primarily to accomplish a charitable purpose and not primarily for investment. For example, an apartment house with subsidized rents for poor people owned by a charity whose purpose is to provide low-income housing to the underprivileged is a program-related asset. A program-related asset is not classified as an "institutional fund" and is not subject to the investment prudency rules of UPMIFA. Prob C §18502(g).

EXAMPLE: A donor gifts a garden to the city-owned museum to be held and maintained into perpetuity as a floral exhibition for residents of and visitors to the city. During the years the garden is so maintained, it is a "program-related asset" and not an "institutional fund." In time, the museum determines it cannot afford to maintain the garden and receives court approval to sell the land. (On the application of the cy pres doctrine, see §16.51.) The sale proceeds will be "institutional funds" and, presumably, be ordered by the court to be held as an "endowment fund" with distributions for garden and floral-related purposes.

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§16.14 4. Standard of Care

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) requires members of the governing board to administer a fund with the "care that an ordinarily prudent person in a like position would exercise under similar circumstances." Prob C §18504(a). In addition, Corp C §5240(b)(1) requires that the corporation's board "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital."

NOTE: Assets directly related to the corporation's public or charitable programs are not subject to these investment standards. Corp C §5240(a).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.15 5. Release or Modification of Restrictions in Gift Instrument

§16.15 5. Release or Modification of Restrictions in Gift Instrument

The release or modification of restrictions on the use or investment of an institutional fund contained in an applicable gift instrument may be highly attractive to a board of directors seeking complete discretion on the use of the funds on a current basis. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) permits the institution, with donor consent, to release or modify, in whole or in part, a restriction in a gift instrument on the management, investment, or purpose of an institutional fund. Prob C §18506(a).

NOTE: A release or modification may not allow a fund to be used for a purpose other than its charitable purpose.

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§16.16 a. Modification by Court Order

The court, on application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if (Prob C §18506(b)):

- The restriction has become impracticable or wasteful;
- The restriction impairs the management or investment of the fund; or
- Because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund.

An institution making such an application must notify the Attorney General of the application, and provide the Attorney General with an opportunity to be heard. Prob C §18506(c).

NOTE: To the extent practicable, any modification must be made in accordance with the donor's probable intention. Prob C §18506(b). At least one case decided prior to the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) appears to lower the standard of determining what was a "material purpose" as intended by the donor's written instrument following the donor's death. See *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 1052, 87 CR3d 413 (provision authorizing co-trustees to identify additional charities is not "material purpose" for purposes of Prob C §15403(b)).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.17 b. Release or Modification Without Court Order

§16.17 b. Release or Modification Without Court Order

If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution may release or modify that restriction without a court order, 60 days after notification to the Attorney General, if (Prob C §18506(d)):

- The institutional fund subject to the restriction has a total value of less than $100,000;
- More than 20 years have elapsed since the fund was established; and
- The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

NOTE: If the Attorney General has concerns, he or she can seek the agreement of the charity to change or abandon the modification, and if that fails, can commence a court action to enjoin it. Thus, in all types of modification the Attorney General continues to be the protector both of the donor's intent and of the public's interest in institutional funds.

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§16.18 C. Investment of Charitable Assets

A relevant example of the legislature's attempt to harmonize applicable provisions of the Nonprofit Corporation Law and the Trust Law (see §16.9) is Corp C §5240, which provides criteria for the investment of assets held by nonprofit public benefit corporations. See Corp C §5240(e) (providing that nothing in section precludes application of Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510)).

NOTE: The laws governing nonprofit mutual benefit and religious corporations do not contain similar provisions. See Corp C §§7110-8910 and Corp C §§9110-9690 for provisions governing those types of corporations. On classification of nonprofit corporations, see §§2.29-2.30.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.19 D. Uniform Prudent Investor Act (UPIA)

§16.19 D. Uniform Prudent Investor Act (UPIA)

The California Legislature has clearly excluded nonprofit corporations from the application of the Trust Law with respect to the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). The UPIA provides the standards that regulate all trustees when they invest assets held in trust. See Prob C §16047.

Corporations Code §5230(b) expressly precludes the application of UPIA to directors of nonprofit public benefit corporations. Thus, this chapter will not discuss UPIA with respect to investment of institutional funds, and practitioners should rely on corporate law provisions for guidance.

NOTE: Nonprofit mutual benefit corporations and religious corporations are treated similarly in this instance. See Corp C §§7230(b), 9240(b).

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§16.20 IV. SPENDING AND INVESTMENT OF ENDOWMENT FUNDS

The discussion in §§16.21-16.29 is only about "endowment funds" as defined in the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510). As noted in §16.11, an endowment fund governed by UPMIFA is always first an "institutional fund." Under UPMIFA, not all institutional funds are endowment funds, but all endowment funds are institutional funds.

The UPMIFA sets clear investment standards for institutional funds. In addition, but separately, UPMIFA sets spending standards for distributions from endowment funds.

NOTE: A careful reading of UPMIFA is essential because some provisions refer to "endowment funds" whereas other provisions refer to "institutional funds." The definition of institutional funds omits the timing element that is essential to the definition of endowment funds. Thus, not all institutional funds are endowment funds, but all endowment funds are institutional funds.

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A. Spending Provisions

§16.21 1. UPMIFA Spending Provisions Generally

Under the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510), expenditures from an endowment fund may include distributions for charitable purposes and amounts used for the management and administration of the fund, including annual charges for fundraising. The UPMIFA no longer restricts spending to amounts above "historic dollar value." A charity may spend any amount it deems prudent after considering several factors, including (Prob C §18504(a)):

- The donor's intent that the endowment fund continue permanently;
- The purposes of the fund; and
- Relevant economic factors.

The UPMIFA encourages charities to establish a spending policy that will be responsive to short-term fluctuations in the value of the fund.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.22 2. Prudence Requirement

§16.22 2. Prudence Requirement

Under Prob C §18504(d), a rebuttable presumption of imprudence arises if expenditures in 1 year exceed 7 percent of the 3-year average value of the assets of an endowment fund. This subsection applies a rolling average of 12 or more calendar quarters in determining the value of the fund for purposes of calculating the base against which the 7-percent factor is multiplied. An institution can rebut the presumption of imprudence by showing that circumstances in a particular year make expenditures above that amount prudent.

NOTE: The value of a fund, as calculated for purposes of determining the 7-percent annual distribution amount, reflects increases due to contributions and investment gains and decreases due to distributions and investment losses. The 7-percent figure includes charges for fundraising and administrative expenses other than investment management expenses.

Prudent decision-makers consider all costs or fees associated with an endowment fund. High costs or fees of investment management could be considered imprudent regardless of whether spending exceeds 7 percent of the fund's value. However, spending above 7 percent in any 1 year will not necessarily be imprudent, and there is no presumption of prudence arising from spending less than or equal to 7 percent. Prob C §18504(d)(3). In fact, fluctuating spending rates may be appropriate for some endowment funds. Although UPMIFA does not apply the percentage for the presumption on a rolling basis (*e.g.,* 21 percent over 3 years), some endowment funds may prudently spend little or nothing in some years and more than 7 percent in others. This allows an institution to maintain appropriate levels of expenditures in time of economic downturn or economic growth.

PRACTICE TIP: Charities with fluctuating spending should maintain adequate records during the accumulation period and should document the decision-making process in the high-spending year to be able to meet the burden of production associated with the presumption.

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§16.23 3. Other Spending Requirements

The expenditure rule of Prob C §18504 (see §16.22) applies only to the extent that a donor and an institution have not reached some other agreement about spending from an endowment. The charity must comply with any specific requirements for spending in a gift instrument. However, if the gift instrument uses more general language, for example, directing the charity to "hold the fund as an endowment" or "retain principal and spend income," then Prob C §18504 provides a rule of construction to guide the charity.

In addition, the governing board may expend the assets of an endowment fund as permitted under other law or the terms of the applicable gift instrument. Prob C §18503.

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§16.24 4. Spending Net Appreciation

The big change of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) is in the rules on spending from endowment funds, *i.e.,* funds that cannot be wholly expended on a current basis. These spending rules apply to "donor-restricted funds" (*i.e.,* money contributed by a donor with the intent that the money be held as an endowment), but not to "board-restricted funds" (*i.e.,* money set aside by a board of directors as an "endowment").

For example, if a charity raises money for its endowment, and donors contribute with the understanding that the charity will hold their contributions in the endowment, the endowment rules apply to that fund. Donor intent in this regard will depend on the applicable "gift instrument," *i.e.,* the documents that define the terms of the gift. The gift instrument may be a letter from the donor accompanying the gift, a solicitation from the charity to which the donor responds, or a gift instrument entered into by the donor and the charity. See *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 1052, 87 CR3d 413 (applying provisions of handwritten note discovered after donor's death to override unequivocal provisions of properly executed trust agreement).

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B. Investment Provisions

§16.25 1. Basic Powers of Governing Board

An institution managing and investing an institutional fund must consider the following factors (Prob C §18503(e)(1)):

- The general economic conditions;
- The effect of inflation or deflation;
- The tax consequences;
- The role of each investment in the fund's overall investment portfolio;
- The expected return from income and investment appreciation;
- The institution's other resources;
- The needs of the institution and the fund to make distributions and to preserve capital.
- An asset's special relationship or value to the institution's charitable purposes.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.26 2. Standard of Care

§16.26 2. Standard of Care

Those responsible for managing and investing an institutional fund must do so in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Prob C §18503(b).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.27 a. Statutory Requirements

§16.27 a. Statutory Requirements

In managing and investing an institutional fund, an institution must (Prob C §18503(c)):

- Incur only costs that are appropriate and reasonable in relation to the assets, the institution's purposes, and the skills available to the institution; and
- Make a reasonable effort to verify facts relevant to the fund's management and investment.

An institution may pool two or more of its funds for purposes of management and investment.

A nonprofit public benefit corporation's governing board must establish and adhere to guidelines for the management and proper utilization of the charity's investment assets, including any endowments. Such guidelines should include (see Corp C §5240; Prob C §18503(f)):

- Parameters for asset allocation;
- Procedures for the selection and monitoring of investment managers/advisors; and
- The establishment of spending policies, including specific provisions governing the disbursement of funds from endowments that are consistent with donor limitations.

A charity's board typically fulfills these responsibilities by delegation to or with the assistance of a finance committee, an investment committee, or an investment subcommittee of a finance committee.

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§16.28 b. Policies and Practices

In many ways UPMIFA may be seen as a codification of practices and considerations that many charities had already incorporated in their administration of the investment and management of available investment assets. Nevertheless, charities should review their investment and spending policies to ensure they include the following:

- A reference to the investment considerations specified in UPMIFA in the charity's investment policy.
- A policy of selecting investment advisors using a periodic competitive evaluation process, and review and rebid these selections periodically.
- A policy of conducting regular meetings with the investment advisors to review and verify underlying facts regarding the activities and results achieved and the advisors' performance as measured against the UPMIFA standards, competitive market performance criteria, the advisors' commitments, and any specific polices and procedures adopted by the charity.

PRACTICE TIP: The meeting with advisors should also focus on monitoring the actual performance of the investment portfolios, including a review of any performance evaluations provided by the advisors, to determine whether the investment goals and objectives are being met, and to ensure that appropriate action is taken if such goals and objectives are not being met consistently, with due regard for overall market conditions, over a reasonable period of time.

- A reference to the spending standards and related considerations specified in the UPMIFA in any endowment spending policy.
- A requirement that the organization determine market values of the invested endowment funds quarterly and include such determinations in the spending policy.
- A practice of ensuring that the spending policy is consistent with and, when necessary, adequately justified under the prudence standard. Generally this will limit any spending from endowment funds to less than 7 percent of their average market value over a 12-month calendar period; if the policy provides for spending in excess of that amount, the charity should be prepared to make a very compelling case to rebut the presumption of imprudence resulting from such presumptively excess spending. On the prudence standard, see §16.22.

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§16.29 3. Delegation of Investment Management

The governing board of an institution holding an endowment fund may delegate investment management to either an external agent, including investment counsel, or its committees, officers, or employees. Prob C §18505(a), (e). On the standard of care to be applied in delegating investment management, see §16.26.

NOTE: The preceding powers may be limited or expanded by the applicable gift instrument or by applicable law relating to governmental institutions or funds. Prob C §18505(a).

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V. SPENDING AND INVESTMENT OF NONENDOWMENT FUNDS

§16.30 A. Spending Provisions

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) provisions related to expenditure of "institutional funds" govern the expenditure of the principal and income of nonendowment institutional funds.

NOTE: When UPMIFA is silent on the expenditure of institutional funds, the Corporations Code fills the gap.

The board of a nonprofit public benefit corporation or mutual benefit corporation is held to the general standard of care, requiring that (Corp C §§5231(a), 7231(a))

> [a] director shall perform the duties of a director… in good faith, in a manner that director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

An almost identical provision governs religious corporations, with the slight difference that the director of a religious corporation must exercise care that is "appropriate under the circumstances." Corp C §9241(a).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.31 B. Investment Provisions

§16.31 B. Investment Provisions

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) provides guidelines for determining the suitability of proposed institutional fund investments. Corporations Code §5240 provides investment criteria for assets held for investment by a public benefit corporation.

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§16.32 1. Statutory Conflict

Potential for conflict exists between UPMIFA's "total portfolio" approach and the Corporations Code's "individual asset" approach.

The Corporations Code requires the board of a nonprofit public benefit corporation to observe the following standards (Corp C §5240(b)):

Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital; and

(2) Comply with additional standards, if any, imposed by the articles, bylaws or express terms of an instrument or agreement that contributed the assets to the corporation.

While the word "funds" is clearly plural, it is not clear that Corp C §5240 authorizes a board to intentionally allocate any portion of its institutional funds to speculative alternative investments. Cautious advisors have concluded that Corp C §5240 prohibits *any* alternative investments.

In contrast, UPMIFA specifically addresses this point. Probate Code §18503(e)(2) expressly states that "management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy." The latter definition indicates that a small percentage of high-risk or alternative investments might be appropriate in a particular portfolio; that same conclusion is not obvious from the language found in the Corporations Code.

PRACTICE TIP: Given this apparent conflict, it is safest to take a conservative approach and conform to both statutes' investment criteria.

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§16.33 2. Investment Criteria

The investment criteria set forth in Corp C §5240 do not apply to the investment of assets that are directly related to the corporation's public or charitable programs. Corp C §5240(a). This provision is consistent with Prob C §18502(e)(1), which states that an "institutional fund" does not include "program-related assets."

EXAMPLE: Investment in low-income housing that barely breaks even, but which furthers the charitable purpose of a particular charity is not imprudent, even if high interest rates could be had from federal treasury bonds.

When a nonendowment fund falls within the definition of an institutional fund, UPMIFA appears to control; Prob C §18503 provides a standard of care expressly applicable to the investment of institutional funds. In addition, Prob C §18504 provides a nonexclusive list of actions that the board of an institution may take with respect to investments. See §16.25.

However, while Corp C §5240 acknowledges the applicability of UPMIFA with respect to investment criteria governing assets held by the corporation, it also states that nothing in the UPMIFA "alters the status of governing boards, or the duties and liabilities of directors, under this part." Corp C §5240(e).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.34 3. Investment Criteria Safe Harbor

§16.34 3. Investment Criteria Safe Harbor

An investment authorized or required by provisions contained in the instrument that contributed the funds to the corporation may not be found to violate the investment criteria set out in Corp C §§5231 and 5240. Corp C §5240(c).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.35 4. Standard of Care

§16.35 4. Standard of Care

A director of a nonprofit public benefit corporation must adhere to a standard of good faith, acting in a manner that the director believes is 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." Corp C §5231(a).

A director must also place the intentions of the charity before his or her own interests. See Corp C §5233 (defining and prohibiting self-dealing transactions by interested directors).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.36 a. Standard of Care for Nonprofit Mutual Benefit Corporations

§16.36 a. Standard of Care for Nonprofit Mutual Benefit Corporations

The provisions applicable to nonprofit mutual benefit corporations (Corp C §§7110-8910) do not contain language expressly governing the investment of assets held by such corporations. Thus, the investment of assets held by a nonprofit mutual benefit corporation are governed by the general standard of care applicable to the performance of duties by a director (Corp C §7231(a)).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.37 b. Standard of Care for Religious Corporations

§16.37 b. Standard of Care for Religious Corporations

Provisions applicable to nonprofit religious corporations expressly direct that the investment, reinvesting, purchasing, acquiring, exchanging, selling, and managing of the corporation's assets by the board is governed by Corp C §9241, which contains the general standard of care applicable to the performance of duties by a director. See §16.30.

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VI. LITIGATION ISSUES

§16.38 A. Standing in General

The basic requirement for standing to intervene in civil litigation is that a person must have an interest in the matter, an interest in the success of either party, or an interest against both parties. CCP §387(a).

The claimed interest under §387 must be "direct or immediate in character to the extent that the intervener will either gain or lose by the direct effect of the judgment." *In re Veterans' Indus.*, *Inc.* (1970) 8 CA3d 902, 921, 88 CR 303. See *L.B. Research & Educ. Found. v UCLA Found.* (2005) 130 CA4th 171, 29 CR3d 710 (donor has standing to enforce terms of trust it created). See also *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 1052, 1060, 87 CR3d 413 (probate proceeding dismissed because successor trustees lacked interest over named charitable beneficiaries, for whose interest proceeding was unnecessary).

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B. Persons With Clearly Established Standing

§16.39 1. Governor

Under Govt C §12010, the Governor must supervise the official conduct of all executive and ministerial officers. The Attorney General is an executive officer vested with primary responsibility for enforcing charitable trusts in California. Cal Const art V, §13; Govt C §12598. Thus, the Governor is required to supervise the Attorney General in carrying out those responsibilities.

Further, the Governor has the power to require the Attorney General to inquire into the affairs or management of any California corporation. Govt C §12014.

NOTE: Nowhere is the Governor expressly delegated the power to compel the Attorney General to file a petition on behalf of a charitable trust.

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§16.40 2. Attorney General

Under both common law and statutory law, the Attorney General is ordinarily the proper party to sue to enforce a charitable trust because the public at large is the real beneficiary of every charitable trust. See Govt C §12598; In *re Los Angeles County Pioneer Soc'y* (1953) 40 C2d 852, 861, 257 P2d 1 (trial court properly allowed attorney general to intervene in dissolution proceedings and challenge proposed distribution of assets of charitable trust). See also Govt C §12598 (nonexclusive list of statutory provisions that allow Attorney General to bring trust enforcement actions).

NOTE: Government Code §12598(b) authorizes the Attorney General to collect costs from a defendant if successful in enforcement of a charitable trust action. See *People v Orange County Charitable Servs.* (1999) 73 CA4th 1054, 87 CR2d 253 (court upheld cost award under §12598(b)).

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§16.41 a. Statutory Authority Under Probate and Corporations Codes

For purposes of enforcement of a charitable trust, the Attorney General stands in the place of the trust beneficiaries and may petition the court on their behalf. Prob C §17210; Comment to Prob C §17210. The Attorney General's power to petition is permissive, not mandatory; thus the Attorney General cannot be compelled to file a petition on behalf of a charitable trust.

The Attorney General also has standing to bring an action to enjoin, correct, obtain damages for, or otherwise remedy a breach of a charitable trust under the Corporations Code. Corp C §§5142(a)(5), 7142(a)(5). The power to bring an action for breach of a charitable trust under the Corporations Code is also permissive, not mandatory. Further, the Attorney General may intervene in, and must be provided with notice of, any action brought by other parties granted standing to sue for breach of a charitable trust. Corp C §§5142(a), 7142(a).

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§16.42 b. Common Law Obligation to Enforce Trust

Although the statutes do not compel an Attorney General to sue on behalf of a charitable trust (see §16.41), California case law imposes a duty on the Attorney General to do so on the public's behalf. See *In re Veterans' Indus., Inc.* (1970) 8 CA3d 902, 919, 88 CR 303, quoting *Brown v Memorial Nat'l Home Found.* (1958) 162 CA2d 513, 537, 329 P2d 118 (Attorney General has obligation, not discretion, "to institute suit when [the Attorney General] has concluded after investigation that there has been a breach of a charitable trust or a departure from the general purposes for which the corporation was formed"). See also *People v Cogswell* (1896) 113 C 129, 136, 45 P 270 ("It is not only the right, but the duty of the attorney general to prosecute [abuses in management of a public trust]").

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§16.43 3. Private Citizens

The Attorney General does not have exclusive standing to sue to enforce a charitable trust. In *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 755, 40 CR 244, the supreme court held that, although the Attorney General has primary responsibility for enforcement of charitable trusts, other responsible individuals may be permitted to sue on the charity's behalf. The court noted that "[t]he administration of charitable trusts stands only to benefit if in addition to the Attorney General other suitable means of enforcement are available." See *L.B. Research & Educ. Found. v UCLA Found.* (2005) 130 CA4th 171, 29 CR3d 710 (Attorney General's power to enforce charitable trusts does not deprive donor who created trust of standing to enforce terms of trust she created).

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§16.44 a. Nonprofit Corporation or Officer or Director of Nonprofit Corporation

A nonprofit corporation, or an officer or director of a nonprofit corporation, are specifically empowered to sue to enjoin, correct, obtain damages for, or to otherwise remedy a breach of a charitable trust. Corp C §§5142(a)(1)-(3), 7142(a)(1)-(3), 9142(a)(1)-(3). This statutory delegation has long been recognized by the courts. *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 757, 40 CR 244 (minority directors have standing to sue majority directors to ensure contributions to trust are used for purpose for which they were received); *L.B. Research & Educ. Found. v UCLA Found.* (2005) 130 CA4th 171, 180, 29 CR3d 710 (donor has standing to sue majority directors to ensure contribution used as donor intended); *San Diego County Council, Boy Scouts of Am. v City of Escondido* (1971) 14 CA3d 189, 195, 92 CR 186 (San Diego Boy Scout council had standing to sue to enforce charitable trust on behalf of all boy and girl Scouts from area).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.45 b. Member of Nonprofit Corporation in the Name of the Corporation

§16.45 b. Member of Nonprofit Corporation in the Name of the Corporation

A member of a nonprofit corporation may sue in the name of the corporation, provided that the member alleges the following in his or her complaint (Corp C §§5710(b), 7710(b)):

- That he or she was a member at the time of the disputed transaction (or that membership subsequently devolved on him or her by operation of law from a holder who was a holder at the time of the transaction); and
- His or her specific efforts to convince the board to sue on behalf of the trust, or the reasons for not making such effort, and that he or she has either informed the corporation or the board in writing of the ultimate facts of each cause of action against each defendant or provided the corporation or board with a copy of the complaint that he or she proposes to file.

PRACTICE TIP: Deering's Annotated Corp C §7710 suggests a form for complying with the above requirements.

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§16.46 4. Settlor and Heirs of Settlor

The settlor or heirs of the settlor are granted standing only when they retain a reversionary, contractual, or property interest in the assets subject to the charitable trust. Corp C §§5142(a)(4), 7142(a)(4), 9142(a)(4). See *O'Hara v Grand Lodge of the Independent Order of Good Templars* (1931) 213 C 131, 139, 2 P2d 21, superseded by statute on other grounds as stated in *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289 (once property "has become fully vested in the trustees for a valid charitable purpose," neither trustor nor trustor's heirs have standing to challenge trust's execution). Thus, a settlor of a charitable remainder unitrust who retained the right to enforce the terms of the trust in the trust instrument may, under the terms of the trust, enforce the trust's terms by objecting to an accounting. See *Patton v Sherwood, supra* (settlor reserved power in trust instruments to receive and object to accountings, to petition for court-supervised accounting, and to bring claim for breach of trust; Prob C §24(d) permits settlor of charitable trust to object to accounting if settlor reserved that power in trust instrument).

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§16.47 5. Persons With a Special Interest

California case law has consistently held that persons with a "special interest" in a charitable trust have standing to sue to enforce the trust. See *Hardman v Feinstein* (1987) 195 CA3d 157, 161, 240 CR 483 (only those with "a special and definite interest in a charitable trust" have standing to bring legal action to enforce or protect trust assets).

Trustees. The trustee of a charitable trust has consistently been held to qualify as a person with a special interest in a charitable trust. In *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 755, 40 CR 244, the California Supreme Court held that minority trustees of a charitable trust had standing to enforce a charitable trust in light of their interest in preserving trust funds and that the trustees were in a special position to learn about breaches of trust and bring relevant facts to the court's attention.

NOTE: Issues may arise in determining what entity is the trustee of a charitable trust. See *e.g., Episcopal Church Cases* (2009) 45 C4th 467, 87 CR3d 275 (local church agreed to be part of greater denominational church and to be bound by that greater church's governing instruments that made clear that local parish owned local church property in trust for greater church); *Guardian Angel Polish Nat'l Catholic Church v Grotnik* (2004) 118 CA4th 919, 931, 13 CR3d 552 (superior organization in hierarchical structure has standing if its articles of incorporation or bylaws expressly provide for trust); *San Diego County Council, Boy Scouts of Am. v City of Escondido* (1971) 14 CA3d 189, 195, 92 CR 186 (San Diego Boy Scout council had standing to enforce charitable trust on behalf of all boy and girl Scouts from area).

Beneficiaries. If the charitable trust has been created for a particularly small class of beneficiaries, the beneficiaries may also be held to have a special interest sufficient to support standing. See *American Ctr. for Educ. v Cavnar* (1978) 80 CA3d 476, 498, 145 CR 736, superseded by statute on other grounds (nonprofit corporation whose purpose was to "safeguard and preserve this Nation's moral, spiritual, economic, political and social concepts" held not to have been created for especially small class of beneficiaries, thus ousted director had no standing to sue as beneficiary).

Holders of interest in trust assets. Persons holding a reversionary, contractual, or property interest in the assets subject to a charitable trust are granted standing to sue under Corp C §§5142(a)(4), 7142(a)(4), and 9142(a)(4), and thus may be considered "persons with a special interest."

NOTE: A party with no interest in a charitable trust other than as a taxpayer and a member of the general public to be benefited lacks the requisite special interest. *Hardman v Feinstein* (1987) 195 CA3d 157, 161, 240 CR 483.

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§16.48 6. Person Granted Relator Status by Attorney General

A person without a direct interest sufficient to permit an intervention may be permitted to sue as a relator to enforce compliance with a charitable trust. A relator is a party in interest who is permitted to institute a proceeding in the name of the People or the Attorney General when that official has the sole right to sue. The Attorney General prescribes the rules for granting such consent and by such consent confers standing to bring an action to remedy a breach of a charitable trust. *In re Veterans' Indus., Inc.* (1970) 8 CA3d 902, 925, 88 CR 303. See Corp C §§5142(a)(5), 7142(a)(5).

NOTE: The Attorney General cannot withdraw a suit brought by a relator to enforce a charitable trust. *People ex rel Garrison v Clark* (1887) 72 C 289, 290.

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§16.49 C. Standards for Deciding When Use Restrictions Are Violated

The main factor in determining whether use restrictions have been violated is the charitable purpose originally stated in the articles of incorporation. See *Queen of Angels Hosp. v Younger* (1977) 66 CA3d 359, 365, 136 CR 36. The question is not whether a new and different purpose is as worthy as, or better than, the purpose stated in the articles, but whether the purpose is authorized by the nonprofit corporation's articles. 66 CA3d at 368. See also *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 759, 40 CR 244 (articles of incorporation stated charitable purpose was teaching osteopathic medicine; teaching any other type of medicine violated restrictions).

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D. Available Remedies

§16.50 1. Enjoin, Correct, Obtain Damages for Breach

Specified parties, including officers, directors, and the Attorney General, are authorized to "bring an action to enjoin, correct, obtain damages for or to otherwise remedy a breach of a charitable trust." Corp C §5142(a). This section will likely be invoked when an authorized party seeks to enforce spending, investment, or use restrictions on a charitable trust held by a nonprofit public benefit corporation. The Corporations Code authorizes identical actions for nonprofit mutual benefit and religious corporations. Corp C §§7142(a), 9142(a).

NOTE: The authority to bring actions for breach of charitable trust under Corp C §§5142, 7142, and 9142 is granted independently of other rights addressed in the "ultra vires" provisions of Corp C §§5141(a), 7141(a), and 9141(a).

In addition, Prob C §17200(a) provides that a beneficiary or a trustee of a charitable trust has the power to petition the court "concerning the internal affairs of the trust," which power is defined in Prob C §17200(b)(12) to include "compelling redress of a breach of the trust by any available remedy."

The Attorney General also may petition to enforce a beneficiary's rights under a charitable trust that is subject to the Attorney General's jurisdiction. Prob C §17210. On Attorney General standing, see §§16.40-16.42.

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§16.51 2. Apply Cy Pres Doctrine

The cy pres doctrine holds that if a settlor with a general charitable intent gives property in trust for a specific purpose and if that purpose becomes permanently impossible, impracticable, or illegal to carry out, a court of equity must direct the disposition of the property to some related charitable purpose to carry out the settlor's intention as nearly as possible. Restatement (Second) of Trusts §399 (1959). See *e.g., O'Hara v Grand Lodge of the Independent Order of Good Templars* (1931) 213 C 131, 140, 2 P2d 21, superseded by statute on other grounds (court approved sale of property held by charitable corporation for operating orphanage that had become impracticable and ordered proceeds to be held until court in proper action ordered its disposition); *Estate of Jackson* (1979) 92 CA3d 486, 490, 155 CR 380 (reasons for applying cy pres doctrine were nonexistent because it was possible to distribute residue to "heart fund" as decedent requested); *Estate of Faulkner* (1954) 128 CA2d 575, 579, 275 P2d 818 (listing cases in which cy pres was applied, but finding case at bar distinct and inappropriate for cy pres). For another example of a situation in which cy pres might apply, see §16.13.

The cy pres doctrine is inapplicable when there is a provision in the trust for a gift over in the event of the failure of the particular charitable purpose (see *Estate of Loring* (1946) 29 C2d 423, 236, 175 P2d 524), or when the donor did not express a general charitable intent (see *Estate of Klinkner* (1978) 85 CA3d 942, 951, 151 CR 20 (cy pres inapplicable because donor intended to benefit only specific parish that had ceased to exist)).

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§16.52 3. Petition for Writ of Mandamus

A writ of mandamus may be issued "by any court to any inferior tribunal, corporation, board, or person, to compel the performance of an act which the law specially enjoins, as a duty resulting from an office, trust, or station." CCP §1085. The petitioner need only seek to have the law executed and the duty enforced. *In re Veterans' Indus., Inc.* (1970) 8 CA3d 902, 925, 88 CR 303. On obtaining a writ of mandamus, see California Civil Writ Practice, chap 2 (4th ed Cal CEB 2008).

PRACTICE TIP: A writ of mandamus as a remedy should be viewed as a last resort. The court in *Veterans' Indus*. suggested that the remedy should be available when the possible cy pres beneficiaries had no standing to intervene and, because the Attorney General was likely to refuse to grant relator status, the right of a relator to institute a proceeding in the name of the people seemed unlikely. *In re Veterans' Indus., Inc., supra.* On standing, see §§16.38-16.48.

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§16.53 4. Return Property to Donor's Estate or Heirs

Property held in trust will be returned to the donor's estate or the donor's heirs when the trust fails (not if the trust is merely breached) only if the donor retained a reversionary interest in the property. In other words, unless the trustor expressly retains a reversionary interest, the charitable purposes of the trust should be fulfilled even though the original purpose fails. The gift instrument itself will determine whether the donor's estate or heirs retained a reversionary interest.

If a donor has not retained a reversionary interest in the trust property, "it has no standing in a court of equity, except as a relator, to attempt to compel the property execution of the trust, or to claim any interest in the trust property." *O'Hara v Grand Lodge of the Independent Order of Good Templars* (1931) 213 C 131, 139, 2 P2d 21, superseded by statute on other grounds. On standing of a relator to sue on behalf of a charitable trust, see §16.48.

NOTE: Courts often recognize the strong public policy interests in charitable gifts and are reluctant to return property to the donor's estate or heirs. In *In re Los Angeles County Pioneer Soc'y* (1953) 40 C2d 852, 866, 257 P2d 1, the California Supreme Court held that the State does not recognize a possibility of reverter in the donor or his successors on dissolution of a charitable corporation to which real property has been conveyed unless the right of reverter is expressly reserved. See *McCarthy v Poulsen* (1985) 173 CA3d 1212, 1218, 219 CR 375 (trustors "totally and completely divested themselves" of any interest in trust assets; cy pres doctrine applied).

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VII. EFFECT OF BANKRUPTCY AND RECEIVERSHIP LAW ON INSTITUTIONAL FUNDS

A. Overview of Bankruptcy Law

§16.54 1. Eligibility

Eligibility for relief under the Bankruptcy Code is limited to entities or individuals identified as "persons" under Bankruptcy Code §109. 11 USC §109. "Person" includes an individual, partnership, corporation, and certain governmental units. 11 USC §101(41). A "corporation," as defined by the Bankruptcy Code, includes a business trust (11 USC §101(9)(A)(v)) but does not include a trust that is not engaged in a business. *In re Parade Realty* (Bankr D Hi 1991) 134 BR 7, 10 (to qualify as "business trust," trust must contain some characteristics of corporation). See also *Hunt v TRC Props., Inc. (In re Hunt)* (BAP 9th Cir 1993) 160 BR 131, 135 (neither nonbusiness trust nor its trustee was "person" eligible to file for Chapter 11 protection). Consequently, although trusts engaged in business are eligible for bankruptcy relief, trusts that are organized merely to hold passive assets are not.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.55 2. Commencement of a Case

§16.55 2. Commencement of a Case

Generally speaking, an entity may enter bankruptcy proceedings either voluntarily or involuntarily.

NOTE: The legislative history of 11 USC §303 indicates that schools, churches, charitable organizations, and foundations are protected from involuntary bankruptcy, but these entities may file a voluntary petition. See H Rep No. 95-595, 95th Cong, 1st Sess (1977); S Rep No. 95-989, 95th Cong, 2d Sess (1978).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.56 a. Voluntary Bankruptcy

§16.56 a. Voluntary Bankruptcy

A voluntary bankruptcy case begins when the entity files a petition with the bankruptcy court under one of the chapters of Title 11. 11 USC §301.

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§16.57 b. Involuntary Bankruptcy

Involuntary bankruptcy generally may not be imposed on a nonprofit corporation described in IRC §501(c)(3). An involuntary Chapter 7 or Chapter 11 petition may not be brought against a corporation that is not a "moneyed, business, or commercial corporation" (11 USC §303(a)), *i.e.,* a for-profit organization. To determine whether the debtor corporation is subject to an involuntary petition, examine its charter of incorporation and corporate activities. See *In re Allen Univ.* (4th Cir 1974) 497 F2d 346, 348 (debtor university was not subject to involuntary petition; although it was chartered as corporation, it had neither capital stock nor return of capital to investors outstanding, and its commercial activities were ancillary to its main purpose of education). See also *Strassburger, McKenna, Gutnick & Potter v Quinn (In re Grace Christian Ministries, Inc.)* (Bankr WD Pa 2002) 287 BR 352, 355 (corporation is not-for-profit and thus may not be involuntary debtor in bankruptcy).

In re Capitol Hill Healthcare Group (Bankr D DC 1999) 242 BR 199, 202, is particularly instructive. In that case, the registration of a nursing home and hospital as nonprofit corporations was held to be not decisive but probative of the fact that neither was a "monied" person under 11 USC §303(a). Each entity was a California mutual benefit corporation that had consistently filed an IRS Form 1120, as neither had ever sought to qualify for income tax exemption. Observing that the party seeking involuntary bankruptcy of the mutual benefit corporations had "failed to adduce any evidence establishing that the debtor is organized or conducted for profit despite its non-profit status under state law," the court stated that corporations' failure to seek to qualify as a charitable organization with the Internal Revenue Service, and its minimal charity cases, did not negate its non-profit status; being a charity is not a prerequisite to not being a "moneyed, business, or commercial corporation" under 11 USC §303(a). *In re Capitol Hill Healthcare Group, supra.*

NOTE: Although *Capitol Hill* is cited for the proposition that a not-for-profit corporation may never be subject to an involuntary Chapter 7 or Chapter 11 petition, the opinion's actual language indicates that if evidence had been introduced that the not-for-profit corporation had been conducting a for-profit business, the result might have been different.

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§16.58 3. The Bankruptcy Estate

The bankruptcy estate is created automatically on the filing of a bankruptcy petition. 11 USC §541(a). The estate consists of a comprehensive range of rights and property interests, including all legal and equitable interests of the debtor at the time the petition is filed. 11 USC §541(a)-(b).

Nonbankruptcy law generally defines the debtor's interest in property. This typically refers to state law, but it may also include federal law. For example, property held by a debtor in a trust for the benefit of another, if recognized as such in state law, would not be considered property of the estate and would not be administered as part of the bankruptcy proceeding. Federal bankruptcy law determines which property interests of the debtor are included in the bankruptcy estate. See, *e.g., Committee of Tort Litigants v Catholic Diocese of Spokane (In re Catholic Bishop of Spokane)* (Bankr ED Wa 2005) 329 BR 304, 328, aff'd in part and rev'd in part (ED Wa 2006) 364 BR 81 (state law determines debtor's interest in property of estate; bankruptcy court has jurisdiction to determine what property constitutes estate in all proceedings arising under Title 11).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.59 4. The Automatic Stay (11 USC §362)

§16.59 4. The Automatic Stay (11 USC §362)

The automatic stay, applicable to all entities, takes effect when the bankruptcy petition is filed and protects the debtor, the debtor's property, and the estate property from certain creditor actions. The stay provides a reprieve for the debtor, promotes an orderly case administration, and helps ensure the uniform treatment of creditors similarly situated.

Specific acts are enjoined during the automatic stay in reference to claims that arose before the bankruptcy petition was filed, including (11 USC §362(a)):

- Commencing or continuing judicial, administrative, or other action against a debtor to recover a prepetition claim;
- Attempting to obtain possession of the estate or any property of the estate;
- Creating, perfecting, or enforcing a lien against the estate if the lien secures a prepetition claim; or
- Attempting to collect, recover, or assess a claim that arose before the petition was filed.

The court may grant relief from the automatic stay of any enjoined act for cause to a party in interest on request and after notice and a hearing. The bankruptcy court has broad discretion to determine what constitutes "cause," which includes lack of adequate protection and the debtor's lack of good faith in filing the petition. 11 USC §362(d).

NOTE: Absent relief from the stay, an individual debtor injured by a willful violation of the stay may recover actual damages, costs, attorney fees, and if warranted, punitive damages. 11 USC §362(k).

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.60 5. Executory Contracts (11 USC §365)

§16.60 5. Executory Contracts (11 USC §365)

The trustee of the estate of a debtor who is a party to an unfavorable executory contract may assume or reject the agreement. 11 USC §365(a). If the trustee rejects the contract, the other party to the contract may assume the status of a prepetition creditor for its breach-of-contract damage claim.

NOTE: In the situation of nonresidential real estate leases and employment agreements, damages are subject to limitations under 11 USC §502(b)(6)-(7).

The trustee may assume a contract if the trustee can cure defaults (other than defaults related to the bankruptcy filing or financial condition) and show adequate assurance of future performance. 11 USC §365(b). If the trustee assumes the contract, the other party to the contract is obligated during the course of the bankruptcy case to perform the contract in accordance with its terms. The other party to the contract, however, may seek relief from stay, adequate assurance of interim performance, or an order compelling the debtor to assume or reject the agreement by a specified time.

PRACTICE TIP: Charitable organizations must be aware that, to the extent there is an agreement as to whether the gift can be characterized as an executory contract, it will be subject to §365 and may require the charity to perform on an interim basis, unless it obtains relief from the bankruptcy court. For example, an executory contract situation can arise when a gift balance is due and the charitable corporation is obligated to engage in some performance in the interim to receive the remainder of the gift.

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§16.61 6. Financial Accommodations

Neither the trustee nor the debtor in possession may assume an executory contract to make a loan or to grant a financial accommodation. 11 USC §365(c)(2).

NOTE: No reported case has decided whether a charitable pledge enforceable under state law is characterized as a "financial accommodation" within the meaning of §365(c)(2). Characterizing a pledge as a financial accommodation would eviscerate the notion of enforceability of a pledge in bankruptcy.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.62 B. Overview of Receivership Law

§16.62 B. Overview of Receivership Law

A receiver is a person appointed by the court to take possession and control of designated assets or property and to administer them in accord with court directive. See CCP §568. A corporation can be liquidated through a receivership as an alternative to bankruptcy (CCP §564(b)(6)); however, debts can only be discharged through bankruptcy. Both federal and state courts can administer receiverships, but in practice, those involving private individuals and entities are generally conducted only in state courts. Federal receiverships are generally found when a federal agency is the party seeking appointment of a receiver.

In a majority of states, including California, a court can order receivership on an ex parte application by verified complaint showing an emergency and the reasons the applicant would suffer an irreparable injury, absent the receivership, during the time necessary for a noticed hearing. Cal Rules of Ct 3.1175(a). A court may also order the appointment of a receiver in a pending litigation, on application by a party or on the court's own motion, in a multitude of specific instances. CCP §564(b)(1)-(12).

NOTE: Usually receivers are used to liquidate corporate assets, but they may also be used when officers, directors, or stockholders are disputing, with the receiver serving as a custodian during the pendency of the dispute.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.63 1. Federal Receivership

§16.63 1. Federal Receivership

Federal receiverships are rare unless requested by a federal agency such as the IRS or the Securities and Exchange Commission (SEC). Unlike state court receiverships that may or may not be prescribed by state statute, federal receiverships are governed by the Federal Rules of Civil Procedure. Under Fed R Civ P 66, federal jurisdiction is limited to liquidating or operating the business for the benefit of a government agency that is owed fines or taxes. Generally, the receiver is not interested in, nor do the court instructions provide for, protecting the interests of trade creditors.

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Source: Business Law/Advising California Nonprofit Corporations/16 Management of Charitable Funds/§16.64 2. California State Receivership

§16.64 2. California State Receivership

State receiverships are governed entirely by state law and vary accordingly. See generally CCP §§564-570; Cal Rules of Ct 3.1175-3.1184. Receiverships under state law typically are allowed for:

- Insolvency,
- Failure to pay debts in a timely manner, or
- Disputes between internal factions.

On receiving notification of the receivership, the creditor should determine whether a claim must be filed. Some states require creditors to file claims, and those who fail to do so may be unable to share in the liquidation of assets or payments of bills in the event of a custodial receivership.

Usually when receivers are authorized to continue the operation, they are authorized and empowered to pay debts as they come due in the ordinary course of business. However, there is no guarantee this will occur. A receiver is only the custodian of the assets and bound by the orders of the court that created the receivership.

PRACTICE TIP: Courts give significant weight to the receiver's advice or opinion regarding the value of the property and its proper disposition. See *People v Riverside Univ.* (1973) 35 CA3d 572, 581, 111 CR 68. Creditors should not only try to work with the receiver, but should also be cautious and not assume that because a receiver is in place, everything will be all right.

Conversely, the appointment of a receiver may be very good news for creditors and an adverse development for members of an insurance trust. *Gill v Rich* (2005) 128 CA4th 1254, 28 CR3d 52 (receiver operating malpractice insurance trust may pursue individual physicians for assessments necessary because of trust underfunding).

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§16.65 3. Involuntary Proceedings Against Charity Permitted Under California Law

California law provides for the involuntary dissolution of a nonprofit public benefit corporation. In addition, at the plaintiff's request, the court may appoint a receiver to preserve the corporation's property if the court has reasonable grounds to believe that, absent appointment of a receiver, the corporation's interests or the corporation's charitable interests will suffer pending hearing and determination of the complaint. Corp C §6513; CCP §554(b)(6), (b)(9).

EXAMPLE: A situation in which a receivership is proper but a bankruptcy not possible illustrates how these two related but independent legal actions might work. Suppose a handful of trade creditors sue a private college formed as a public benefit corporation, each receiving a judgment on its open account with the college. Because the college is a charity, it may not be forced into bankruptcy per 11 USC §303(a). Any of the trade creditors could, however, seek the appointment of a receiver pursuant to CCP §564(b)(3). Upon appointment, the receiver would have the ability to collect sums due the college and pay them over to the trade creditor. In practice, it is not uncommon for a "going business" for which a receiver is sought in (and likely will be appointed by) state court, to itself seek protection by reason of the automatic stay upon its own voluntary filing in the federal bankruptcy court under Chapter 11. Such filing by the entity automatically divests the state court of jurisdiction and, at least temporarily, allows the entity's board of directors to remain "in the driver's seat" in the federal bankruptcy court.

For a detailed discussion of involuntary dissolution, see §§20.137-20.148.

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§16.66 C. Choosing Between Bankruptcy and Receivership

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When evaluating whether to proceed to federal bankruptcy court or under a state receivership statute, a practitioner should consider the following:

- Only the charity itself may elect bankruptcy;
- Only some types of charities may file for bankruptcy;
- Although a board faction may not be able to file a bankruptcy, it may qualify to petition for a receiver;
- A creditor of a charity (including, *e.g.*, a vendor or a labor union representing organized employees named in the articles) may qualify to petition for a receiver; and
- An authorized party named in the Articles of Incorporation may qualify to petition for a receiver.

The following table shows some of the differences between a bankruptcy and a receivership.

	Bankruptcy	Receivership
Authority	Federal Bankruptcy Law	State laws and limited federal
Involuntary proceedings allowed against nonprofit organizations	No, not against IRC §501(c)(3) entities, and possibly not against other nonprofit corporations	Yes
Ability to discharge debt	Yes	No
Creditors allowed to bring proceedings	No	Yes, in some situations

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VIII. ASSETS REACHABLE BY CREDITORS

§16.67 A. General Assets (Unrestricted Funds)

The general assets of a nonprofit organization are subject to attachment and reachable by creditors to satisfy their claims, subject to applicable state law. On nonendowed funds, see §16.6.

NOTE: Unlike endowments, reserves represent a cushion that can be drawn down at the discretion of the charity. These are considered part of the bankruptcy estate under 11 USC §541 and thus may be reached by creditors should a charity file for bankruptcy.

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§16.68 B. Quasi-Endowments

The distinction between quasi-endowments and true endowments (see §16.69) is that the organization may decide to expend the principal balance of the quasi-endowment anytime, whereas the principal balance of the true endowment must remain intact according to the donor's restrictions. See §16.5. Because the organization holds legal and equitable title to the unrestricted principal and income of a quasi-endowment, creditors will most likely be able to reach the quasi-endowment.

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§16.69 C. Assets Held by Nonprofit Corporation (Endowed Funds)

Property transferred to a nonprofit organization without any restrictions remains subject to the charity's limitations defined by the organization's purposes and bylaws. If the charity uses an unrestricted gift to purchase assets or commingles such funds in an account with general assets, the gift will become available to creditors.

Current case law suggests that the principal of restricted assets will not become part of the bankruptcy estate available to creditors. However, income from an endowment fund has been considered as part of the bankruptcy estate available to pay off obligations owing to creditors during the pendency of the bankruptcy proceeding. *Salisbury v Ameritrust Tex., N.A. (In re Bishop College)* (Bankr ND Tex 1993) 151 BR 394.

PRACTICE TIP: When a charity serves as its own trustee, it is essential that it scrupulously observe the separate existence of its endowment. A failure to do so may result in the endowment being characterized by a court as a quasi-endowment and potentially subject to attachment. On the doctrine of merger, see Witkin, Summary of California Law, *Trusts* §44(3) (10th ed 2005). The directors of the bankrupt entity are potentially at risk in this situation should a subsequent superior court conclude that the directors violated their respective duty under Bus & P C §17510.8 because they could have done more to preserve the separate existence of the endowment.

Doctrine of merger. An "endowment" is a type of charitable trust. When an operating charitable trust (*e.g.*, a museum or hospital) holds its own endowment, such that the charity is both the trustee and the beneficiary, and is in a position to make and carry out an interpretation of what is the "proper" distribution from the restricted fund, then the question naturally arises as to whether "merger" has occurred.

Consistent with century-old cases, UPMIFA states that merger does not occur. This is presumably because the "beneficiary" is not deemed to be the charity that is itself the trustee holding its own endowment, but rather that class of individuals who are intended to be benefited by the charity.

This result was not always apparent. Various creditors have argued that if a donor really wants his or her restricted or endowment gift to be exempt from the claims of creditors, the donor should have handed that restricted gift to a third party to hold in trust for the expressed purpose, rather than to the charity itself. There are many instances in which a charity's board of directors has authorized the invasion of a restricted fund (for example an endowment fund which is time-restricted) for purposes not authorized in the gift instrument. These actions are a breach of trust. See Bus & P C §17510.8. See also §§16.40-16.47.

NOTE: Many legal commentators take the position that the donor, who was in the position to protect his or her desire to see restrictions enforced, should not be rewarded at the expense of hourly employees seeking unpaid wages and bona fide trade creditors who may remain uncompensated in a bankruptcy.

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§16.70 D. Assets Held by Independent Third Party Trustee

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Property whose legal title is held by an independent third party trustee is not property of the estate. 11 USC §541. Vesting legal title in a third party is the safest way for an organization to prevent creditors from reaching endowment funds should a charity file for bankruptcy.

The scope of the debtor's estate is limited to property interests held by the debtor when the bankruptcy petition was filed. 11 USC §541(a). Typically, the nature and extent of a debtor's property rights as of the petition date are defined by nonbankruptcy law. If an independent third party holds the endowment as trustee, neither the income nor the principal becomes part of the bankruptcy estate. Therefore the endowment is unavailable to creditors. See *Salisbury v Ameritrust Tex., N.A. (In re Bishop College)* (Bankr ND Tex 1993) 151 BR 394, 398. See also *Bennett College v United Bank of Denver* (Colo 1990) 799 P2d 364 (trustee no longer obligated to disburse trust money to college which had ceased to exist by virtue of bankruptcy and subsequent sale of its assets).

In re Bishop College, supra, dealt with the difference between charity-held endowments ("institutional funds") and commercial-bank-held endowments for the benefit of a charity. In the first situation, the college itself held the endowment. The bankruptcy court ruled that the corpus of that endowment would be preserved, but that the income generated from that endowment fund's corpus during the pendency of the bankruptcy proceeding (about 2 years) would be available to pay creditors. That same bankruptcy held that, in contrast to the charity-held endowment, no portion of the bank-trustee endowment or income was available to pay the claims of creditors of the bankrupt college, and the bank should seek reformation under the cy pres doctrine.

NOTE: If a charity's endowment is held by a for-profit financial institution, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) might not apply because banks and other financial institutions that act as trustees are not "institutions." An institution is an incorporated or unincorporated organization formed and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of these purposes.

	Is principal reachable by creditors?	Is income reachable by creditors?
General assets	Yes	Yes
Board-restricted fund	Yes	Yes
Gift principal (donor allows board to spend)	Most likely	Yes
Donor-restricted fund; charity acts as trustee	Uncertain; possibly not	Yes
Donor-restricted fund; independent third party acts as trustee	No	No

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17

Taxation of Investment and Business Activities of Tax-Exempt Corporations

J. Patrick Whaley

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§17.1 I. SCOPE OF CHAPTER

This chapter discusses tax considerations concerning a nonprofit organization's income from investments and other business activities. The chapter covers the taxation of investment income of private foundations (see §§17.3-17.10) and the taxation of recapture income (see §17.11). It includes an extensive discussion of tax on unrelated business income and how that concept is defined. See §§17.12-17.67. The chapter also briefly addresses issues arising when operating the business through another entity (see §§17.68-17.74), as well as the taxation of investments in tax shelters (see §§17.75-17.78).

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§17.2 II. SOURCES OF FUNDS

Tax-exempt corporations obtain funds from several sources, such as charitable contributions (see chap 15); dues, membership fees, and similar assessments (see §10.121); auctions, dinner dances, athletic events, and other fundraising efforts (see chap 15); borrowing (see §§18.2-18.4); business activities; and investments. Subject to the limitations on the ownership of excess business holdings by private foundations (see §4.41) and possible loss of certain advantages, including loss of tax-exempt status (see §17.67), a tax-exempt corporation may carry on business and investment activities itself or through other corporations, partnerships, and limited liability companies.

A tax-exempt organization that is a private foundation pays a federal excise tax on its net investment income. See §4.40. Income characterized as recapture of certain prior tax deductions will be taxed to an exempt organization. See §17.3. In some circumstances, income derived from sources other than charitable contributions and borrowing will be taxed as unrelated business taxable income. In a few situations, a tax-exempt corporation's ownership interest in another entity can affect the income tax liabilities of that entity or other entities. If a tax-exempt entity is a party to a prohibited tax shelter transaction, the entity and its managers may be subject to federal excise taxes. See §§17.75-17.78.

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III. TAXATION OF INVESTMENT INCOME OF PRIVATE FOUNDATIONS

§17.3 A. Taxation and Exemption From Taxation

Except for exempt operating foundations (see §4.50), private foundations pay an annual federal excise tax on their net investment income. IRC §4940(a). See §4.40. An exempt operating foundation is a private foundation that for the taxable year (IRC §4940(d))

- Is an operating foundation (see §4.47);
- Has been publicly supported for at least 10 taxable years by meeting the requirements of IRC §170(b)(1)(A)(vi) or §509(a)(2);
- Has a governing body of individuals at least 75 percent of whom are not disqualified persons as defined in IRC §4940(d)(3)(B) and that is broadly representative of the public; and
- At no time during the taxable year has an officer who is a disqualified person.

A private operating foundation that was an operating foundation as of January 1, 1983, or as of its last taxable year ending before January 1, 1983, does not have to satisfy the publicly supported test. It is likely that few, if any, organizations formed after January 1, 1983, will qualify as exempt operating foundations because they will not be private foundations if they met the publicly supported tests of IRC §170(b)(1)(A)(vii) or §509(a)(2).

There is no similar tax imposed under California law. For a more detailed discussion of the excise tax imposed on the investment income of private foundations, see Hill & Mancino, Taxation of Exempt Organizations ¶¶12.01-12.02(6) (2002).

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§17.4 B. Normal Tax Rates

The annual tax rate imposed on private foundations that are exempt from federal income tax under IRC §501(c) is 2 percent of net investment income. IRC §4940(a). The tax imposed on private foundations that are not exempt is equal to the excess, if any, of 2 percent of net investment income plus the tax that would have been paid on unrelated business taxable income (see §17.12) had the private foundation been exempt, over the normal federal income tax that the organization is obligated to pay.

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§17.5 C. Reduction in Tax

A tax-exempt private foundation may reduce its tax on net investment income from 2 percent to 1 percent if it increases its qualified distributions (see §4.40). IRC §4940(e). This decreased rate will apply for a particular taxable year if the private foundation was not liable for excise tax under IRC §4942 for any of the 5 preceding taxable years, and the sum of the qualified distributions made during that year equals or exceeds the sum of (IRC §4940(e)(2))

- One percent of the net investment income for such year, and
- The average percentage paid on the value of its investment assets for the previous 5 years multiplied by the value of its investment assets for such taxable year.

PRACTICE TIP: The disadvantage of qualifying for this reduction on a continuous basis is that it requires a private foundation to continue to ratchet up its qualifying distributions from year to year. Therefore, foundations often employ it only in those years when they have unusually large amounts of net investment income.

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§17.6 D. Net Investment Income

Net investment income is the amount by which the sum of gross income and capital gain net income exceeds allowable deductions. IRC §4940(c)(1). Net investment income does not include interest that is exempt from tax under IRC §103.

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§17.7 1. Gross Investment Income

Gross investment income means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in IRC §512(a)(5)), royalties, and similar sources but does not include any unrelated business taxable income. IRC §4940(c)(2).

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§17.8 2. Capital Gain Net Income

Capital gains or losses from the sale of property are taken into consideration to the same extent that they are taken into account for purposes of computing the tax on unrelated business taxable income (see §17.29). IRC §4940(c)(4)(A). Property held on December 31, 1969 has a tax basis equal to its value on that date. IRC §4940(c)(4)(B). Capital losses are allowed only to the extent of capital gains, and there are no loss carryovers or carrybacks. IRC §4940(c)(4)(C). Gain or loss from the sale of property that has been used for at least 1 year for an exempt purpose or function will not be taken into account if exchanged for similar property; rules similar to those in IRC §1031 apply. IRC §4940(c)(4)(D).

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§17.9 3. Allowable Deductions

The deductions that may be taken in determining net investment income are those for ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of income. IRC §4940(c)(3)(A). For this purpose, depreciation must be claimed on the straight-line basis, and no percentage depletion may be claimed. IRC §4940(c)(3)(B).

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§17.10 E. Reporting of Taxes

The 2-percent (or 1-percent) excise tax imposed by IRC §4940 is reported on the IRS Form 990-PF. The tax must be paid on an estimated basis in quarterly installments. IRC §6655(g).

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Source: Business Law/Advising California Nonprofit Corporations/17 Taxation of Investment and Business Activities of Tax-Exempt Corporations/§17.11 IV. RECAPTURE INCOME

§17.11 IV. RECAPTURE INCOME

Any recapture income realized as a result of the sale or exchange of property pursuant to the following IRC provisions is fully taxable to an exempt organization:

- IRC §1245: Depreciation recapture on the disposition of personal property.
- IRC §1250: Depreciation recapture on the disposition of real property.
- IRC §1252: Recapture of certain expenditures on the disposition of farm lands.
- IRC §1254: Recapture of certain expenditures on the disposition of interests in oil, gas, geothermal, or other mineral properties.
- IRC §1255: Recapture of certain government cost-sharing program payments for conservation purposes on the disposition of property.
- IRC §1257: Gain realized on the disposition of certain converted wetlands or highly erodible croplands.

These IRC provisions override all other statutory exclusions, including those pertaining to tax exemption (IRC §501(a)) and unrelated business taxable income (IRC §§511-514). For recapture of depreciation under IRC §§1245 and 1250, only depreciation allowed or allowable in computing an exempt organization's unrelated business income or in computing taxable income of the organization (or a predecessor organization) while not exempt is taken into account. Treas Reg §§1.1245-2(a)(8), 1.1250-2(d)(6). While this same rule logically should apply to recapture income under IRC §§1252, 1254, and 1255, the regulations under those sections do not contain such a rule.

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V. UNRELATED BUSINESS INCOME TAX (UBIT)

§17.12 A. Imposition of Tax

Income subject to 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 purpose or functions that qualify the organization for tax exemption. Taxes may also be imposed on income from the following sources:

- Property subject to a mortgage or other encumbrance and assets purchased with borrowed funds (see §§17.45-17.58);
- Payments received from controlled entities (IRC §512(b)(13); see §§17.68-17.74);
- Deemed distributions from insurance income of a controlled foreign corporation (see §17.40); and
- Net income earned on certain private-use property funded with proceeds from tax-exempt bond financing (see §17.29).

If an organization's unrelated trade or business is or will be substantial, the organization may lose, or fail to obtain, tax-exempt status. See §17.67. Unrelated business income could also result in a partial or complete loss of the welfare exemption from property tax (see chap 11), disqualification of tax-exempt bond financing (see chap 18), and limitation on reduced postal rates (see §13.52).

California law. California tax law generally conforms to federal tax law on taxation of unrelated business income of exempt organizations. Rev & T C §§23731-23740. Any differences between federal and state law are noted in this chapter.

For more detailed discussions of the taxation of unrelated business income, see Hopkins, The Law of Tax-Exempt Organizations (9th ed 2007); Frietag, *Unrelated Business Income Tax*, Tax Mgmt Portfolios 874-2d (2001). The publications Cobb, *UBIT Traps in Alternative Revenue*, 14 Exempt Org Tax Rev 229 (Aug. 1996) and Hasson, *Controversies Old and New Mark Recent UBIT Developments*, 10 J Tax'n Exempt Orgs 123 (Nov./Dec. 1998) discuss several activities that have been the subject of IRS scrutiny (*e.g.,* licensing and royalty arrangements, insurance arrangements, advertising, catalog and bookstore sales, corporate sponsorship, travel tours).

Social clubs. Social clubs (described in IRC §501(c)(7)), voluntary employees' beneficiary associations (described in IRC §501(c)(9)), supplemental unemployment plan trusts (described in IRC §501(c)(17)), and group legal service plans (described in IRC §501(c)(20)) are taxed under a special rule. These organizations are taxed on all income except the following (IRC §512(a)(3)):

- Membership income;
- Capital gains from the sale of real property that are used to further an exempt purpose, if those gains are reinvested in such property; and
- Certain income paid or set aside for charitable purposes or, as to voluntary employees' associations, supplemental employment plan trusts, and group legal service plans, for the payment of certain benefits.

This income is taxable to these types of corporations whether or not the activity generating the income is conducted regularly. *Ye Mystic Krewe of Gasparilla* (1983) 80 TC 755.

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§17.13 B. Organizations Subject to Tax

With two limited exceptions, the following organizations are subject to federal tax on unrelated business taxable income (IRC §§501(b), 511(a)(2)):

- Organizations exempt from federal income tax under IRC §501(a) (including organizations described in IRC §§401(a), 501(c)-(d);
- Public colleges and universities; and
- Corporations wholly owned by public colleges or universities.

The exceptions to this rule are corporations organized under an act of Congress that are exempt under that act from federal income tax (IRC §§501(c)(1), 511(a)(2)(A)) and certain federally licensed businesses of religious orders (IRC §512(b)(15)).

Corporations exempt under Chapter 4 of Part 11 of Division 2 the California Revenue and Taxation Code (Rev & T C §§23701-23778) are subject to California tax on their unrelated business taxable income. Rev & T C §23731(a). A charitable trust that is tax-exempt under Rev & T C §23701d is defined as a "corporation." Rev & T C §23038(e).

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C. Definition of "Unrelated Trade or Business"

§17.14 1. Basic Test

An "unrelated trade or business" is an enterprise (see §§17.14-17.44) that is regularly carried on (see §17.20) by an exempt organization and that is not substantially related (other than through the production of funds) to the organization's exercise or performance of its exempt purposes (see §17.23). IRC §513(a). The term generally does not include businesses (IRC §513(a)):

- Whose work is substantially performed by volunteers;
- That operate primarily for the convenience of their members, students, patients, officers; or
- That sell merchandise, substantially all of which has been received as gifts or contributions.

Fundraising activities that are regularly carried on, including but not limited to awards of premiums in consideration for charitable contributions, lotteries, and golf tournaments, will be unrelated businesses unless they are covered by one of the exclusions discussed in §§17.25-17.43.

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2. Elements of Basic Test

§17.15 a. Trade or Business

Although there is no authoritative definition of the term "trade or business" (see 1 Bittker & Lokken, Federal Taxation of Income, Estates and Gifts §20.1.2 (3d ed rev 2005)), the term has the same meaning in the unrelated trade or business context as elsewhere in the Internal Revenue Code (*Cooper Tire & Rubber Co. Employees' Retirement Fund* (1961) 36 TC 96, aff'd (6th Cir 1962) 306 F2d 20). Generally, a trade or business is an activity that involves selling goods or services to produce income. IRC §513(c); Treas Reg §1.513-1(b). For example, providing insurance to members constitutes the conduct of a trade or business because the activity involves sales and the performance of services and possesses the general characteristics of a trade or business. *U.S. v American Bar Endowment* (1986) 477 US 105, 91 L Ed 2d 89, 106 S Ct 2426.

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§17.16 (1) Comparison With Nonexempt Enterprises

An activity may be a trade or business even if it does not compete with taxable enterprises. *Clarence LaBelle Post No. 217 v U.S.* (8th Cir 1978) 580 F2d 270. But see *Hope Sch. v U.S.* (7th Cir 1980) 612 F2d 298 (lack of competition primary but not sole factor in deciding whether there was unrelated trade or business). The continuing validity of the *Hope* decision is questioned in *Veterans of Foreign Wars* (1987) 89 TC 7.

For a review of cases discussing the importance of competitive and commercial efforts by an exempt organization in determining whether an unrelated trade or business exists, see *Carolinas Farm & Power Equip. Dealers Ass'n v U.S.* (4th Cir 1983) 699 F2d 167. In any event, comparison with nonexempt enterprises may otherwise be relevant, *e.g.,* in determining whether a trade or business is regularly carried on. See §17.20.

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§17.17 (2) Profit Intent

To be a "trade or business," an activity must be carried on with the intention of making a profit. *Texas Farm Bureau v U.S.* (5th Cir 1995) 53 F3d 120, 125 (determining whether profit motive exists is "key inquiry"); *Veterans of Foreign Wars* (1987) 89 TC 7. Losses do not prevent an activity carried on for profit from being a "trade or business." IRC §513(c).

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§17.18 (3) Operation as Part of Larger Enterprise

A trade or business does not lose its separate identity merely because it is a part of a larger endeavor that is conducted to further an exempt purpose. IRC §513(c). For example, although the publication of a monthly medical journal may be an exempt function, sales of advertisements in that journal can be an unrelated trade or business. *U.S. v American College of Physicians* (1986) 475 US 834, 89 L Ed 2d 841, 106 S Ct 1591 (see §17.18). Similarly, although an exempt hospital's operation of a pharmacy is an exempt function, the pharmacy's regular sales to persons who are not hospital patients can be an unrelated trade or business. See §17.38.

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§17.19 (4) Providing "Commercial Type" Insurance

A tax-exempt organization that writes "commercial type" insurance that is not a substantial part of its activities is treated as carrying on an unrelated trade or business and is taxed as an insurance company under IRC §§801-848 rather than under IRC §511. IRC §501(m)(2). See *Paratransit Ins. Corp.* (1994) 102 TC 745; *Nonprofits' Ins. Alliance v U.S.* (1994) 32 Fed Cl 277. However, Nonprofits' Insurance Alliance is exempt under IRC §501(n) and its insurance activities are not taxed as an unrelated trade or business.

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§17.20 b. Regularly Carried On

In determining whether a trade or business is regularly carried on, its frequency and continuity are compared with similar activities of a nonexempt organization. Treas Reg §1.513-1(c)(1). Determining whether "intermittent" activities are regular may present difficult factual questions, and the cases and rulings dealing with the issue are not always consistent in their conclusions.

An activity is not "regular" if it is carried on for only 1 or 2 weeks a year by an exempt enterprise as compared with a similar activity carried on daily throughout the year by nonexempt enterprises. However, once a week throughout the year is considered "regular." If the normal span of an activity is seasonal, such as horse racing, then "regularity" is determined with reference to that span. Treas Reg §1.513-1(c)(2)(i).

Infrequent conduct, such as an annual dance or a fundraising event, is not regular. Treas Reg §1.513-1(c)(2)(iii). Casual sales in conjunction with an exempt activity, such as occasional sales to persons other than patients by a hospital pharmacy or to persons other than students by a college bookstore, are not regular. Treas Reg §1.513-1(c)(2)(ii).

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§17.21 (1) Advertising Sales

Income from selling advertising space in programs for an annual basketball championship tournament is not a regularly carried on business. *National Collegiate Athletic Ass'n v Commissioner* (10th Cir 1990) 914 F2d 1417. The relevant period in determining whether the activity was intermittent was held to be the approximately 3-week-long tournament when the games were played and the advertising actually occurred. The court thus ignored the considerable time and effort spent in soliciting advertisements and preparing the programs for publication before the tournament. See also *Suffolk County Patrolmen's Benevolent Ass'n* (1981) 77 TC 1314, 1321, acq 1984-2 Cum Bull 2 (despite up to 16 weeks of professional solicitation of advertising for program for annual event, activity was deemed intermittent, not "regularly carried on").

Income from selling displays and listings in an annual yearbook was held to be unrelated business taxable income in *State Police Ass'n v Commissioner* (1st Cir 1997) 125 F3d 1, cert denied (1998) 522 US 1108. The court distinguished *Suffolk County Patrolmen's Benevolent Association* and *National Collegiate Athletic Association* on the ground that the advertising in those cases was associated with particular events, suggesting that publications are to be treated differently than events.

The IRS has attempted to limit the reach of the decision in *Suffolk County Patrolmen's Benevolent Association,* and has expressed its disagreement with the decision of the court of appeals in *National Collegiate Athletic Association.* In IRS Letter Ruling 9712001, the IRS ruled that a concert series sponsored by an association of local firefighters' unions exempt under IRC §501(c)(5) conducted twice each year in several areas of a state was an unrelated trade or business. Tickets to the events were sold via telemarketing efforts employed in a solicitation campaign conducted by an independent commercial firm throughout most of the year, and there was a 6-month preparatory period for each series of events. See also IRS Letter Ruling 200128059, in which the IRS concluded that income from selling advertising in connection with an annual golf tournament was an unrelated trade or business.

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§17.22 (2) Single Occurrences

A termination agreement by which an exempt organization receives a single payment in consideration for its nonsponsorship and noncompetition commitment is not a regularly carried on business. *Ohio Farm Bureau Fed'n* (1996) 106 TC 222, 233.

The lease by a tax-exempt aeronautical museum of an airplane (which had been donated to the museum) to an aircraft manufacturer to test engines was held not to be a regularly conducted activity. *Museum of Flight Found. v U.S.* (WD Wash 1999) 63 F Supp 2d 1257. The court distinguished *Cooper Tire & Rubber Co. Employees' Retirement Fund* (1961) 36 TC 96, aff'd (6th Cir 1962) 306 F2d 20, which found that income received by an exempt organization from the lease of tire manufacturing machines that it purchased was taxable even though the exempt organization engaged in one single leasing transaction.

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§17.23 c. Relationship to Exempt Purpose

Determining if business is "substantially related." A trade or business must make an important contribution to an organization's exempt purposes other than through the production of funds to be "substantially related" to those purposes. The fact that profits of the trade or business are used by a nonprofit corporation for exempt purposes or are essential to its financial well-being does not convert an unrelated activity into a related activity. Treas Reg §1.513-1(d)(2). Determining whether an activity is substantially related to an organization's exempt purposes requires careful examination of those purposes. The degree to which an activity furthers an exempt purpose may vary according to the circumstances, and fine distinctions may be made. For example, commercial operation of a television station by a state university was found unrelated even though there was substantial student and faculty involvement. *Iowa State Univ. of Science & Technol. v U.S.* (Ct Cl 1974) 500 F2d 508. On the other hand, the sale of radio and television broadcasting rights for a football game by a regional athletic conference was related because the event itself was related to the educational purposes of the member colleges. Rev Rul 80-296, 1980-2 Cum Bull 195.

Are sales of product related? Disposing of the product of an exempt function may be related if no business efforts are made beyond those appropriate or necessary to that function. However, conducting an activity commercially beyond that necessary to support an exempt purpose is treated as an unrelated business to the extent of the excess, *e.g.,* the sale of milk and cream from a scientific dairy herd is related, whereas the sale of ice cream made from the milk and cream may not be. Treas Reg §1.513-1(d)(4)(ii).

Is dual use of facility related? Dual use of assets or facilities may result in an unrelated activity. For example, a museum's use of its auditorium during evening hours as an ordinary motion picture theater showing current films for public entertainment would be unrelated. Treas Reg §1.513-1(d)(4)(iii).

Sales by hospital pharmacy. Income from sales by a hospital pharmacy to private patients of staff doctors is related business income if the sales serve the hospital's exempt purposes by attracting doctors to a rural area hospital, but sales to the general public are an unrelated business. *Hi-Plains Hosp. v U.S.* (5th Cir 1982) 670 F2d 528. Pharmacy sales to private patients of staff doctors who operated an independent clinic adjacent to the hospital were also found unrelated. *Carle Found. v U.S.* (7th Cir 1979) 611 F2d 1192.

Sales of advertising in medical journal. Sales of advertising in a scholarly medical journal are an unrelated trade or business even though publication of the journal is *not* unrelated to the educational purposes of the organization. *U.S. v American College of Physicians* (1986) 475 US 834, 89 L Ed 2d 841, 106 S Ct 1591. In *American College,* the court rejected the IRS's argument that advertising per se constitutes an unrelated trade or business and held that the determination of whether the sale of advertising is related to an organization's exempt purposes should be made on the basis of how the organization conducts the activity rather than on the basis of the effect of the activity on subscribers. In this case, the appropriate inquiry was whether the publisher of the journal performed the advertising services in a manner that showed an intention to use the advertisements for the purpose of contributing to the educational value of the journal. The court concluded that the organization had not intended to do so for the following reasons (475 US at 849, 89 L Ed 2d at 853):

- The organization did not use its advertising to provide readers with a comprehensive or systematic presentation;
- Advertisements were sold to anyone willing to pay;
- Advertisements were often repeated and were for established drugs or devices; and
- Some advertisements concerned matters that had no conceivable relationship to the organization's exempt purposes.

IRS rulings on specific activities. The IRS has taken positions on the following specific activities:

- **Travel tours** conducted by educational, cultural, and other organizations (Treas Reg §1.513-7 provides six examples of travel tour programs conducted by exempt organizations that may be treated by the IRS as substantially related or not substantially related to an organization's exempt purposes; each program must be examined on the basis of its relevant facts and circumstances, including, but not limited to how a travel tour is

developed, promoted, and operated);

- **Bookstore and catalog sales by museums** (see Rev Rul 73-104, 1973-1 Cum Bull 263 (related); Rev Rul 73-105, 1973-1 Cum Bull 264 (related); IRS Letter Ruling 9550003 (unrelated)); and
- **Rental of a museum's facilities** for corporate and social events (see IRS Technical Advice Memorandum 9702003 (unrelated); *John W. Madden, Jr.,* TC Memo 1997-395 (related; rental of museum property for private celebrations not unrelated activity because museum's primary intent in making its facilities available was to further its educational purposes not to raise revenue).

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§17.24 3. Qualified Sponsorship Income

Solicitation and receipt of a "qualified sponsorship payment," *e.g.,* a payment received in support of an athletic event conducted by an exempt organization for which the payor only receives recognition, is not an unrelated trade or business. IRC §513(i). This exclusion does not apply to payments made in connection with either qualified convention and trade show activities (see §17.35) or income from the sale of advertising or acknowledgments in a regularly scheduled periodical that is not related to, primarily distributed with respect to, a particular event conducted by an exempt organization. IRC §513(i)(2)(B)(ii).

"Qualified sponsorship payment" and "substantial return benefit" defined. The term "qualified sponsorship payment" means "any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit." Treas Reg §1.513-4(c)(1). A "substantial return benefit" may include the following (Treas Reg §1.513-4(c)(2)(i)):

- Advertising of a payor's products or services (including messages containing quantitative or comparative language, price information, or other indication of savings or value, an endorsement, or inducement to purchase, sell, or use any facilities, products, or services). Treas Reg §1.513-4(c)(2)(iii)(A), (c)(2)(v).
- Exclusive-provider arrangement that limits or prohibits the exempt organization's sale, distribution, availability, or use of products, services, or facilities of the payor's competitors. Treas Reg §1.513-4(c)(2)(iii)(B), (c)(2)(vi)(B).
- Goods, facilities, services, or other privileges. Treas Reg §1.513-4(c)(2)(iii)(C).
- Exclusive or nonexclusive rights to use an intangible asset (*e.g.,* trademark, patent, or logo) owned by an exempt organization. Treas Reg §1.513-4(c)(2)(iii)(D).

If benefits provided by an exempt organization during a taxable year do not have an aggregate fair market value in excess of 2 percent of a payment, they are ignored. Treas Reg §1.513-4(c)(2)(ii).

Excluded from "substantial return benefits." "Substantial return benefits" do not include the use or acknowledgment of the name or logo of the payor's trade or business in connection with the activities of an exempt organization (including exclusive sponsorship arrangements as defined in Treas Reg §1.513-4(c)(2)(vi)(A)); logos that do not contain qualitative or comparative descriptions of the payor's product, services, or facilities; a list of the payor's locations, telephone number, or Internet address; value neutral descriptions, including displays or visual depictions; and the payor's brand name or trade name and product or service listings. Treas Reg §1.513-4(c)(2)(iv).

EXAMPLE: An exempt symphony orchestra that receives financial support from a music store could state in a program guide "the concert is sponsored by the Music Shop located at 123 Main Street, telephone number 555-1234," but it could not state "visit the Music Shop today for the finest selection of music CDs and cassette tapes." Treas Reg §1.513-4(f), Example 8.

Level of attendance contingency. If any part of a payment is contingent on a level of attendance at one or more events, broadcast ratings, or other factors indicative of the degree of public exposure, that part will not constitute a qualified sponsorship payment. IRC §513(i)(2)(B)(i).

Fair market value of return benefit. Because a qualified sponsorship payment will be limited to the amount, if any, by which the payment or payments received exceed the fair market value of the return benefit or benefits realized by the payor, the exempt organization must establish such fair value. If a payment or part of a payment is not a qualified sponsorship, this does not mean that it necessarily is included in unrelated business taxable income. One or more other rules discussed in this chapter might apply to exclude it. For further discussion, see Woods, *Tax Treatment of Corporate Sponsorship Payments to Exempt Organizations: Final Regulations*, 97 J Tax 174 (2002).

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§17.25 4. Statutory Exceptions and Modifications

By statute, certain activities are not considered unrelated trades or businesses. Income realized from an unrelated trade or business is also subject to certain statutory "modifications." IRC §512(b). Some of these modifications, however, are really exceptions. See §§17.26-17.43.

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Source: Business Law/Advising California Nonprofit Corporations/17 Taxation of Investment and Business Activities of Tax-Exempt Corporations/§17.26 a. Use of Premiums in Soliciting Contributions

§17.26 a. Use of Premiums in Soliciting Contributions

The tax on unrelated business income does not apply to distributions of low-cost articles incidental to a solicitation of charitable contributions. Treas Reg §1.513-1(b). If an organization is exempt under IRC §501(c) and donations to the organization are deductible as charitable contributions under IRC §170(c)(2) or §170(c)(3), the organization does not engage in an unrelated trade or business by distributing articles in the course of soliciting contributions as long as the following apply (IRC §513(h)):

- All articles distributed to any one person during any calendar year do not have a cost to the distributing organization of more than $9.60 for 2010 (adjusted annually for inflation; see Rev Proc 2009-50, §3.25, 2009-45 Int Rev Bull 617);
- The distribution is not made at the request of the distributee;
- The distribution is made without the express consent of the distributee; and
- The distribution is accompanied by both a request for a charitable contribution and a statement that the distributee may retain the article even if a contribution is not made.

However, the IRS has taken the position that the sale of items that met these criteria did not qualify under IRC §513(h) when the solicitations were often in competition with for-profit vendors, sometimes violated copyright laws, and at times were illegal. IRS Letter Ruling 9652004. For a critical comment on this ruling, see Tesdahl, *UBIT Ruling Raises New Concerns for Soliciting Charities*, 16 Exempt Org Tax Rev 481 (Mar. 1997).

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§17.27 b. Activities Performed by Volunteers

An activity is not considered an unrelated trade or business if unpaid volunteers perform substantially all the work without compensation. IRC §513(a)(1). See *Greene County Med. Soc'y Found. v U.S.* (WD Mo 1972) 345 F Supp 900, disapproved on other grounds in *Louisiana Credit Union League v U.S.* (5th Cir 1982) 693 F2d 525 (sale of phonograph records by "Singing Doctors" not trade or business; even if it were, it would be exempt because performers were unpaid). Thus, weekly public dances held by a volunteer fire department are exempt if unpaid volunteers provide all services. Rev Rul 74-361, 1974-2 Cum Bull 159.

"Compensation" as not trifling. "Compensation," as used in the statute, is not meant to include a "trifling inducement." *Waco Lodge No. 166 v Commissioner* (5th Cir 1983) 696 F2d 372, 375. The *Waco Lodge* court ignored the value of free beverages furnished to otherwise uncompensated workers in determining whether work was performed without compensation. (The value of the beverages was about $2.22 per worker per night, or about $.63 an hour.) The IRS follows the decision in *Waco Lodge* and applies the tests of IRC §132(e)(1) and Treas Reg §1.132-6 to determine what constitutes a trifling amount. GCM 39786 (Oct. 26, 1988).

Members of religious orders. Members of a religious order who receive food, shelter, clothing, and medical care, but who are not required to render any services to obtain such benefits, have been held to be volunteers under IRC §513(a)(1). *St. Joseph Farms, Inc.* (1985) 85 TC 9, nonacq 1986-2 Cum Bull 1. Persons who must render services to receive such benefits have been held not to be volunteers. *Shiloh Youth Revival Ctrs.* (1987) 88 TC 565.

"Material income-producing factor" requirement. The IRS takes the position that the volunteer exception applies only if the performance of services is a material income-producing factor. It has concluded that this exception does not apply to income derived from leasing various kinds of machinery for periods of 5 to 8 years with options to renew even when the limited work in finding lessees, negotiating rental agreements, and processing rental payments is performed by volunteers. Rev Rul 78-144, 1978-1 Cum Bull 168.

Scrip sales. A program administered by uncompensated persons in which an exempt organization sells scrip to be used by purchasers to buy goods or services from retailers is not an unrelated trade or business because the volunteer exception applies. IRS Letter Ruling 9704012. See IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 2000, p 278 (available at http://www.irs.gov/charities/article/0,,id=161088,00.html).

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§17.28 c. Sale of Donated Merchandise

Selling merchandise is not an unrelated trade or business if substantially all the merchandise was received as gifts. IRC §513(a)(3). A thrift shop that sells donated articles is exempt from tax even though it is separately incorporated. Rev Rul 71-581, 1971-2 Cum Bull 236.

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§17.29 d. Income From Investment Transactions Generally

Arguably, passive investment activity does not rise to the level of a trade or business. See Rev Rul 78-88, 1978-1 Cum Bull 163; compare GCM 37313 (Nov. 7, 1977) (securities "lending" transactions are not a trade or business) with GCM 39615 (Mar. 12, 1987) (stock index arbitrage activities constitute trade or business). For discussion of the tax consequences of investments by exempt organizations, see Ensminger, *Making and Getting Charitable Contributions of Derivative Securities*, 10 J Tax'n Exempt Orgs 65 (Sept./Oct. 1998) and Walker, *Investments in Derivatives Could Face Tax as an Unrelated Business*, 13 J Tax'n Exempt Orgs 259 (May/June 2002).

In any event, dividends, interest, annuities, royalties, gains, or losses from sales or exchanges of property that is neither inventory nor held for sale to customers in the ordinary course of a trade of business (see IRS Letter Ruling 200619024, stating criteria IRS will consider in deciding whether sales of real property were made in ordinary course of trade or business) and other income from investment activities are specifically excluded from unrelated business taxable income unless they are derived from debt-financed property (see §§17.45-17.58) or, in certain circumstances, are paid by a controlled entity or are deemed distributions from insurance income of controlled foreign corporations (see §17.39). IRC §512(b)(1)-(2), (4)-(5). This exclusion applies to distributions from real estate investment trusts. Rev Rul 66-106, 1966-1 Cum Bull 151. Because of these exclusions, transactions should be structured to produce one of these types of income, if possible. For example, an exempt organization's book publication and sales may result in income taxed as unrelated business taxable income, but a royalty received from licensing publication rights to a commercial publisher would not. Rev Rul 69-430, 1969-2 Cum Bull 129. However, an exempt organization's attempt to classify revenues as excluded royalty income may fail if its participation in the activities creating the income is not passive or de minimis. *Arkansas State Police Ass'n v Commissioner* (8th Cir 2002) 282 F3d 556.

Notional principal contracts. Income from notional principal contracts and other substantially similar income from ordinary and routine investments are excluded from unrelated business taxable income, to the extent determined by the IRS. Treas Reg §1.512(b)-1(a)(1). These exclusions do not apply to income earned by brokers or dealers. Gains or losses from the sale or disposition of notional principal contracts are governed by IRC §512(b)(5). Treas Reg §1.512(b)-1(a)(2). A "notional principal contract" is defined in Treas Reg §§1.446-3(c)(1) and 1.863-7(a)(1).

Options and forfeitures. Gains or losses recognized in connection with an exempt organization's investment activities from the lapse or termination of options to buy or sell securities (as defined in IRC §1236(c)) or real property and gains or losses from the forfeiture of good faith deposits for the purchase, sale, or lease of real property are excluded from unrelated business taxable income. IRC §512(b)(5).

Timber sales. The exclusion does not apply to gains or losses recognized from timber sales described in IRC §631(a). Treas Reg §1.512(b)-1(d)(1).

Securities loan payments. Income from certain securities lending transactions is excluded from unrelated business taxable income. IRC §512(a)(5), (b)(1).

Loan commitment fees. Income from loan commitment fees is excluded. IRC §512(b)(1).

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§17.30 e. Mailing List Sales

Payments received by an exempt organization from sales of its donor mailing lists have been held not to be royalty income excluded from unrelated business taxable income under IRC §512(b)(2) because that income was not derived from "passive" activities. *Disabled Am. Veterans v Commissioner* (Ct Cl 1981) 650 F2d 1178. For further discussion of the meaning of "royalty," see *Texas Farm Bureau v U.S.* (5th Cir 1995) 53 F3d 120.

The decision in *Disabled Am. Veterans v Commissioner, supra,* has been overridden in part by IRC §513(h), which provides that, if an organization is exempt under IRC §501(c)(3) and contributions to the organization are deductible under IRC §170(c)(2) or §170(c)(3), the organization will not be considered engaged in an unrelated trade or business as a result of exchanging with, or renting to, similar organizations the names and addresses of donors or members.

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§17.31 f. Mailing List Rentals, Logos, and Affinity Cards

Income from mailing list rentals. The Tax Court has held that income derived from the rental of mailing lists constitutes royalty income excluded from unrelated business taxable income under IRC §512(b)(2). *Sierra Club, Inc.,* TC Memo 1993-199 (club was tax-exempt under IRC §501(c)(4) and thus could not rely on IRC §513(h)). The court rejected the IRS's contention that this exclusion should be limited to "passive" royalties. The court reserved for trial the issue of the extent, if any, to which payments were received for services in connection with the rental of lists and from the sale of media on which the lists were furnished (*e.g.,* magnetic tapes, labels), but this issue was later resolved between the parties.

Affinity card programs. In addition, the Tax Court has held that payments received under an affinity credit card program, which allowed financial institutions to promote their credit cards through use of the Sierra Club name, were also excluded royalty income under IRC §512(b)(2). *Sierra Club, Inc.* (1994) 103 TC 307. On appeal, the court affirmed that income from renting mailing lists was excluded royalty income but reversed the decision that income from the affinity credit card program also qualified as royalty income. *Sierra Club, Inc. v Commissioner* (9th Cir 1996) 86 F3d 1526. The court defined a "royalty" as a payment for the use of intangible property that does not represent compensation for services rendered by the owner of the property. Because the Sierra Club did not perform any services with respect to the mailing lists, the income from licensing use of the lists was royalty income. The case was remanded to the Tax Court for additional consideration about whether Sierra Club rendered services for the credit card program. On remand, the Tax Court found that no part of the amounts paid to the Sierra Club represented compensation for services. Similar conclusions were reached as to mailing list rentals in *Common Cause* (1999) 112 TC 332 and *Planned Parenthood Fed'n of Am., Inc.,* TC Memo 1999-206; and as to affinity cards in *Oregon State Univ. Alumni Ass'n v Commissioner* (9th Cir 1999) 193 F3d 1098.

NOTE: As a result of the above decisions adverse to its position, the IRS will no longer assert that income received from rentals of mailing lists and affinity cards is not royalty income excluded from unrelated business taxable income under IRC §512(b)(2). See 28 Exempt Org Tax Rev 18 (Apr. 2000). However, the active involvement of an exempt organization in a business activity can result in loss of the royalty exclusion. See *Arkansas State Police Ass'n v Commissione*r (8th Cir 2002) 282 F3d 556; Light, *Denial of the Royalty Exclusion Because of Excess Participation in Arkansas State Police Ass'n v Commissioner*, 55 Tax Law 351 (Fall 2001).

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§17.32 g. Rental Income

Income from renting real property is not included in unrelated business taxable income unless it is derived from debt-financed property (see §§17.45-17.58) or, in certain circumstances, is paid by a controlled entity (see §17.68). IRC §512(b)(3). This rental exclusion is unavailable if the lessor renders services related to the rental property beyond those usually rendered in connection with the rental of space only. For example, supplying maid service with the rental of living quarters is a disqualifying service, but furnishing heat and light, cleaning public areas, and collecting trash are not. Treas Reg §1.512(b)-1(c)(5). When a university leased its stadium to a professional football team, the IRS ruled that providing field and grounds maintenance, dressing rooms, linen, and security constituted substantial disqualifying services. Rev Rul 80-298, 1980-2 Cum Bull 197. In *John W. Madden, Jr.,* TC Memo 1997-395, the provision of parking spaces, maintenance, and security did not result in loss of the rental exemption.

PRACTICE TIP: It may be possible to avoid rental income being taxable as a result of services being rendered in conjunction with the rental of real property either by demonstrating that the services were not for the convenience of the lessee or by separately charging for services. See IRS Letter Ruling 9835001.

The rental exclusion is also unavailable if the rent is set wholly or in part by reference to the income or profits realized by any person from the leased property (other than an amount based on a fixed percentage or percentages of receipts or sales). IRC §512(b)(3)(B)(ii).

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§17.33 (1) Personal Property Included

The exclusion from unrelated business taxable income is also unavailable if personal property is leased with the real property and more than 50 percent of the total rental income is attributable to the personal property. IRC §512(b)(3)(B)(i). If the rent attributable to the personal property is an incidental part (*i.e.,* no more than 10 percent of the total), the exclusion is available for both the real and personal property rents. Treas Reg §1.512(b)-1(c)(2)(ii). If the rent attributable to the personal property is more than 10 percent but less than 50 percent of the total, the exclusion is available for the real property rental but not for the personal property rental. Both the 10-percent test and the 50-percent test are applied on the lessee's initial use, on certain additions to or replacements of personal property, and on modifications of the rental price. Treas Reg §1.512(b)-1(c)(3)(iv)-(v).

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§17.34 (2) Rental for Business Operations

An exempt organization might receive a greater return by renting real property on a tax-free basis than by operating a business on the property if the income from the business would be taxable. For example, income derived by a charitable organization from operating farms and orchards is taxable as unrelated business income, but rental income from a tenant on such property is not. *U.S. v Myra Found.* (8th Cir 1967) 382 F2d 107.

Despite the foregoing, if a facility is purchased with proceeds from a private activity bond that at the time of issue purported to be a qualified IRC §501(c)(3) bond (see §18.12), and if any portion of such facility is used by a person other than an organization exempt under IRC §501(c)(3) or a government unit, then a §501(c)(3) organization owner of such portion will be treated as engaged in an unrelated trade or business with respect to such portion. The resulting rental income received by the §501(c) organization will be taxed as unrelated trade or business income. For this purpose, the owner's gross income will not be less than fair rental value, and no deduction is allowed for interest on loans financed from bond proceeds. IRC §150(b)(3).

Under California law, rental income received directly or indirectly from one tax-exempt church by another tax-exempt church for rental of exempt-function church property is excluded from unrelated business taxable income. Rev & T C §23741.

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Source: Business Law/Advising California Nonprofit Corporations/17 Taxation of Investment and Business Activities of Tax-Exempt Corporations/§17.35 h. Trade Shows, State Fairs, and Similar Activities

§17.35 h. Trade Shows, State Fairs, and Similar Activities

Certain activities relating to trade shows, state fairs, and similar events are not treated as unrelated trades or businesses. IRC §513(d).

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§17.36 i. Bingo Games and Gambling

Conducting bingo games in accordance with state or local law is not treated as an unrelated trade or business if (IRC §513(f))

- The games are of a type in which wagers are usually placed, winners determined, and prizes distributed in the presence of all persons placing wagers; and
- The games are ordinarily not conducted on a commercial basis.

If these conditions are not met, a regularly conducted gambling activity, including bingo, is an unrelated trade or business. See *Executive Network Club, Inc.,* TC Memo 1995-21. In this exception, "bingo" is defined to mean a game of chance in which numbers corresponding to preprinted numbers on a card are called according to random selection to player participants; thus, games using instant bingo cards are excluded from the definition. *Julius M. Israel Lodge of B'nai B'rith v Commissioner* (5th Cir 1996) 98 F3d 190.

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§17.37 j. Income From Research

Income from and deductions relating to research are excluded from unrelated business taxable income if the research is performed for

- Any governmental agency (IRC §512(b)(7));
- Any person by a college, university, or hospital (IRC §512(b)(8)); or
- Any person by an organization operated primarily to conduct fundamental research, the results of which are freely available to the public (IRC §512(b)(9)).

NOTE: The regulations state that "the term 'research' does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc." Treas Reg §1.512(b)-1(f)(4). The validity of the "testing" aspect of this regulation is doubtful. See H Rep No. 2319, 81st Cong, 2d Sess (1950), reprinted in 1950-2 Cum Bull 409. See also *Midwest Research Inst. v U.S.* (WD Mo 1983) 554 F Supp 1379, aff'd (8th Cir 1984) 744 F2d 635 (questioning validity of language in Treas Reg §1.501(c)(3)-1(d)(5)(ii) pertaining to "ordinary testing," which language is identical to that in Treas Reg §1.512(b)-1(f)(4)).

For a discussion about the conduct of research activities by exempt organizations, see Gilbert, *Research Technology Transfers and the Unrelated Business Tax*, 9 Exempt Org Tax Rev 1277 (June 1994); Kertz & Hasson, *University Research and Development Activities: The Federal Income Tax Consequences of Research Contracts. Research Subsidiaries and Joint Ventures*, 13 JC & UL 109 (1986).

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§17.38 k. Activities for Convenience of Persons Related to Certain Organizations

Organizations described in IRC §501(c)(3), public colleges and universities, and certain employees' associations, may carry on activities primarily for the convenience of their members, students, patients, officers, or employees without having those activities considered unrelated trades or businesses. IRC §513(a)(2). Thus, a laundry operated by a university for the convenience of its students, officers, and employees is exempt from taxation. Rev Rul 55-676, 1955-2 Cum Bull 266.

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Source: Business Law/Advising California Nonprofit Corporations/17 Taxation of Investment and Business Activities of Tax-Exempt Corporations/§17.39 I. Services Rendered Between Unrelated Hospitals

§17.39 I. Services Rendered Between Unrelated Hospitals

Fees received by one exempt hospital for rendering services to an unrelated exempt hospital are not treated as income from an unrelated trade or business if (IRC §513(e))

- The hospital receiving services has no more than 100 inpatients;
- The services would be exempt activities if performed by the hospital on its own behalf; and
- The services are provided for a fee that does not exceed the actual cost of providing the service, including straight-line depreciation and a reasonable amount for return on capital goods used to produce such services.

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§17.40 m. Insurance Income of Controlled Foreign Corporation

A United States shareholder, including an exempt organization, is deemed to receive as dividends its pro rata share of certain types of income earned by certain controlled foreign corporations. IRC §§951-954. Any such dividend income that is attributable to the writing of insurance that would have been taxed as unrelated business income if the insurance activity had been carried on directly by the exempt organization is included in unrelated business taxable income, except for dividends that are attributable to insurance issued to the tax-exempt organization, its tax-exempt affiliates, and individuals insured against risks associated with the performance of services for the exempt organization or its affiliates. IRC §512(b)(17).

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§17.41 n. Dues Paid to Agricultural and Horticultural Organizations

Annual dues not exceeding $100 (indexed for inflation) paid by members of an agricultural or horticultural organization described in IRC §501(c)(5) are not taxed as unrelated business taxable income as a result of benefits being conferred on those members by the organization. IRC §512(d). The amount is $146 for 2010. Rev Proc 2009-50, §3.24, 2009-45 Int Rev Bull 617. Subject to IRC §512(d), the IRS will treat as unrelated business income dues from associate members if the associate member category has been formed or availed of for the principal purpose of producing revenue rather than furthering the organization's exempt purposes. Rev Proc 97-12, 1997-1 Cum Bull 631.

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§17.42 o. Sales of Inventory Acquired From Certain Financial Institutions

Income from sales and mortgages of real property held primarily for sale to customers in the ordinary course of a trade or business is excluded from unrelated business taxable income if such real property was acquired under limited conditions from certain financial institutions in economic distress. Generally, for the income to be excluded, the property must be designated for sale within 9 months after its acquisition and sold within 30 months after acquisition. No more than half of property acquired in a single transaction may be so designated, and the amount spent on improvements and development may not exceed 20 percent of the net selling price. IRC §512(b)(16).

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§17.43 p. Disposition of Brownfield Properties

Gain or loss from the sale or exchange of certain narrowly defined brownfield properties (*i.e.,* environmentally damaged properties) is excluded from unrelated trade or business income. IRC §512(b)(19). This exclusion is discussed in Brewer & Hibbs, *The Brownfield Exemption from the Unrelated Business Income Tax*, 18 Tax'n Exempt Orgs 109 (Nov./Dec. 2006).

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§17.44 5. Internet Activities

Internet activities by tax-exempt organizations have attracted the attention of the IRS, which has been conducting an apparently ongoing study to determine whether such activities will result in unrelated business taxable income. Some of the issues that have troubled the IRS are identified in the IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 2000, pp 131-140 (available at http://www.irs.gov/charities/article/0,,id=161088,00.html). The IRS asked for comments on the subject in IRS Announcement 2000-84, 2000-2 Cum Bull 385.

Material published electronically. Treasury Regulation §1.513-4(b) provides that "printed material" includes "material that is published electronically," indicating that, in the opinion of the IRS, Internet activity under certain circumstances is equivalent to a periodical in which advertising can appear. For purposes of IRC §513(i), a mere hyperlink on an exempt organization's website to a sponsor's website is an acknowledgment that does not constitute a substantial return benefit to the sponsor, and payment for it is thus a qualified sponsorship payment. Treas Reg §1.513-4(f), Example 11. See §17.24. However, if there is a hyperlink to the sponsor's website where an endorsement of the sponsor's product by the exempt organization appears that was reviewed and approved by the exempt organization, this constitutes advertising. Treas Reg §1.513-4(f), Example 12.

Providing free hyperlinks. In IRS Letter Ruling 200303062, the IRS ruled that an agricultural organization exempt under IRC §501(c)(5) that provided free links on its website to the websites of third parties who provide services to its members was not engaged in an unrelated trade or business as a result of this activity, providing these links were not services that would cause a portion of the royalty payments to be taxable (see §17.31), and the sale of banner advertising on the organization's website was not advertising under Treas Reg §1.512(a)-1(f) as long as it was not included in an online periodical.

Charging fee for website listing. Revenue Ruling 2004-112, 2004-2 Cum Bull 985, involved two different situations with respect to website activities of a trade association exempt under IRC §501(c)(6). In the first situation, the association, as one of its substantial exempt activities, conducted a 10-day semiannual trade show. During that 10-day period and for the 3 days before and after, the organization added a section to its website posting information available at the trade show, links to visual exhibits, order forms, and an online purchasing arrangement. Exhibitors were charged a fee for website listings. The IRS held that these website activities constituted "qualified convention and trade show activities" and that the fees were thus excluded from unrelated business treatment by IRC §513(d)(3)(B). See §17.35.

Providing virtual trade show. In the second situation, for a 2-week period that had no connection to any actual trade show or other activity, the exempt trade association maintained a website that contained product information, displays, listings, order forms, an online purchasing arrangement, and links to the organization's members as well as to suppliers to its members. Those who listed information on the website were charged a fee. The IRS held that this virtual trade show was not a qualified convention or trade show activity and thus would have to be tested under the normal rules used to determine whether an activity is an unrelated trade or business. In the author's opinion, the trade association could make a strong argument that this activity furthered its exempt purpose and was thus not an unrelated trade or business. See §17.23.

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§17.45 D. Unrelated Debt-Financed Income

If an exempt organization derives income from debt-financed property (see §§17.46-17.49), all or part of that income may be taxed as unrelated business income (see §§17.50-17.58). IRC §514(a). This provision overrides several exceptions that would otherwise apply in determining whether an organization has unrelated business income and should be considered whenever an exempt organization borrows funds to acquire or improve an asset or acquires an encumbered asset. For example, securities purchased on margin are debt-financed property and thus part of the dividends from the securities and gains realized on their sale is taxable. *Henry E. & Nancy Horton Bartels Trust ex rel University of New Haven v U.S.* (2d Cir 2000) 209 F3d 147. Interest earned on borrowed funds is also taxed. *Kern County Elec. Pension Fund* (1991) 96 TC 845, aff'd (9th Cir 1993) 988 F2d 120. The debt-financed income rules generally apply to encumbered property received by an exempt organization as a gift or bequest as well as when an exempt organization borrows to acquire property. See §17.52. The debt-financed income rules are thoroughly discussed in two related articles: McDowell, *What You Need to Know About the Unrelated Debt-Financed Income Rules*, 14 J Tax'n Exempt Orgs 206 (Mar./Apr. 2003); McDowell & Abrams, *Applying the Unrelated Debt-Financed Income Rules to Investments in Real Property*, 15 J Tax'n Exempt Orgs 3 (July/Aug. 2003).

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§17.46 1. Debt-Financed Property Defined

"Debt-financed property" is property (1) that is held to produce income and (2) with respect to which there is acquisition indebtedness (see §§17.51-17.55) at any time during the taxable year (or, if the property is disposed of during the taxable year, at any time during the preceding 12 months). IRC §514(b)(1). Income includes nonrecurring income such as capital gains. Treas Reg §1.514(b)-1(a).

Income from a short sale through a broker is not debt-financed when borrowed funds are not used as collateral or to acquire the securities that were used to cover the short sale. Rev Rul 95-8, 1995-1 Cum Bull 107.

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§17.47 a. Property Used in Connection With Exempt Purposes

Property is not considered debt-financed property if substantially all its use is related (other than through production of income) to the exercise or performance of the organization's exempt purposes or functions. IRC §514(b)(1)(A)(i). "Substantially all its use" means at least 85 percent, measured by time or space. Treas Reg §1.514(b)-1(b)(1)(ii). Property is not considered to be debt-financed if it is acquired for use in an activity that itself is not subject to the unrelated trade or business tax by virtue of IRC §513(a)(1) (activities in which substantially all the work is performed without compensation; see §17.27), §513(a)(2) (activities for the benefit of members, students, patients, officers, or employees; see §17.38), §513(a)(3) (selling merchandise received as gifts; see §17.28), or §512(b)(7)-(9) (certain research; see §17.37).

If property owned by an exempt organization is used by a related organization, it is treated for the above purposes as if used by the organization that owns it. IRC §514(b)(2). Basis, indebtedness, income, and deductions are allocated if the property is used for one of the above purposes and also for other purposes. IRC §514(e); Treas Reg §1.514(e)-1. Real property leased to a medical clinic to accomplish the lessor's exempt purposes is not treated as debt-financed property. IRC §514(b)(1); Treas Reg §1.514(b)-1(c)(1).

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§17.48 b. Property Used in Unrelated Trade or Business

If property that would otherwise be considered debt-financed property is used in an unrelated trade or business, income from the property is already taxed as unrelated business taxable income and is thus excepted from debt-financed property to the extent of that unrelated business taxable income. This exception does not apply to gain to the extent that it is excluded from unrelated business taxable income under IRC §512(b)(5). IRC §514(b)(1)(B); Treas Reg §1.514(b)-1(b)(2)(i).

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§17.49 c. Property Near Existing Facility

Property that is purchased in the "neighborhood" of an existing facility used for an exempt purpose (*e.g.,* a hospital) and that is to be used in conjunction with that facility within 10 years is exempt from debt-financed property treatment for that 10-year period if, after 5 years, the IRS finds that the intended use will occur within that period. IRC §514(b)(3); Treas Reg §1.514(b)-1(d). This exemption applies only to land and existing buildings to be demolished and does not apply to structures erected on land after it is acquired. IRC §514(b)(3)(C); Treas Reg §1.514(b)-1(d)(3). To be in the "neighborhood," the property being acquired must be contiguous to the existing facilities or, if no contiguous property is available, within one mile of the facilities. Treas Reg §1.514(b)-1(d)(1)(ii).

For churches, the 10-year period is extended to 15 years and the property being acquired need not be in the neighborhood. IRC §514(b)(3)(E).

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2. Determining Debt-Financed Income Subject to Tax

§17.50 a. Basic Formula

Unrelated business taxable income includes part of the income from debt-financed property. This portion (not exceeding 100 percent) is determined each year by applying the ratio of that year's average acquisition indebtedness relating to the property (see §17.56) to its average adjusted basis for the year (see §17.57). IRC §514(a)(1).

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(1) What Is Acquisition Indebtedness?

§17.51 (a) General Test

"Acquisition indebtedness" generally means (IRC §514(c)(1))

- Indebtedness incurred in acquiring or improving debt-financed property; and
- Indebtedness that would not have been incurred but for the acquisition or improvement, whether it is incurred before or after the acquisition or improvement.

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§17.52 (b) Property Acquired Subject to Indebtedness

If an organization acquires property subject to a mortgage or other lien, the amount of the mortgage or lien is treated as an indebtedness incurred to acquire the property even though the organization does not assume or agree to pay the indebtedness. IRC §514(c)(2)(A). This rule applies to a property tax lien only after it has become due and payable and the owner has had an opportunity to pay it. IRC §514(c)(2)(C).

The rule does not apply to property acquired by bequest or devise during the 10-year period following acquisition, nor does it apply to property acquired by gift for the 10-year period following the gift if the donor had held the property for more than 5 years and the debt is more than 5 years old. These exceptions do not apply if the transferee assumes the debt obligation or pays for an equity interest in the transferred property. IRC §514(c)(2)(B).

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§17.53 (c) Effect of Terminating Exempt Purpose of Property

If property subject to an indebtedness ceases to be used for an exempt purpose and thus becomes debt-financed property, the debt on the property becomes acquisition indebtedness. Treas Reg §1.514(c)-1(a)(3). If property used for an exempt function is sold, indebtedness relating to that property is not paid off, and the proceeds are used to purchase debt-financed property, then the retained indebtedness becomes acquisition indebtedness with respect to the new property. Treas Reg §1.514(c)-1(a)(4).

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§17.54 (d) Exclusions

Acquisition indebtedness does not include indebtedness that is inherently incurred to further an exempt function, such as that incurred by a credit union in accepting deposits from its members. IRC §514(c)(4). It does not include an obligation to pay certain annuity contracts (IRC §514(c)(5)), nor does it include an obligation to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons to the extent insured by the Federal Housing Administration (IRC §514(c)(6)).

Organizations described in IRC §170(b)(1)(A)(ii) (educational institutions having a regular curriculum, faculty, and student body) and certain affiliates of those organizations enjoy a limited exclusion for indebtedness relating to acquisitions of real property. IRC §514(c)(9).

Acquisition indebtedness does not include indebtedness on brownfield (*i.e.,* environmentally damaged) property excluded under IRC §512(b)(8) and §514(b)(1)(E). See §17.43.

Organizations described in IRC §501(c)(25) (small trusts or corporations organized solely to invest in, hold, collect, and pay income from real property) enjoy a limited exclusion from acquisition indebtedness under IRC §514(c)(9). This exclusion may be effectively used, through the holding of interests in an organization exempt under IRC §501(c)(25), only by exempt organizations described in IRC §170(b)(1)(A)(ii) or by qualified pension trusts. IRC §514(c)(9)(F).

California law generally conforms to IRC §514. Rev & T C §23735.

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§17.55 (e) Burden of Debt Not on Exempt Organization

Debt-financed property rules might not apply if the burden of the debt falls on another entity. See Rev Rul 70-132, 1970-1 Cum Bull 138; Rev Rul 76-95, 1976-1 Cum Bull 172. For example, debt-financed property might not exist under the following set of conditions (see IRS Letter Ruling 8317126):

- An exempt organization owns unimproved, unencumbered real property;
- It leases the property to an entity that erects a building on the property;
- The funds for construction are borrowed from a lender that insists that the exempt organization's fee interest be subordinated to the deed of trust securing the lender's loan; and
- The mortgage term is less than the lease term.

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§17.56 (2) Determining Average Acquisition Indebtedness

Average acquisition indebtedness during a tax year other than a year in which the property is sold is the average of the amounts of acquisition indebtedness with respect to a property on the first day of each calendar month of that year during which the property is held. For the year the property is sold, it is the highest amount of acquisition indebtedness with respect to the property during the 12 months preceding the sale. IRC §514(c)(7); Treas Reg §§1.514(a)-1(a)(1)(v), (a)(3). If property is acquired for an indeterminate price, the initial acquisition indebtedness is its fair market value on the date of acquisition less any initial principal payment. Treas Reg §1.514(a)-1(a)(4)(iii).

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§17.57 (3) Determining Average Adjusted Basis

Average adjusted basis is the average of the adjusted bases of a property on the first day of the taxable year and the last day in the taxable year on which the property is held. Treas Reg §1.514(a)-1(a)(3)(ii). If property is acquired for an indeterminate price, its unadjusted basis is its fair market value. Treas Reg §1.514(a)-1(a)(4)(ii). In determining adjusted basis, straight-line depreciation is used and must be treated as taken for all years during which the property is held. IRC §514(a)(3); Treas Reg §1.514(a)-1(a)(2)(ii).

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§17.58 b. Offsetting Direct Expenses of Debt-Financed Property

Expenses directly connected with debt-financed property or with the income from that property are offset against the income from the property by applying the ratio of that year's average acquisition indebtedness relating to the property's average adjusted basis for the year. These expenses include straight-line depreciation and the dividends-received deductions set forth in IRC §§243-245. IRC §514(a)(2)-(3); Treas Reg §1.514(a)-1(b).

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§17.59 E. Computing Tax on Unrelated Business Income

Tax is levied on unrelated business taxable income derived by an exempt organization from any unrelated trade or business, less allowable deductions directly connected with carrying on the business, subject to certain modifications. IRC §512(a)(1).

Social clubs, voluntary employees' beneficiary associations, supplemental employment plan trusts, and group legal service plan associations may generally deduct only expenses directly connected with taxable income (see §17.60), charitable contributions (see §17.61), a $1000 specific deduction (see §17.62), and net operating losses (see §17.63). IRC §512(a)(3). They cannot take deductions under IRC §§243-245 for dividends received. *Rolling Rock Club v U.S.* (3d Cir 1986) 785 F2d 93. Other special rules apply to foreign organizations (IRC §512(a)(2)) (but California law does not have a similar position; see Rev & T C §23732) and to veterans associations (IRC §512(a)(4)).

Internal Revenue Code §448 requires C corporations with annual gross receipts of $5 million or more to use the accrual method of accounting for income tax reporting purposes. Temporary Regulation §1.448-1T(a)(3) takes the position that this requirement applies to exempt corporations and trusts with unrelated business taxable income. The $5 million test is applied to gross receipts from activities that constitute an unrelated trade or business. Temp Treas Reg §1.448-1T(f)(2). For these purposes, an exempt trust with unrelated trade or business activities is treated as a C corporation. IRC §448(c)(6).

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1. Expenses and Deductions

§17.60 a. Expenses Attributable to Unrelated Business

Expenses (including depreciation) attributable solely to unrelated business activities are chargeable against unrelated business income. Treas Reg §1.512(a)-1(b). If facilities are used both to conduct an unrelated trade or business and to carry on other activities, expenses (including administrative overhead) must be allocated between the two uses on a reasonable basis. Treas Reg §1.512(a)-1(c). Allocation of fixed overhead expenses on the basis of actual time used for the respective activities is reasonable. *Rensselaer Polytechnic Inst.* (1982) 79 TC 967, aff'd (2d Cir 1984) 732 F2d 1058 (court rejected IRS contention that fixed overhead must be allocated by ratio of hours of use over total number of hours in year).

Expenses incurred in exploiting an exempt activity, such as advertising in a magazine published to further an organization's exempt purposes, may require a special and more complex allocation. See Treas Reg §1.512(a)-1(d)-(f). See also Treas Reg §1.513-1(d)(4)(iv), Examples 5-7. For discussion of the rules applied in computing unrelated business income realized from advertising, see *American Med. Ass'n v U.S.* (7th Cir 1989) 887 F2d 760.

Social clubs exempt under IRC §501(c)(7) may offset losses from the sale of services to nonmembers against investment income only if the nonmember sales were motivated by an intention to make a profit. An exempt organization must use the same allocation method to determine whether a profit intent exists as it uses to compute its actual profit or loss. *Portland Golf Club v Commissioner* (1990) 497 US 154, 111 L Ed 2d 126, 110 S Ct 2780. A social club may deduct from advertising income the editorial expenses of a magazine distributed free of charge to its members. *Chicago Metro. Ski Council* (1995) 104 TC 341.

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§17.61 b. Charitable Deduction

A charitable deduction (IRC §170) is allowable, subject to a ceiling for corporations of 10 percent of unrelated business income. IRC §512(b)(10). An exempt trust is subject to the percentage ceilings of IRC §170(b)(1)(A)-(B) applied to its unrelated business taxable income. Distribution to a beneficiary of an exempt trust is treated as a charitable contribution if the beneficiary is an exempt organization. IRC §512(b)(11).

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§17.62 c. Specific Deduction

A specific deduction of $1000 is allowed, but it may not be taken in computing a net operating loss. Special rules allow multiple deductions for local units of certain religious organizations. IRC §512(b)(12).

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§17.63 d. Net Operating Loss

A net operating loss carryover is allowable as a deduction, but losses are only carried over to or from years in which the organization is subject to the unrelated business income tax even though all years are counted in determining the carryover period. IRC §512(b)(6).

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2. Rate of Tax

§17.64 a. Basic Rate

The corporate tax rates apply to the unrelated business taxable income of exempt organizations that are corporations. IRC §511(a)(1); Rev & T C §23731(a). The tax rates applicable to trusts apply to the unrelated business taxable income of exempt trusts. IRC §511(b)(1); Rev & T C §23731(b). For California income tax purposes, however, a trust exempt under Rev & T C §23701d is treated as a corporation. See §17.13. Income from an insurance business that is an unrelated trade or business is taxed under IRC §§801-848. See §17.19.

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§17.65 b. Alternative Minimum Tax

When an exempt organization computes its alternative minimum tax liability, the base for that tax is the organization's unrelated business taxable income. IRC §55(b)(2); Rev & T C §23455(b).

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§17.66 c. Returns and Estimated Taxes

Federal and California tax returns (IRS Form 990-T and FTB Form 109, respectively) must be filed for years in which a tax-exempt entity has unrelated business taxable income. For taxable years beginning after 2006, the public inspection and disclosure rules applicable to Form 990 are also applicable to Form 990-T. See §11.51. Federal and California estimated taxes must be paid on unrelated business taxable income. See Instructions for FTB Form 109.

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§17.67 F. Effect of Unrelated Business Income on Exempt Status

"Reasonably commensurate" concept. Unrelated business income is not only taxable; it may have a worse result. Too much of such income might prevent an organization from qualifying for exempt status. An organization will be denied an IRC §501(c)(3) exemption if it is "organized and operated for the primary purpose of carrying on an unrelated trade or business." Treas Reg §1.501(c)(3)-1(e). This limitation is often misinterpreted by incorrectly equating "activity" with "purpose." The IRS has long been applying the principle that an organization's tax-exempt status under IRC §501(c)(3) will not be jeopardized as long as it maintains an exempt program that is reasonably commensurate with its financial resources. For an organization that derived all its revenue from selling tickets to participate in a game of chance and used that income to support athletic education, its tax-exempt status was not an issue. *Education Athletic Ass'n* (1999) TC Memo 1999-75. The court held that the income was unrelated trade or business income and that the organization was a private foundation (thus exposing it to excise tax under IRC §4943 on excess business holdings; see §4.41).

In IRS Letter Ruling 9711003, exemption was not denied when over 95 percent of an organization's income was derived from a nonexempt activity, because its primary purpose was charitable. Applying the commensurate concept, the IRS did not revoke the IRC §501(c)(3) exempt status of an organization whose sole activities were conducting bingo games not subject to unrelated business income tax and distributing profits to other charitable organizations. The rationale for the commensurate concept is discussed in Troyer, *Unrelated Trade or Business: Current Developments and Amount of UBIT Compatible with Charitable Exemption*, 20 NYU Conf on Tax Planning for 501(c)(3) Organizations §§10.03-10.06 (1992). For a discussion of the erratic way in which this concept has evolved, see Siegel, *Commensurate in Scope: Myth, Mystery or Ghost? (Part One)*, 20 Taxation of Exempts 26 (Nov./Dec. 2008) and *(Part Two)*, 20 Taxation of Exempts 8 (Jan. 2009). See also Hill & Mancino, *Taxation of Exempt Orgs* ¶21.03[1][a] (2002).

It is not known if and to what extent the IRS will apply the commensurate concept to exempt organizations other than those described in IRC §501(c)(3). The IRS has demonstrated that it will not employ that concept in deciding whether a labor organization qualifies for exemption under IRC §501(c)(6). See *Associated Master Barbers & Beauticians* (1977) 69 TC 53 (involving IRC §501(c)(6) organization).

When concept inapplicable. This concept, however, may not be applied by the IRS when an organization obtains its IRC §501(c)(3) exemption under the "integral part" theory as a result of its close relationship with another such organization. GCM 39684 (Dec. 10, 1987).

Business leagues. Exempt status under §50l(c)(6) can be lost as a result of too much unrelated business taxable income. Unfortunately, however, there is no definitive test for determining how much is too much. Treasury Regulations pertaining to §50l(c)(6) organizations provide as follows (Treas Reg §1.501(c)(6)-1):

> A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of kind ordinarily carried on for profit… An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self sustaining, is not a business league.

Thus, there is an initial question of whether an organization's purpose is to "engage in a regular business of a kind ordinarily carried on for profit." Some courts have found that a business operation that is only "incidental" to a §501(c)(6) purpose will not result in loss of exemption. See *Retailers Credit Ass'n v Commissioner* (9th Cir 1937) 90 F2d 47. A review of authorities reveals no bright-line test for how much unrelated business taxable income is too much. See Hill & Mancino, *Taxation of Exempt Organizations*, 14.02[10] (2002).

Social clubs. Social clubs are subject to limitations on nonmember income. See IRC §501(c)(7); Rev Proc 71-17, 1971-1 Cum Bull 683; S Rep No. 94-1318, 94th Cong, 2d Sess (1976), reprinted in 1976 US Code Cong & Ad News 6051; Internal Revenue Manual 4.76.16, Social and Recreational Clubs (Apr. 1, 2003); IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 1995, p 74 (available at http://www.irs.gov/charities/article/0,,id=161088,00.html).

Title-holding organizations. By their very nature, title-holding organizations exempt under IRC §501(c)(2) or §501(c)(25) are limited in the extent to which they may engage in a trade or business other than holding title to property and collecting income from it, and the only property that an IRC §501(c)(25) organization may hold is real property. An IRC §501(c)(2) organization may have unrelated business taxable income consisting of debt-financed income (see §17.45), income received from controlled entities (see §17.68), and rents from personal property leased with real property (see §17.32). Treas Reg §1.501(c)(2)-1. Internal Revenue Code §§501(c)(2), (c)(25) organizations may receive unrelated business taxable income that would otherwise result in loss of exempt status of up to 10 percent of gross income for any taxable year as long as it is incidentally derived from the holding of real property. Exemption will be lost to such an organization if disqualifying unrelated business taxable income exceeds 10 percent of gross income unless the IRS is convinced that the receipt of such income was inadvertent and the organization takes steps to prevent a recurrence. IRC §501(c)(25)(G).

Commercial type insurance providers. An organization cannot qualify if a substantial part of its activities consists of providing "commercial type" insurance. IRC §501(m).

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§17.68 VI. OPERATING BUSINESS THROUGH ANOTHER ENTITY—CONTROLLED ENTITIES

Tax classification of other entity. Rather than carrying on a business as a proprietorship, a tax-exempt corporation may decide to control or own all or a part of that business through another entity that under state law is a corporation, a partnership, or a limited liability company. The tax status of an entity other than a corporation is determined under the income tax laws and not state corporate, partnership, or limited liability company laws. For example, a limited partnership could be taxed as a corporation. This tax status will control how income distributable to or received by an exempt corporation from such an entity is taxed to the exempt corporation. In addition, the tax liability of the other entity may be affected by the ownership of an interest in the entity by an exempt corporation. Therefore, if a choice of tax classification is available, the tax consequences should be carefully weighed before choosing. See ABA Panel Discussion, *The Intended and Unintended Effects of the Check-the-Box Regulations on Tax-Exempt Organizations*, 17 Exempt Org Tax Rev 46 (July 1997); Fritz, *Structuring Joint Ventures Between for Profit and Nonprofit Organizations*, 9 J Tax'n Exempt Orgs 259 (May/June 1998).

Taxation of income from other entity. Despite the general exclusion of interest, annuities, royalties, and rent from unrelated business taxable income, if an exempt organization receives or accrues any such income directly or indirectly from a controlled organization, that income will be partially or entirely included in the unrelated business taxable income of the controlling organization to the extent that it reduces the net unrelated income or deemed unrelated net income (or increases any net unrelated actual or deemed loss) of the controlled entity. IRC §512(b)(13). Expenses incurred by the controlling organization that are directly connected to such income may be deducted.

If the controlled entity is tax-exempt, its net unrelated income is the amount of its unrelated business taxable income. If the controlled entity is not tax-exempt, its net unrelated income is considered to be that portion of its income that would be unrelated business taxable income if it were tax-exempt and had the same exempt purposes as the controlling organization.

NOTE: "Control" means ownership (by vote or value) of more than 50 percent of the stock of a corporation, the profits or capital interests of a partnership, or the beneficial interests of any other entity.

The constructive ownership rules of IRC §318 apply so that an exempt organization may be considered to own stock and other interests not only directly but also indirectly through others.

Effect of PPA. The Pension Protection Act of 2006 (PPA) (Pub L 109-280, 120 Stat 780), as amended by Pub L 110-343, §306(a), 122 Stat 3765, has temporarily modified the rules with respect to payments received or accrued by a controlling corporation after December 31, 2005, and before January 1, 2009, when the payments are made under a contract in effect on Aug. 17, 2006 (the date the PPA was enacted) or a contract renewed on substantially similar terms. Pursuant to the PPA revision, the rules discussed above apply only to the portion of such a payment received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the payment had been determined under the principles of IRC §482. IRC §512(b)(13)(E)(i). Generally stated, §482 allows the IRS to reallocate income, deductions, and other items arising as a result of transactions between related organizations on the basis of fair market values determined by market analyses. For example, if a controlled tax-exempt corporation paid rent to a controlling tax-exempt organization, only the amount of the rent that exceeded fair rental value would be taxable as unrelated business income under the modified rule. However, there is an additional 20-percent tax on the lower of (1) such excess determined without regard to any amendment or supplement to a return of tax or (2) such excess determined with regard to all amendments and supplements. IRC §512(b)(13)(E)(ii).

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§17.69 A. Operating Through Corporations

Dividend income, interest, annuities, royalties, and rent, except for certain deemed distributions of insurance income from a controlled foreign corporation (see §17.40) and except to the extent that the controlled entity rules (see §17.68) apply, and subject to the debt-financed property rules (see §§17.45-17.49), are excluded from unrelated business taxable income.

Income received by one exempt corporation as a result of rendering services or selling goods to another exempt corporation is not taxable to the former if both corporations are part of a controlled group. Treas Reg §1.502-1(b); Rev Rul 68-26, 1968-1 Cum Bull 272.

Distributions to an exempt organization by a taxable corporation controlled by the exempt organization are dividends, not charitable contributions deductible to the distributing corporation. *Dave Inv. Co.,* TC Memo 1970-291 aff'd (9th Cir 1972) 462 F2d 1373; *Richardson Carbon & Gasoline Co. v U.S.* (5th Cir 1969) 416 F2d 867; *U.S. v Knapp Bros. Shoe Mfg. Corp.* (1st Cir 1967) 384 F2d 692.

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§17.70 1. S Corporations

An organization exempt under IRC §501(c)(3) may be a shareholder in an S corporation without terminating the S status of that corporation. IRC §1361(c)(6). All income realized by a §501(c)(3) organization as a result of its being a shareholder of an S corporation is taxable as unrelated business taxable income even if the income consists of dividends, royalties, interest, rents, and capital gains earned by the S corporation.

Gains and losses realized by an exempt organization on the sale of an S corporation's stock are also taxable as unrelated business taxable income. In these situations, it could be preferable for an IRC §501(c)(3) organization to be a partner in a partnership, rather than a shareholder of an S corporation, because dividends, interest, royalties, some rents, and capital gains passed through a partnership to a exempt corporation partner are not taxable unless they are derived from debt-financed property. See §17.73.

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§17.71 2. Liquidation and Reorganization of Taxable Subsidiary Corporation

No gain or loss is recognized to a subsidiary corporation on its distribution of property in liquidation into a parent corporation owning at least 80 percent of the subsidiary's stock. IRC §337(b)(2). However, if the parent corporation is tax-exempt, this general rule does not apply unless the parent immediately uses the property in an unrelated trade or business. If the parent does so, it will realize taxable gain when it later disposes of the property or ceases to use it in an unrelated trade or business. The amount of that taxable gain will be the gain that would have been realized when the subsidiary was liquidated had a tax applied at that time.

Subject to certain exceptions or limitations applicable to homeowners' associations exempt under IRC §528, mutual or cooperative companies exempt under IRC §512(c)(12), political organizations described in IRC §527, social clubs exempt under IRC §512(c)(7), and property and casualty insurance companies exempt under IRC §512(c)(15), a taxable corporation will recognize gain or loss if it transfers all or substantially all its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity. Treas Reg §1.337(d)-4. This lays a potential trap for an exempt organization that is considering operating an unrelated trade or business through a taxable subsidiary. For example, if a taxable subsidiary operates a hotel, a tax will be paid on any capital gains realized by it when it disposes of the hotel. Had the exempt parent itself owned and operated the hotel, it would have paid no tax on gain from the sale except to the extent of any debt-financed income. For a discussion of debt-financed income, see §§17.45-17.49.

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§17.72 3. Attributing Activities of Taxable Corporation to Exempt Organization

Ownership of equity interest. An exempt organization's mere ownership of a controlling equity interest in a taxable corporation will not jeopardize the tax-exempt status of the exempt organization. Over the years, the IRS has issued hundreds of rulings recognizing this fact. The only ways that such a relationship might have an adverse impact on the exempt organization is as a result of either treating revenue received by it from the subsidiary as unrelated business taxable income (see §17.68) or ignoring the separate status of the subsidiary and treating all or a part of its activities as being carried on directly by the exempt organization.

Activities of subsidiary. The IRS position is that the activities of a taxable subsidiary are not usually attributed to its exempt parent "unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent." GCM 39326 (Jan. 17, 1985). According to the IRS, factors to be analyzed include the following (GCM 39598 (Jan. 23, 1987); IRS Letter Ruling 8530132):

- The existence of a bona fide business purpose of the subsidiary;
- The degree to which the subsidiary is managed by an independent board of directors;
- The parent's involvement in the subsidiary's daily operation; and
- Whether transactions between the parent and the subsidiary are at arm's length.

(The IRS has ruled favorably in circumstances in which there could be an overlap of directors and officers. See IRS Letter Rulings 8805059, 8743070.) Such warnings reflect the IRS's concern that exempt organizations, acting through taxable subsidiaries, might be doing indirectly what they may not do directly.

Author's perspective. In the author's opinion, the IRS pronouncements threatening to ignore the separate status of subsidiary organizations are for the most part in terrorem statements lacking substance. It has been historically and consistently held that the separate existence of a corporation may not be ignored under the tax laws as long as the corporation has a business purpose or activity and is not acting as an agent for another. See *Moline Props. v Commissioner* (1943) 319 US 436, 87 L Ed 1499, 63 S Ct 1132; *Britt v U.S.* (5th Cir 1970) 431 F2d 227, 234. See also *Commissioner v Bollinger* (1988) 485 US 340, 99 L Ed 2d 357, 108 S Ct 1173. Therefore, even if there are common directors and officers, the IRS cannot legally attribute the activities of a taxable subsidiary to an exempt parent if (a) there is an actual business purpose or activity of the subsidiary, (b) dealings between the parent and the subsidiary are at arm's length and are properly documented and accounted for, and (c) the activities at issue are carried on by the subsidiary on its own behalf rather than as agent for its parent. The IRS recognizes the great difficulty in ignoring a corporate entity (GCM 39326 (Jan. 17, 1985), quoting GCM 35719 (Mar. 11, 1974)):

> To disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or a finding of a true agency or trust relationship between the entities.
>
> Thus, the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent. This is an evidentiary burden that is not easily overcome.

To the author's knowledge, in only two cases has the IRS successfully denied exemption because of the activities of a for-profit subsidiary, and in the author's opinion these are anomalies. *Orange County Agric. Soc'y,* TC Memo 1988-380, aff'd (2d Cir 1990) 893 F2d 529; *Greater United Navajo Dev. Enters.* (1980) 74 TC 69, aff'd without published opinion (9th Cir 1981) 672 F2d 922. However, the IRS has considered the activities of a for-profit subsidiary in revoking an organization's §501(c)(3) status. IRS Letter Ruling 200842050.

Although the IRS may not be able to attribute a subsidiary's activities to an exempt parent under some type of alter ego theory, it may be able to attribute a particular activity to the parent if the subsidiary is acting as a mere conduit for or agent of the parent. Representatives of the IRS have warned that, if a taxable subsidiary acts as an agent or conduit for an exempt parent, it may deny the exempt status of the latter:

> [T]he use of a wholly owned subsidiary of the [exempt] hospital to act as a general partner will not insulate

the hospital from the partnership's activities if the facts establish that the hospital has used its control over the subsidiary to benefit private individuals.

Griffin & Harvey, *Service Perspective on the Current Charitable Scene: Service Official "Tells It Like It Is,"* 14 NYU Biennial Conf on Tax Planning for Charitable Sector 3-1, at 3-19 (1985). At the same time, the IRS will not ignore the separate existence of a subsidiary that clearly acts independently. For example, the IRS Chief Counsel did not impute the political and legislative activities of a taxable subsidiary operating a newspaper to its exempt parent because the subsidiary was acting independently, not merely as a guise to enable the parent to carry out activities prohibited by IRC §501(c)(3). GCM 33912 (Aug. 15, 1968). See also GCM 39598 (Jan. 23, 1987), as modified by GCM 39646 (June 30, 1987), in which the Chief Counsel refused to recommend revocation of a parent organization's exempt status as a result of a subsidiary's nonexempt activities because there was no evidence that the subsidiary was acting as a mere conduit to pass funds from an exempt hospital through the subsidiary to physicians and thereby avoid the inurement prohibition.

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§17.73 B. Operating Through Partnerships

Subject to controlled entity rules. Interest, annuities, royalties, and rent paid to an exempt organization by a partnership are subject to the controlled entity rules. See §17.68. Otherwise, an exempt organization's distributive shares of partnership income, losses, and deductions are treated as though it had earned or incurred them directly. Each such item must be examined separately under the rules in this chapter to ascertain whether the exempt organization would have realized unrelated trade or business income had it carried on the partnership activity that generated the income, loss, or deduction. IRC §512(c). It is apparently the position of the IRS that distributions from a publicly traded partnership will be treated in this manner even though the partnership is taxed as a corporation. Internal Revenue Manual 7.27.6.8 (Feb. 23, 1999). A "publicly traded partnership" is defined in IRC §7704 as a partnership whose interests either are traded on an established securities market or are readily traded on a secondary market. See Buckles, *Publicly Traded Partnerships and Unrelated Business Taxable Income*, 53 Tax Law 129 (Fall 1999) (criticizing this position).

Types of partnerships not distinguished. No distinction is made between general and limited partnerships under IRC §512(c). *Service Bolt & Nut Co. v Commissioner* (6th Cir 1983) 724 F2d 519, 523. The court in *Service Bolt & Nut* rejected the arguments of exempt profit-sharing trusts that had invested as limited partners that their partnership interests should not be characterized as businesses but should be treated as investments because the trusts did not participate in the management of the partnership and their liability was limited to their capital contributions. See also *Leila G. Newhall Unitrust* (1995) 104 TC 236, aff'd (9th Cir 1997) 105 F3d 482.

Leased property. If a partnership leases property to a tax-exempt entity or has a partner that is a tax-exempt entity, the depreciation deduction claimed by the lessor partnership may be restricted. IRC §168(h).

Organization as partner. The exempt status of an organization participating in a partnership will not be jeopardized if such participation furthers the organization's exempt purposes and allows the organization to act exclusively for such purposes and not to benefit nonexempt partners. *Plumstead Theatre Soc'y, Inc.* (1980) 74 TC 1324, aff'd (9th Cir 1982) 675 F2d 244; GCM 39005 (Dec. 17, 1982). In Rev Rul 98-15, 1998-1 Cum Bull 718, the IRS describes its method of determining whether the criteria of *Plumstead* have been met. In *Housing Pioneers, Inc.,* TC Memo 1993-120, aff'd (9th Cir 1995) 49 F3d 1395 and *Redlands Surgical Servs.* (1999) 113 TC 47, aff'd (9th Cir 2001) 242 F3d 904, the courts concluded that the partnerships impermissibly served private purposes. See also *St. David's Health Care Sys. v U.S.* (5th Cir 2003) 349 F3d 232, which appears to adopt a requirement that the exempt organization partner must control the partnership to ensure that private purposes are not being inappropriately served. For further discussion, see Griffith, *Redefining Joint Venture Control Requirements: St. David's vs. Goliath?*, 37 Exempt Org Tax Rev 255 (Aug. 2002). In Rev Rul 2004-51, 2004-1 Cum Bull 974, the IRS attempted to provide guidance on this issue. But this ruling has been criticized in J. Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground in Housing*, 47 Exempt Org Tax Rev 21 (Jan. 2005).

Transactions with borrowed funds. An exempt organization may have debt-financed income if it purchases an interest in a partnership with borrowed funds or if the partnership invests with borrowed funds. Treas Reg §1.514(c)-1(a)(2), Example 4; Rev Rul 74-197, 1974-1 Cum Bull 143; IRS Letter Ruling 9651001. See §§17.45-17.49. Under some circumstances, taxation of income received from an investment in a limited partnership under the debt-financed income rules due to the partnership borrowing funds can be avoided if the partnership is an offshore entity that elects under United States tax laws to be treated as a corporation and is located in a tax haven that imposes no taxes on the entity. See Daher, *Can a "Blocker" Entity Take the "Debt-Financed" Out of Investment Income?*, 17 J Tax'n Exempt Orgs 46 (July/Aug. 2005).

Exception to acquisition indebtedness. Acquisition indebtedness does not include indebtedness incurred after October 22, 2004, by a partnership that is a small business investment company licensed after that date, which indebtedness is evidenced by a debenture issued by that company under the Small Business Investment Act of 1958 §303(a) and held or guaranteed by the Small Business Administration. This exclusion, however, does not apply during any period that (IRC §514(c)):

- Any exempt organization (other than a governmental unit) owns more than 25 percent of the capital or profit interest in the small business investment company; or
- Exempt organizations (*including* governmental units other than an agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in that company.

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§17.74 C. Limited Liability Companies

A limited liability company with more than one member is classified as either a corporation or a partnership under the income tax laws; if it only has one member, it is classified as either a corporation or as a proprietorship. The classification establishes which unrelated business taxable income rules will apply. Therefore, the rules in §§17.69-17.72 will apply if treated as a corporation, those in §17.73 will apply if treated as a partnership, and those in §§17.12-17.67 will apply if treated as a proprietorship.

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§17.75 VII. INVESTMENTS IN TAX SHELTERS

A tax-exempt organization that participates in certain transactions designated as tax shelters may be required to disclose its participation to the IRS under IRC §6011 or §6033(a)(2), *or both*. Failure to do so may result in significant penalties. In addition, IRC §4965 imposes excise taxes on tax-exempt organizations described in IRC §501(c)-(d) that are parties to prohibited tax shelter transactions and in some situations imposes excise taxes on managers of such entities who are also parties to prohibited tax shelters. See §17.77.

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§17.76 A. Disclosure Under IRC §6011

"Reportable transactions" defined. Under authority granted to it in IRC §6011, the Treasury Department has promulgated regulations requiring persons filing tax returns to file statements with the IRS disclosing participation in certain tax shelters described as "reportable transactions." The regulations apply to tax-exempt entities as well as taxable entities and individuals. An exempt organization may participate in such transactions to avoid or reduce tax on unrelated business tax income or an excise tax or to enable others to claim tax benefits. The term "reportable transaction" includes (Treas Reg §1.6011-4(b); Prop Reg §1.6011-4(b)(7)):

- A "listed transaction," which is the same or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and has been so identified by notice, regulation, or other IRS published guidance;
- A transaction that has been offered to a taxpayer under conditions of confidentiality and for which a taxpayer has paid an advisor a specified minimum fee;
- A transaction whereby others contract with a taxpayer to refund fees if all or part of the intended tax consequences from the transaction are not realized, or fees to be paid by a taxpayer are contingent on the taxpayer's realization of tax benefits from the transaction;
- Certain transactions that enable a taxpayer to claim a loss under IRC §165;
- A transaction that is substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other published guidance as a "transaction of interest"; and
- Either (1) a transaction for which a taxpayer, directly or indirectly, pays a fee in any amount to a patent holder or the patent holder's agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent, or (2) a transaction for which a taxpayer as a patent holder or a patent holder's agent has the right to payment for another person's use of a tax planning method that is the subject of the patent.

Reporting procedure. Reportable transactions must be reported to the IRS on IRS Form 8886. Normally, Form 8886 must be filed with a taxpayer's regular tax return or any amended return and within the time period allowed for filing those returns.

Penalties. There are significant penalties for failure to timely disclose under §6011. IRC §6707A. The penalty with respect to a listed transaction is $100,000 for an individual and $200,000 in any other situation. The penalty for failure to disclose any other reportable transaction is $10,000 for an individual and $50,000 in any other situation.

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§17.77 B. IRC §4965 Excise Taxes

When imposed. A tax is imposed under IRC §4965 on a tax-exempt entity for any taxable year in which it becomes a party to a prohibited tax shelter transaction and for any subsequent taxable year that it continues to be a party. This tax applies even if the transaction was entered into before May 17, 2006, when §4965 became effective. A tax is also imposed on a tax-exempt entity in any taxable year that it is a party to a subsequently listed transaction. IRC §4965(a)(1)(B). This tax applies whether or not the tax-exempt entity knew or had reason to know that it was a party to a prohibited transaction.

"Prohibited tax shelter transactions" include listed transactions, confidential transactions, and transactions with contractual protection that are reportable transactions described in §17.76. IRC §§4965(e)(1), 6707A(c). A "subsequently listed" transaction is one that the IRS published as a listed transaction after a tax-exempt entity became a party to the transaction, if the transaction was not a prohibited reportable transaction when the entity became a party. IRC §4965(e)(2).

Calculating tax. Generally, the tax on a tax-exempt entity for a particular year is the amount obtained by multiplying the highest corporate tax rate by the greater of (IRC §4965(b)(1)(A)):

- The entity's net income from the transaction for that year, or
- 75 percent of the proceeds received from the transaction by the tax-exempt entity for that year.

However, if the tax-exempt entity knew or had reason to know that it was entering into a prohibited transaction, the penalty will be the greater of 100 percent of the entity's net income from the prohibited transaction, or 75 percent of the proceeds from the prohibited transaction. Net income will be adjusted with respect to a subsequently listed transaction. IRC §4965(b)(1)(B). For this purpose, "any amount that is a gift or a contribution to a tax-exempt entity and is attributable to a prohibited tax shelter transaction will be treated as proceeds." Prop Treas Reg §53.4965-8(b)(2)(iii).

Tax imposed on managers who approve transaction. An excise tax of $20,000 is imposed on any manager of a tax-exempt entity who approves of the entity's participation in a prohibited tax shelter transaction if the manager knew or had reason to know that it was a tax shelter transaction. IRC §4965(a)(2), (b)(2). The tax applies separately to each approval or other act causing the participation. A "manager" is a person with authority similar to that exercised by an officer or director and with authority to approve a transaction or cause the entity to be a party to a transaction. IRC §4965(d).

A tax-exempt entity or a manager that is liable for §4965 tax must report the tax liability on IRS Form 4720.

An excellent discussion of §4965 is presented in Hill & Mancino, *Exempt Orgs. and Tax Shelters: The 4965 Prop. Regs. Reflect Interests of Many Interested Parties*, 107 J of Tax 359 (Dec. 2007).

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§17.78 C. Disclosure Under IRC §6033(a)(2)

A tax-exempt entity must disclose to the IRS that it is a party to a prohibited tax shelter transaction subject to tax under IRC §4965, and must provide the identities of other participating parties known to the tax-exempt entity. IRC §6033(a)(2). The required disclosure is made on IRS Form 8886-T. The penalty for each failure to disclose is $100 per day, not to exceed $50,000 with respect to any one disclosure. However, for organizations with gross receipts of $1 million or less, the penalty is $20 per day, not to exceed the lesser of $10,000 or 5 percent of the organization's gross receipts for the year. IRC §6652(c)(1)(A)(ii). If a manager of a tax exempt entity fails to make the required disclosures after a demand by the IRS, an additional penalty of $10 applies per day, up to $5000 for any one disclosure, pending compliance with the demand. IRC §6652(c)(1)(B)(ii).

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18

Tax-Exempt Financing for Nonprofit Corporations

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§18.1 I. SCOPE OF CHAPTER

This chapter contains a general discussion of tax-exempt financing for nonprofit corporations, including the authority of nonprofit corporations to borrow (see §18.2-), as well as the parties involved in tax-exempt financing (see §§18.5-18.10). The chapter also addresses:

- The types of nonprofit corporations that can undertake such financings (see §18.12);
- Requirements and restrictions imposed by the Internal Revenue Code and other applicable laws (see §§18.14-18.30);
- Securities law requirements (see §§18.31-18.32) and state bond requirements (see §18.33);
- Typical tax-exempt financing structures (see §§18.34-18.42);
- The financing process (see §§18.43-18.53); and
- Corporation counsel's role during the course of a financing (see §§18.45-18.59).

A primary focus of this chapter is federal tax law. Unlike the Internal Revenue Code, California tax law imposes few requirements for a state tax exemption for government-issued debt, even when the proceeds of that debt are loaned by the governmental entity to a nonprofit corporation. Interest on bonds issued by state and local governments is specifically exempted from personal income tax regardless of source of payment or type of improvements financed. Rev & T C §17133.

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§18.2 II. CORPORATE POWER TO BORROW

Nonprofit corporations have the power to incur indebtedness, subject to any restrictions in their articles of incorporation or by-laws, just as their for-profit counterparts do.

Certain nonprofit corporations also have the ability to borrow on a tax-exempt basis through a governmental entity. In such a financing, the governmental entity issues debt and lends the money raised to the nonprofit corporation, usually at or close to the same interest rate. The interest earned on the governmental entity's debt instruments is not included in the bondholders' income for either federal or state income tax (but is usually exempt only in the state where the governmental entity is located). Tax-exempt financing can be a great advantage for a nonprofit borrower. Investors generally accept lower interest rates on tax-exempt obligations because the interest income is not taxed. Compared with conventional borrowing, however, the increased complexity of this type of financing means that the borrower incurs greater initial costs. Consequently, tax-exempt financing is most cost effective only for multimillion dollar projects.

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§18.3 A. Terminology

In this chapter, the governmental entity involved in a tax-exempt financing (sometimes called tax-exempt conduit financing) will be referred to as the "issuer." See §18.6. The nonprofit corporation that is the beneficiary of the financing will be referred to as the "corporation." The obligations of the issuer that bear tax-exempt interest, which may be in the form of bonds, notes, or installment sale payments, will be referred to as "bonds." The independent counsel retained to prepare the documents and related resolutions, and render an opinion on the validity and tax-exempt status of the bonds, is referred to as "bond counsel." See §18.8.

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§18.4 B. Other Sources of Information

For counsel wishing a more in-depth treatment of certain aspects of tax-exempt financing described in this chapter, several useful sources are available: The National Association of Bond Lawyers (NABL) publishes material used in connection with various annual workshops and conferences. The 2009 Fundamentals of Municipal Bond Law may provide the best overview of the whole topic of municipal finance, and the materials collected for annual Bond Attorneys' Workshops and conferences on arbitrage may also be helpful to a practitioner. For the NABL website, see http://www.nabl.org. See also Gelfand, State & Local Government Debt Financing (1986).

For more information on the application of federal securities laws to tax-exempt debt, see Fippinger, The Securities Law of Public Finance (2d ed 1993).

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§18.5 III. PARTIES TO A TAX-EXEMPT FINANCING

In many financings, there are two parties, the borrower and the lender. If the financing involves a sale of debt or equity securities to the public, several additional parties are usually involved, including an underwriter who purchases the bonds from the issuer and offers the bonds for sale to investors. Often in a debt financing the investors are represented by a trustee under an indenture of trust or a trust agreement (see §18.9).

Issuer and bond counsel. In a tax-exempt financing, the issuer and an independent counsel, known as bond counsel, are added to this mix. Bond counsel is a specialist retained to prepare the documents and related resolutions, and render an opinion on the validity and tax-exempt status of the bonds. In addition, depending on the structure of the financing, there may be a provider of credit enhancement (often a bond insurer or a bank that provides a letter of credit). Some bond structures use swaps and other hedge devices. In those transactions, a swap counterparty is involved and perhaps a swap advisor that provides independent advice to the corporation regarding the swap structure and pricing. A more complete description of these parties is in §§18.6 and 18.8.

Corporate counsel. The parties typically engage their own counsel to protect their respective interests. The corporation's counsel plays a vital role in providing certain opinions and managing the legal risks to the corporation. See §§18.54-18.59.

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§18.6 A. Issuer

Statewide financing authorities. The identity of the bond issuer depends on the location of the project to be financed, the type of project, and the powers and policies of a particular issuer. Statewide authorities, such as the California Health Facilities Financing Authority, the California Infrastructure and Economic Development Bank (see http://www.ibank.ca.gov/), and the California Educational Facilities Financing Authority (see http://www.treasurer.ca.gov/cefa/), exist primarily to assist qualified institutions to obtain tax-exempt financing.

Municipalities and local agencies. Specialized financing authorities are not the only eligible issuers. Municipalities and/or other local agencies in whose jurisdiction the financed facilities are to be located can often be persuaded to participate in a financing, although state law must be consulted to ascertain whether they have the power to enter into the type of financing contemplated. Certain cities that have "home rule" power under the California constitution, depending on their charter provisions, have the power to issue revenue bonds for the benefit of corporations (*e.g.,* the City of Glendale has adopted the City of Glendale Health Facility Revenue Bond Law to assist healthcare institutions within city boundaries to obtain tax-exempt financing).

Joint powers authority. In addition to state and local agencies, a third type of issuer, common in California, is a "joint powers authority," which is formed by two or more political subdivisions to pool their powers for a common purpose. Govt C §§6500-6599.3. Several such joint powers authorities, *e.g.,* the California Statewide Communities Development Authority (see http://www.cacommunities.org/) and the Association of Bay Area Governments (see http://www.abag.ca.gov/), have been formed to facilitate financings for projects on behalf of corporations.

Restrictions on issuers. Many issuers, particularly those who frequently undertake financings, are constrained by policies adopted by their governing boards. For example, issuers may have credit requirements that prevent them from issuing bonds that are not rated with the three highest rating categories by a nationally known rating agency. This is a high credit threshold for many nonprofit corporations, which partly explains the use of credit enhancement in connection with bonds for nonprofit corporations. See §18.10.

The issuer's role. Although primarily limited to issuing the bonds, some issuers actively monitor use of proceeds and compliance with covenants after the bonds are issued. An issuer in any tax-exempt conduit financing, whether for an IRC §501(c)(3) organization or a for-profit corporation, is typically obligated to pay the interest and principal of the bonds only to the extent that it receives payments from the beneficiary (*e.g.,* the borrower of the proceeds) of the financing. The financing documents and the disclosure document distributed to the investors explicitly state that the issuer is not liable for paying the bonds, except from the specified source of payments. The reasons are as follows:

- The structure of the financing, which is really a borrowing by the nonprofit corporation using the issuer as a conduit to obtain the benefit of tax-exempt financing; and
- Constitutional debt limitations in Cal Const art XVI, §18, which prohibit issuers from incurring debt that is not approved by the voters unless the debt is payable from special funds.

Thus, another condition for a tax-exempt conduit financing is that the issuer's credit not be involved.

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§18.7 B. Purchaser or Underwriter

Many tax-exempt financings are arranged by the lender or the purchaser of the bonds. Although the initial purchaser may hold bonds for its own account, it often underwrites the issue, reselling the bonds to other investors.

Underwriters. An underwriter plays a crucial role in structuring the financing, locating an issuer, and assisting in obtaining credit enhancement. The underwriter typically retains counsel, who ordinarily takes primary responsibility for preparing the disclosure document, referred to as the "official statement," as well as the contract among the issuer, the corporation, and the underwriter, referred to as the "bond purchase contract," which provides for the purchase of the bonds by the underwriter and describes who bears the costs and risks associated with a public offering of the bonds.

Financial advisors. Although the underwriter often provides financial advice to the corporation, some issuers and corporations seek advice from an independent financial expert because an underwriter's compensation is almost always contingent on issuing the bonds. This financial expert is referred to as a "financial advisor." The financial advisor assists with structuring the financing and provides an independent check on the pricing of the bonds.

Private placement. Bonds may also be privately placed, that is without an underwriter. Private placement issuances are defined as the placement of bonds directly with one investor (or a very limited number of investors) rather than through an underwriter to the broader market.

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§18.8 C. Bond Counsel

Bond counsel's role. For historical reasons related to municipal bond defaults in the 19th century, the practice has grown in this country of using counsel independent of an issuer to approve an issuer's proceedings in connection with the bond issuance, so that bondholders are assured that the bonds are valid under state law. As a result of this practice, bond counsel now:

- Takes responsibility for drafting the legal documents and resolutions (see §§18.48-18.49) for the issuer;
- Structures the issuance to qualify interest on the bonds for exemption from income tax; and
- Opines that the bonds are valid and that interest on the bonds is exempt from federal and state income taxes.

The documents normally prepared by bond counsel include the indenture or trust agreement that sets forth the rights of the bondholders and the duties of the issuer and the loan agreement (or the lease or sale agreement) that specifies the duties of the corporation, including the payment of principal and interest on the bonds, and related security agreements.

Representation issues. The role of bond counsel and whom bond counsel represents are often the subject of debate. Bond counsel's expertise is important to many parties:

- The corporation, because bond counsel renders advice on the numerous restrictions under state and federal law that affect the financing;
- The issuer, because bond counsel prepares the form of the bonds and related agreements and advises the issuer on state and federal law requirements to ensure validity and tax-exempt status of interest on the bonds;
- The underwriter, which depends on and distributes an opinion of bond counsel in order to market the bonds; and
- The bondholders, who rely on bond counsel's opinion on the validity and tax-exempt status of interest on the bonds.

WARNING: Bond counsel may or may not represent the issuer, which is often represented by separate counsel. The corporation's interests also should be represented by separate counsel. On representing multiple clients, see §§1.25-1.31.

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§18.9 D. Trustee

As a rule, the issuer appoints an institutional trustee, *i.e.*, a bank or a trust company, to administer the revenue and collateral, if any, to make payments to the bondholders, and to handle administrative matters. The trustee represents the interests of the bondholders in any default.

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Source: Business Law/Advising California Nonprofit Corporations/18 Tax-Exempt Financing for Nonprofit Corporations/ §18.10 E. Credit Enhancement Provider and Swap Provider

§18.10 E. Credit Enhancement Provider and Swap Provider

The practice of using a bond insurer, a bank, or other financial institution to provide credit enhancement for bonds is prevalent for several reasons. Many issuers have policies that require bonds issued on behalf of a private entity to carry a certain credit rating. Because many corporations do not have the financial strength to obtain such a rating, credit enhancement is necessary to obtain the benefits of tax-exempt financing. Although an issuer need not pay the bonds from its own funds if the corporation fails to pay, the issuer is often concerned that a default by the corporation might hurt the issuer's reputation and credit standing. Moreover, credit enhancement often results in interest rate savings, because bonds bearing a higher credit rating have a lower interest cost in the marketplace. See generally California Debt and Investment Advisory Commission, Bond Insurance as a Form of Credit Enhancement in California's Municipal Bond Market, CDIAC 02-1 (Jan. 2002), which is available on the CDIAC website at http://www.treasurer.ca.gov/cdiac/publications/alphabetical.asp.

NOTE: Bond counsel requires representations from the underwriter that credit enhancement will result in an interest savings over its cost in order that the cost will be considered when calculating yield to ascertain compliance with the arbitrage rules. See Treas Reg §1.148-4(f); see also §18.22.

Letters of credit. When a letter of credit secures a bond issue, the letter constitutes a written promise by the issuing bank to pay drafts or other demands by the bond trustee up to the stated fixed amount. The letter of credit is irrevocable and the bank cannot assert defenses such as set-off, breach of covenants, or bankruptcy by the corporation or the issuer. In a letter of credit enhancement, the three parties involved are the corporation that applies for the letter of credit to achieve the desired credit rating, the bank that issues the letter of credit and is obligated to make payments to the bond trustee when stated conditions are satisfied, and the bond trustee who is the beneficiary under the letter of credit for the benefit of the bondholders.

Two types of letters of credit may be used in bond financing. The first is a "standby" letter of credit that entitles the trustee to one draw in the full amount in a default. The other is a "direct draw" or "payment" letter, under which the trustee may make a series of draws to meet principal and interest payments from time to time before the bonds mature.

Reimbursement agreement. As a condition for issuing the letter of credit, the corporation must enter into a separate agreement, typically referred to as the reimbursement agreement, with the bank, pursuant to which the corporation agrees to reimburse the bank for any and all funds drawn by the trustee under the letter of credit. The reimbursement agreement contains many of the same terms that are found in conventional loan agreements, such as the corporation's covenants to maintain its existence and financial targets and not to permit liens to be created upon its assets, other than liens in favor of the bank.

Bond insurance. Another form of credit enhancement is bond insurance. A bond insurance policy covers the principal and interest payments on the bonds. The coverage may include payments when due or only on acceleration. Like the letter of credit banks, the insurer has a separate credit agreement with the corporation that ordinarily calls for tighter restrictions than under the other bond documents.

Who prepares documents. A credit enhancement provider and its counsel prepare the necessary documents, whether a letter of credit, bond insurance policy, or other credit enhancement, as evidence of the credit enhancer's obligation to the bondholders, or to the trustee for the benefit of the bondholders, and the corporation's obligations to pay the provider's fees, to furnish collateral to the provider, and to reimburse the provider if it is obligated to pay. These documents usually contain restrictive covenants, which may require analysis and negotiation by the corporation so that its business is not unduly restricted. See §18.42.

Derivative products. The public finance debt markets have evolved over the past several years to incorporate derivative products, *e.g.,* interest rate swaps and caps, into debt structures. These derivative products are becoming more common in tax-exempt conduit financings. A typical structure involves the issuance of variable rate bonds coupled with a variable to fixed interest rate swap. Taken all together, the interest costs of the financing are fixed, though there could be some interest variations over time if the basis for determining the variable rates on the bonds is not exactly

the same as the basis for determining the variable rates under the swap.

In transactions that include a swap or other hedge product, there will be a swap provider that also has independent counsel. Swap providers prepare the swap documentation and negotiate terms of the swap, including the priority position of swap payments to be made to the swap provider. Issuers and conduit borrowers may engage swap advisors to assist with negotiating the swap terms.

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IV. ELIGIBILITY FOR TAX-EXEMPT FINANCING

§18.11 A. Need for Government Entity

Tax-exempt bonds may be issued by governmental entities under IRC §§141-150 to use the proceeds for governmental purposes or to make loans to IRC §501(c)(3) organizations. An IRC §501(c)(3) corporation is not a governmental entity and, as such, cannot itself issue tax-exempt bonds. Therefore, a governmental entity is a necessary party to accomplish any tax-exempt financing for a nonprofit corporation. Without a governmental issuer, interest on the corporation's debt would be taxable and would reflect the taxable status in higher interest rates.

Conduit financing. Many governmental entities are willing to assist nonprofit corporations in financing their capital needs, and some governmental entities are established solely for that purpose. The governmental entity, as one of its public purposes, issues bonds and makes the proceeds available to the corporation with the expectation that the corporation pays the principal and interest on the indebtedness, the cost of the financing, and any issuer fees and expenses. A governmental entity that issues indebtedness for a nongovernmental entity is often referred to as a "conduit issuer," the IRC §501(c)(3) corporation is labeled the "conduit borrower," and the financing is known as "conduit financing."

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§18.12 B. Eligible Nonprofit Corporations

Private activity bonds. The Internal Revenue Code, through the interplay of several of its provisions, limits the availability of tax-exempt financing. Under IRC §103, interest on bonds of a state or political subdivision is not taxable to the bondholders. Although this exclusion does not apply to most private activity bonds, interest on certain limited types of private activity bonds may qualify for tax exemption. Private activity bonds are defined as bonds (IRC §141(a)):

- More than 10 percent of the proceeds of which are used for a private business purpose *and* payment of more than 10 percent of the principal of and interest on which is secured by or derived from private property; or
- More than the lesser of $5 million or 5 percent of the proceeds of which are lent to a private entity or individual.

Private business use occurs if a nongovernmental entity uses facilities financed with bonds in its trade or business, including instances in which the nongovernmental entity owns, leases, or, in certain situations, manages the financed facilities. Private business use also occurs if a nongovernmental entity receives special benefits from the financed facilities, such as economic benefits derived from research activity.

Qualified IRC §501(c)(3) bond. One type of private activity bond that enjoys tax-exempt status is a qualified §501(c)(3) bond. IRC §141(e). The term "qualified IRC §501(c)(3) bond" means any private activity bond if all the property to be financed by the issuance is owned by an IRC §501(c)(3) organization or a governmental entity. IRC §145. In addition, the general requirement that no more than 10 percent of an issuance can be used for a nonexempt private business use is modified by IRC §145(a), which decreases the percentage to 5 percent and redefines private business use as use by any entity in its trade or business, other than a governmental entity or an entity established under IRC §501(c)(3) in connection with its charitable purposes. Use in an unrelated trade or business of a nonprofit corporation is not considered use in connection with a corporation's charitable purpose and is therefore treated as private business use. In addition, use of proceeds of bonds to pay costs of issuance, which may aggregate up to 2 percent of those proceeds, is treated as private business use. On private business use, see §18.16.

NOTE: Examples of costs of issuance include fees for legal advice; publishing; financial advice; the services of accountants, the rating agency, and the trustee; as well as underwriter fees and expenses and bond-related feasibility studies.

A nonprofit corporation that is qualified under IRC §501(c)(3) can thus obtain the benefits of tax-exempt financing if a governmental entity issues indebtedness on its behalf, and no more than 5 percent of the proceeds of the bonds (*i.e.,* the project financed by the bonds) is used by other than an IRC §501(c)(3) organization or a state or local government. As noted above, the use by an IRC §501(c)(3) organization must be related to its charitable purpose.

NOTE: The Code imposes no restrictions on the types of IRC §501(c)(3) organizations that can take advantage of tax-exempt financing, other than corporations providing residential rental housing, to which special rules apply. See IRC §145(d). The types of IRC §501(c)(3) organizations that frequently use tax-exempt financing include hospitals, schools, colleges and universities, nonprofit housing corporations, museums and cultural institutions, and community welfare institutions.

Other nonprofit corporations. Nonprofit corporations that are not established under IRC §501(c)(3) (*e.g.,* an organization qualified under IRC §501(c)(4)) are treated like for-profit corporations under the Internal Revenue Code for purposes of tax-exempt financing. They are generally ineligible for tax-exempt financing unless they are seeking to finance a facility for which tax-exempt private activity bonds could be issued, despite for-profit corporation involvement (such as a solid waste disposal facility or an airport facility). See IRC §§141(e), 142.

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§18.13 C. Eligible Costs

The purpose of the financing affects whether a corporation is eligible for tax-exempt financing. Generally, the financing proceeds must be used to provide or refinance capital improvements, which can be property acquisitions, construction, rehabilitation, remodeling, and related costs. Proceeds of the bonds are often held by the trustee and released as costs are incurred.

Section 501(c)(3) bond proceeds may be used to finance a variety of activities, including healthcare facilities, housing for the elderly (including assisted living facilities), nursing homes, low-income housing, community centers, employment training facilities, schools, museums, libraries and performing arts centers. Permissible uses of IRC §501(c)(3) bond proceeds include the costs of acquiring land and existing facilities. IRC §147(c)-(d). However, IRC §501(c)(3) bond proceeds may not be used to finance an airplane, skybox, or other private luxury box; health club facilities; facilities primarily used for gambling, or a store that has the principal business of selling alcoholic beverages for consumption off-premises. IRC §147(e).

Refinancing rules. In a refinancing, special rules apply to what can be refinanced. If permitted by state law (see, *e.g.,* Govt C §§15432(h), 15438), working capital related to the financed capital project may also be financed and, in some instances, general working capital may be financed. In the latter case, the corporation must show a projected deficit that is in the amount of working capital to be borrowed. Treasury Regulations limit both the amount of bonds that can be issued for working capital purposes and the time period over which the bonds must be repaid. Treas Reg §§1.148-1(c)(4), 1.148-6(d).

Costs of issuing the bonds that are paid out of proceeds of the bonds, including the underwriter's compensation, may not exceed 2 percent of the proceeds. IRC §147(g). If the costs exceed 2 percent, the corporation must pay for them from funds other than the bond proceeds. Any issuance costs paid from the proceeds are applied against the 5-percent cap on private business use. See IRC §§145(a), 147(g).

EXAMPLE: If 1.5 percent of bond proceeds are used to pay issuance costs, the corporation must then limit its private business use of the bond-financed project to no more than 3.5 percent of bond proceeds.

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§18.14 V. RESTRICTIONS ON TAX-EXEMPT FINANCING

The Internal Revenue Code conditions the availability of tax-exempt financing on numerous restrictions generally designed to prevent abuses in the use and investment of the proceeds of tax-exempt bonds. In addition, to gain access to the public capital markets, federal and state securities laws require disclosure about the financing, the financing's beneficiary, and the issuer. State laws that enable an issuer to participate in a financing for a corporation may restrict the issuer's ability to provide tax-exempt financing. The issuer's own policies and procedures may impose additional restrictions and requirements.

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§18.15 A. Internal Revenue Code Requirements

In the discussion below, §§18.16-18.30 generally describe some of the more important federal income tax restrictions that affect an issuance of tax-exempt bonds for a corporation. This discussion is by no means complete: in any tax-exempt financing, it is essential to obtain bond counsel's advice on these and other aspects of the Internal Revenue Code. On the public hearing and approval required by the Code before the bonds may be issued, see §18.47.

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§18.16 1. Private Business Use

The interest on a qualified IRC §501(c)(3) bond (see §18.12) can lose, retroactive to the date of issue, the benefit of tax-exempt status if more than 5 percent of the bond proceeds are for private, nonexempt business use or if the corporation no longer qualifies as an IRC §501(c)(3) corporation. In most cases, private business use is measured over the entire term of the bond issue, rather than on an annual or more frequent basis. Many private business use issues can be solved by an allocation of tax-exempt bond proceeds to IRC §501(c)(3) use or an allocation of bond-financed facilities among the various users. For example, a corporation that plans to have its cafeteria operated by a for-profit operator may avoid the private business use prohibition by financing the cafeteria portion of the project with funds other than bond proceeds.

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§18.17 a. Short-Term Contracts

Private business use problems often arise in tax-exempt financings for corporations by virtue of contracts that grant for-profit entities or individuals rights to use a facility (in whole or in part) that is being financed with bonds. Certain short-term arrangements of 50 days or less do not result in private business use and, in limited circumstances, contracts of up to 200 days may be entered into without causing private business use. See Treas Reg §1.141-3(c)(3), (d)(3). Long-term contracts, however, that do not otherwise comply with the safe harbor provisions discussed below can lead to a contrary conclusion.

EXAMPLE: Nonprofit hospital corporations often contract with physicians or physician-controlled corporations to operate a department or a facility within the hospital. These contracts, which can be numerous in any hospital organization, receive detailed scrutiny by bond counsel and may require renegotiation.

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§18.18 b. Safe Harbor for Management and Service Contracts

The Internal Revenue Service has created a safe harbor specifying that management or service contracts that meet all three of the following conditions do not constitute private business use (Treas Reg §1.141-3(b)(4); Rev Proc 97-13, 1997-5 Int Rev Bull 18, as modified by Rev Proc 2001-39, 2001-28 Int Rev Bull 38):

- Compensation must be reasonable for the amount of services rendered, and none of the compensation may be based on a share of net profits.
- The service provider may not have any influence on the corporation that would impair the corporation's ability to exercise its rights under the contract.
- The arrangement must fall within one of six categories of permissible arrangements involving type of compensation and length of term of contract.

The important contract terms in the six permissible categories are:

- The length of the contract;
- The nature of the compensation paid to or received by the contracting party; and
- The corporation's termination rights.

Generally, the safe harbor requires that the service provider's compensation be determined by a periodic fixed fee, a capitation fee (an amount per person, regardless of services rendered), a per-unit-of-service fee, or a percentage of gross revenues or expenses, but in no event by a percentage of net revenues or profits. The permitted length of a contract (including all binding renewal options) is limited depending on the type of compensation. A longer contract term is permitted when the compensation is more fixed.

EXAMPLE: If compensation is based on at least 95 percent fixed fees, the contract may be for a term of up to 15 years. On the other hand, the term is limited to 3 years for contracts that provide compensation based upon per-unit fees (provided that the contract is cancelable by the corporation within 2 years).

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§18.19 c. Sponsored Research

Private business use problems frequently arise over research sponsored by a nongovernmental entity (typically a college or a university) when the research is conducted using bond-financed property. If the nongovernmental entity pays a market price for a license or use of resulting technology, however, private business use does not result. See Treas Reg §1.141-3(b)(6). A corporate-sponsored research agreement relating to property used for basic research supported or sponsored by a sponsor does not result in private business use if (Rev Proc 2007-47, §6.02, 2007-29 Int Rev Bull 108):

- Any license or other use of the resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, nonsponsoring party (that is, the sponsor must pay a competitive price for its use); and
- The price paid for that use must be determined at the time the license or other resulting technology is available for use.

NOTE: Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any nonsponsoring party for those same rights. Rev Proc 2007-47, §6.02, 2007-29 Int Rev Bull 108. Special rules apply to industry or federally sponsored research. See Rev Proc 2007-47, §§6.03-6.04, 2007-29 Int Rev Bull 108.

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§18.20 d. Naming Privileges

Private business use issues may also arise when all or a portion of a bond-financed facility is identified with or named for an individual or business donor. Naming privileges do not generally present issues with respect to an individual in his or her individual capacity. Naming privileges for business interests, however, could raise questions of whether or to what extent private use results.

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§18.21 e. Private Business Use Distinguished From Unrelated Business Taxable Income

The question of private business use should be distinguished from that of unrelated business taxable income as defined in IRC §512. See chap 17. A corporation may receive little or no unrelated business taxable income (or revenue, for that matter) from an activity that nonetheless constitutes private business use of a bond-financed facility, because the activity either (a) constitutes unrelated trade or business of the corporation or (b) involves the use of the corporation's facility in the trade or business of a for-profit entity or individual.

Income that does not constitute unrelated business taxable income solely because of IRC §512(b) could still indicate conduct of an unrelated trade or business. That is, an unrelated business activity will constitute private business use of a facility and may disqualify the tax-exempt status of bonds issued to finance the facility even if the income derived from it is not unrelated business taxable income *under IRC §512(b).* Further, the presence of unrelated business taxable income (or income excluded under §512(b)) will indicate conduct of an unrelated trade or business and must be analyzed to ascertain the extent of private business use. See IRC §§145(a), 512-513.

Problem areas. Common settings that involve potentially problematic private business use resulting in unrelated trade or business income include, *e.g.,* a hospital's laboratory services or pharmacy sales to the public, parking lots open to the general public, museum gift shops selling items unrelated to the museum's exempt purposes, college facilities used for unrelated summer camps, and performing arts facilities rented for meetings unrelated to the exempt purposes.

For additional information on questions of private business use, see Kalick, *Final Regulations Issued on Private Use of Tax-Exempt Bonds*, 17 Exempt Org Tax Rev 115 (July 1997).

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2. Arbitrage Bonds

§18.22 a. Definition; Prohibition On

Definition; lack of tax-exempt status. Bonds characterized as arbitrage bonds do not have tax-exempt status under the Internal Revenue Code. An arbitrage bond is any bond (IRC §148(a))

> issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

Bonds are arbitrage bonds if more than 5 percent or $100,000, whichever is lesser, of amounts treated as bond proceeds are reasonably expected to be used, or to replace funds used, directly or indirectly to acquire higher yielding investments. Amounts treated as bond proceeds for purposes of arbitrage can include amounts pledged to payment of bonds, or a sinking fund or other funds from which repayment of bonds may reasonably be expected to be made.

Calculating bond yield. Calculating bond yield is complex and requires familiarity with the regulations implementing IRC §148. Generally, the yield on a bond is its average interest rate, as adjusted for any premium or discount paid for the bond when issued and the costs of credit enhancement.

EXAMPLE: An arbitrage bond is one that is issued bearing interest at x percent, if the proceeds are not expended but are invested at a yield of x + 2 percent for the life of the bond.

A "higher yielding investment" is any investment that produces a yield over the term of the bonds that is materially higher than the yield on the bonds. IRC §148(b)(1). What constitutes a materially higher yield depends on the type of investment and type of financing. A yield of 1/8 of 1 percent or less in excess of bond yield is generally permissible, but other thresholds apply in certain types of transactions. See Treas Reg §1.148-2(d)(2).

When gifts to corporation may be deemed arbitrage bonds. Under certain circumstances, gifts and pledges to the corporation may be deemed to constitute arbitraged bond proceeds. The problem can arise in the following basic contexts:

- Gifts or pledges that donors have restricted to the project to be financed by tax-exempt bonds;
- Gifts or pledges that have been restricted to the project by the terms of the corporation's solicitation; and
- Gifts, pledges, and funds with some other significant "nexus" with the project sufficient to give rise to replacement proceeds status.

PRACTICE TIP: Even if a fundraising effort is contemporaneous with the tax-exempt bond financing, or includes specific references to the project to be financed, certain steps may be taken to preclude funds raised from being arbitrage-restricted. For example, the corporation could ensure that the solicitation is open-ended; the solicitation does not invite donors to earmark the gift for the project; and all contracts, acknowledgement letters, or other writings associated with the solicitation or receipt of gifts or pledges are not specific to the project.

The purpose of the prohibition on arbitrage is to prevent the issuance of bonds earlier, allowing the bonds to stay outstanding longer, or issuing more bonds than necessary for the principal purpose of making an arbitrage profit that may be available by investing the proceeds of the bond, which may bear lower interest because of their tax-exempt status, in higher yielding, nontax-exempt debt. Since 1969, IRC §148 and predecessor sections have been amended several times and increasingly complex regulations have been adopted to address this issue.

NOTE: To render an opinion that the bonds bear tax-exempt interest, bond counsel will seek representations and covenants from both the corporation and the issuer as to the investment of bond proceeds and payments received or money set aside to pay the bonds.

The arbitrage rules can affect a corporation that has a substantial endowment, if the endowment is pledged to payment of the bonds. Generally, the investment yield on funds that are pledged or that the corporation can reasonably

expect to be available to pay debt service on bonds may not be materially higher than the yield on the bonds, even if the corporation does not anticipate that the funds will be so used. The investment of a pledged endowment must be restricted to obligations that would earn no more than the yield on the bonds or must be invested in tax-exempt obligations. See Treas Reg §1.148-2(d)(2)(v). In either type of investment, because the amount that an endowment fund can produce could be substantially curtailed, corporations need to be aware of the consequences of such a security arrangement.

For further discussion of issues relating to arbitrage, see Gelfand, State & Local Government Debt Financing, chap 7 (1986); Ballard, ABCs of Arbitrage (ABA 2007).

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§18.23 b. Rebate Rule

Rebate of arbitrage profit generally required. In limited circumstances, applicable regulations permit bond proceeds to be invested at a materially higher yield. See §18.41. However, such arbitrage profit is generally unavailable to the corporation: even if the Internal Revenue Code allows funds to be invested at a yield higher than the yield on the bonds, such as funds deposited in a reasonably required reserve fund, the IRC also generally requires that any amounts earned in excess of the yield on the bonds be rebated, or paid, to the federal government. See IRC §148(f). On reserve funds, see §18.41. If the corporation is required to make arbitrage payments, it must do so at least once every 5 years. Each payment must equal at least 90 percent of the arbitrage profits. The balance is due within 60 days after the outstanding bonds are retired. IRC §148(f)(3). A $1000 credit may be applied each year against rebate payments owed to cover the costs of complying with this rebate requirement. Treas Reg §1.148-3(d)(1)(iv). If the corporation fails to make the required rebate payments, the bonds will not be treated as being, or ever having been, tax-exempt bonds. Although the rebate payments need be made only every 5 years, many issuers require calculations to be made annually to ensure that the bonds are not arbitrage bonds. If the corporation does not make this calculation itself, it may hire consultants to do so; the consultant's fee, while relatively modest, is an ongoing corporation expense.

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§18.24 c. Exceptions to Rebate Rule

There are a few exceptions to the requirement that arbitrage profit be rebated to the federal government. The exceptions generally require that bond proceeds (except reserve funds) be spent within specified time periods and are based on the premise that the proceeds will not be invested long enough to earn significant arbitrage profit. IRC §148(f)(4)(B).

Under the first exception, rebate is not required if the corporation expends the bond "net proceeds" within 2 years in accordance with the following schedule: 10 percent within 6 months; 45 percent within 1 year; 75 percent within 18 months; and 100 percent within 2 years. Additionally, the 2-year period may be extended to 3 years if the requirement would have been met within 2 years but for a reasonable retainage not exceeding 5 percent required to ensure compliance with the terms of the construction contract. IRC §148(f)(4)(C).

A second exception to the rebate requirement applies if all gross proceeds of the issuance (except for proceeds placed in a reasonably required reserved fund) are expended as follows: at least 15 percent within 6 months; at least 60 percent within 12 months; and 100 percent within 18 months (with an exception for a reasonable retainage spent within 30 months). Treas Reg §1.148-7(d)(1)(i), (d)(2).

An issue is also exempt from the rebate requirement if all gross proceeds (except for proceeds placed in a reasonably required reserve fund) are expended within 6 months. Treas Reg §1.148-7(c).

Another exception applies to a bona fide debt service fund with aggregate annual earnings of $100,000 or less. IRC §148(f)(4)(A). A bona fide debt service fund consists of payments by the corporation and investment earnings on the fund that the trustee holds, pending payment to the bondholders. IRC §148(f)(4)(A).

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§18.25 3. Useful Life

Bonds are limited as to maturity by the economic life of the facilities financed with the proceeds of the issue. The average maturity of bonds may not exceed 120 percent of the average reasonably expected economic life of the financed facilities. IRC §147(b). For this reason, working capital, which generally has an economic life equal to zero, should not be financed with bonds. Similarly, corporations should avoid selecting equipment, information systems, and other short-term assets for a significant portion of the assets to be financed if a long term tax-exempt bond financing is anticipated.

Average economic life must be weighted by taking into account the respective costs of the components of the project. Economic life is to be determined as of the date the bonds are issued or the date the facilities are placed into service, whichever is later. Land is generally disregarded in determining the average.

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§18.26 4. Reimbursement

Bond proceeds can also be used to reimburse the corporation for expenses incurred before the bonds are issued if the requirements of Treas Reg §1.150-2(d) are met. Generally, the Treasury Regulations require written evidence of the corporation's intent (referred to in the regulations as "official intent") to finance the costs for which it is seeking reimbursement on a tax-exempt basis. The official intent must specify the general nature of the project or projects to be financed and the anticipated amount of bonds needed for financing. It must be dated within 60 days after the costs to be reimbursed are paid.

PRACTICE TIP: Typically, a corporation's board of directors adopts a resolution at an early stage of the project as evidence of intent. However, official intent can also be evidenced by the written statement of an individual authorized by the board. For a form of resolution, see §18.49.

Reimbursable costs. Costs paid within 60 days before the date of the official intent are reimbursable with bond proceeds. In addition, certain preliminary expenditures that are incurred before commencement of acquisition, rehabilitation, or construction of the project, such as architectural, engineering, surveying, soil testing, and feasibility study fees, may be reimbursed without regard to when those costs were paid. However, land acquisition is not considered a preliminary expenditure for this purpose. There is no disadvantage to adopting an official intent resolution, as it only preserves the possibility—rather than imposing on the corporation the obligation—of using tax-exempt bonds in the future.

PRACTICE TIP: When tax-exempt financing is being considered, corporation counsel should advise the corporation to adopt a reimbursement resolution as early as possible if any costs of the project will be undertaken before the bonds are issued.

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§18.27 5. Spending Proceeds

Timing requirements. When the bonds are issued, the corporation must expect to spend at least 85 percent of the proceeds available for the project within a 3-year period after the date on which the bonds are issued and no more than 50 percent of the proceeds may be put into an investment having a substantially guaranteed yield for 4 years or more. IRC §149(g)(3). This requirement is intended to ensure that bonds are not being issued too early or as a hedge against rising interest rates. If the corporation does not expect to spend the requisite percentage within 3 years, the bonds can still maintain their tax-exempt status if the corporation reasonably expects to spend 10 percent within 1 year, 30 percent within 2 years, 60 percent within 3 years, and 85 percent within 5 years. IRC §149(g)(2). In addition, 95 percent of the reasonably expected issuance costs must be paid no later than 180 days after the bonds' issue date. IRC §149(f)(3).

Reasonable accounting method. When applying bond proceeds and other funds to the costs of a project, the corporation may use any reasonable, consistently applied method to account for the expenditure of bond proceeds. For example, a "first in, first out" method or a "bond proceeds first" method of accounting could be used. Treas Reg §1.148-6(d). Funds derived from capital campaigns specifically relating to a financed project must be taken into account.

PRACTICE TIP: Capital campaign literature should be reviewed by bond counsel or corporation counsel to ensure the broadest possible uses of the donated funds to avoid severe restrictions on the ability of the corporation to borrow on a tax-exempt basis.

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§18.28 6. Change in Use

A change in use of the facilities financed with the bonds may adversely affect their tax-exempt status if the new use would not have qualified at the time the bonds were issued. Accordingly, such a change can have severe consequences for bondholders, although the regulations provide some relief. See Treas Reg §§1.141-2(d), 1.141-12. See also Rev Proc 97-15, 1997-5 Int Rev Bull 21.

EXAMPLE: If a nonprofit hospital sold its facilities to a for-profit entity, the new owner would not be able to obtain tax-exempt financing for the hospital. The continued tax-exempt status of any outstanding bonds that financed the facilities would be in jeopardy unless appropriate remedial action was undertaken, such as redeeming the bonds within 90 days after the sale.

Remedial actions. A primary requirement for issuing bonds is that the corporation and the issuer reasonably expect on the date the bonds are issued that they will continue to meet all the requirements for qualified IRC §501(c)(3) bonds until fully paid, and thus will not become taxable private activity bonds. Treas Reg §1.141-2(d). If a change in use occurs after the bonds are issued, one permissible remedial action is redemption or defeasance of the bonds. This action generally requires that bonds be redeemable within 10½ years after issuance; however, this requirement does not apply to bonds issued before May 16, 1997. Treas Reg §1.141-16(b). If, at the time of the issuance, the corporation reasonably expects to take some action that will cause the bonds to lose their tax-exempt status, that expectation may be disregarded and the bonds may be issued as long as they are subject to redemption within 6 months after the change of use. Other permissible remedial actions include spending cash proceeds resulting from the change in use (the proceeds must be exclusively cash) within 2 years after the disposition in a manner that would not cause the bonds to meet the private business use test or the private loan financing test or using the facility financed with bonds in any other manner that would qualify as a use eligible for tax-exempt financing. Finally, tax-exempt status may be preserved by entering into an agreement with the IRS that requires the corporation to make a payment to the federal government. Rev Proc 97-15, 1997-5 Int Rev Bull 21.

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§18.29 7. Limitation on Amount of Outstanding Bonds

In contrast to other private activity bonds (see §18.16), bonds issued for nonprofit corporations are not subject to any limitation on the amount of bonds that may be issued, as long as 95 percent or more of the proceeds are used for capital expenditures incurred on or after August 5, 1997, the date of the enactment of the Taxpayer Relief Act of 1997 (Pub L 105-34, 111 Stat 788). IRC §145(b)(5). Financing or refinancing of expenditures that were incurred before August 5, 1997, may be subject to a $150 million limit on the amount of bonds (issued for other than hospital purposes) outstanding for any one corporation. Qualified hospital bonds (bonds of which at least 95 percent of the net proceeds are used to finance hospital facilities) are exempt from this limitation regardless of when the expenditure was incurred. IRC §145(b)-(c).

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§18.30 8. Federal Guaranty Prohibition

Interest on bonds is not entitled to tax exemption if the payment of principal or interest is directly or indirectly guaranteed in whole or in part by the United States or any of its agencies or instrumentalities. Bonds will be treated as guaranteed by the federal government if 5 percent or more of the proceeds are used to make loans guaranteed by the federal government or to invest in federally insured deposits or accounts. Exceptions are made to permit proceeds to be invested in United States Treasury obligations and to permit investments of bona fide debt service funds, reasonably required reserve funds, and funds to hold proceeds before their initial use. IRC §149(b). In enacting this prohibition, Congress intended to prevent a double subsidy, that is, providing both tax-exempt debt and a federal guaranty. The concern was that by virtue of the double subsidy, federally guaranteed tax-exempt bonds would be more attractive than United States Treasury securities. The proliferation of such bonds could make it difficult for federal and state governments to raise funds in the bond market.

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§18.30A 9. Qualified Bank Bonds and the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) (Pub L 111-5, 123 Stat 115) implemented a number of changes to the IRC, including certain changes to the tax-exempt bond provisions. For many IRC §501(c)(3) organizations, changes to IRC §265 will be the most important tax-exempt bond changes contained in the Act.

Prior to ARRA, IRC §265 made it disadvantageous for banks to purchase and hold tax-exempt bonds. Specifically, banks were disallowed deductions for any interest expense in an amount proportional to the amount of interest they received on their investments in tax-exempt bonds. This effectively reduced the yield to the banks on tax-exempt bonds. However, the "qualified small issuer exception" provided some relief. If a qualified issuer issued tax-exempt bonds not exceeding $10 million in the aggregate in a given calendar year, then the issuer could designate the bonds as bank qualified bonds for special tax treatment under IRC §265. Under this special treatment, the bank could receive 80 percent of the benefit of the tax-exempt interest on its investment in bank qualified bonds.

ARRA makes two important changes to the provisions of IRC §265, but only for bonds issued in 2009 and 2010. First, the annual limit on the amount of bonds that may be designated as bank qualified bonds is increased from $10 million to $30 million. Second, for qualified IRC §501(c)(3) bonds, the IRC §501(c)(3) borrower is treated as the "issuer" for purposes of applying the $30 million cap.

Both changes should enable IRC §501(c)(3) organizations to potentially lower their borrowing costs in tax-exempt bond conduit financings. Lower borrowing costs should result from the first change because banks have more of an incentive to invest in tax-exempt bonds issued in 2009 and 2010 (*i.e.,* deduction of a greater proportion of their interest expense). The second change should also lower IRC §501(c)(3) organizations' borrowing costs because of the increase in the volume of qualified bank bonds that may be issued in 2009 and 2010: An issuer, such as a joint powers authority, may issue up to $30 million in qualified IRC §501(c)(3) bonds to each IRC §501(c)(3) borrower, rather than being limited to issuing $30 million in the aggregate to all IRC §501(c)(3) borrowers, as was true for bonds issued before 2009.

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B. Securities Law Requirements

§18.31 1. Federal

Registration exemption; disclosure requirements. Bonds issued by states and their political subdivisions are exempt from the registration requirements of the Securities Act of 1933 (15 USC §§77a-77aa) by virtue of Securities Act §3(a)(2) (15 USC §77c(a)(2)), as are securities issued by many nonprofit corporations under Securities Act §3(a)(4) (15 USC §77c(a)(4)). These exemptions do not exempt an issuer or a corporation from the antifraud provisions in Securities Act §17(a) (15 USC §77q(a)) or in Securities Exchange Act of 1934 §10(b) (15 USC §78j(b)). Underwriters and brokers who deal in bonds are subject to regulation under Exchange Act §15B (15 USC §78o-4). Therefore, if a corporation embarks on a tax-exempt financing that will be a public offering, the corporation is subject to the same general requirements on disclosure in the marketplace as for-profit corporations, even though for-profit corporations must adhere to specific SEC disclosure standards and must often undergo SEC review of their disclosure documents before distribution. Industry standards, including those promulgated by issuer associations, often establish what is included in the disclosure documents.

"Official statement." The primary disclosure document, or the "official statement," typically discloses the following:

- The structure of the financing;
- The principal features of the bonds, including their source of security;
- The risks associated with a bond investment;
- The corporation, its business, and finances;
- The project that is being financed by bond proceeds;
- Any credit enhancement; and
- The issuer.

Corporate financial statements, descriptions of the relevant legal documents, and often a form of bond counsel opinion are attached to the official statement. The official statement is usually issued in both preliminary and final form. Because the preliminary version is released before the underwriter prices the bonds, information on their interest rate and redemption features will not be complete.

Rule 15c2-12 disclosures. The Securities and Exchange Commission (SEC) has adopted SEC Rule 15c2-12 (17 CFR §240.15c2-12) to regulate municipal bond underwriters. It was enacted in reaction to concerns about disclosure in certain municipal bond offerings. There is no rule directly requiring issuers to comply with SEC disclosure requirements because Exchange Act §15B(d)(1) (15 USC §78o-4(d)(1)) prohibits the SEC from requiring an issuer in a municipal bond offering to file or register with the SEC. SEC Rule 15c2-12 does, however, require certain disclosure practices by issuers. For example, underwriters are prohibited from purchasing bonds for resale to the public unless the issuer and the corporation deem the preliminary official statement to be final as of its date and unless the corporation agrees to provide annual information to certain securities information depositories in order to give the public updated information about the issuance and the corporation on an annual basis. The information to be provided includes annual financial statements, notifications of certain adverse events such as nonpayment of debt and bankruptcy, and certain operating data. For each financing, the corporation must sign a continuing disclosure agreement prepared by bond counsel or counsel to the underwriter, indicating what information will be provided annually for as long as the bonds are outstanding.

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§18.32 2. State

Each state has laws regulating securities issued in that state. Most states exempt some forms of offerings of tax-exempt securities from statutory registration requirements. See, *e.g.,* Corp C §25100(a), which exempts indebtedness issued by municipalities from qualification requirements of the Corporate Securities Law of 1968. However, the antifraud provisions of those laws usually apply to all securities offerings in the state. See, *e.g.,* Corp C §§25400-25404. The structure of a financing often determines whether a state filing (a "blue sky" filing) is required.

NOTE: Counsel to the underwriter typically provides advice to its client when filings are required if the financing involves a public offering.

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§18.33 C. State Laws Governing Bond Issuance

Various state laws and policies of issuers may also restrict a tax-exempt financing. Some statutes condition financing on matters that may directly affect a corporation's business. For example, Govt C §§15459-15459.4 require, as a condition to the tax-exempt financing of any health facility through the California Health Facilities Financing Authority or any local agency (including a city, county, or joint powers authority), that a corporation give assurances to the Financing Authority that the facility's services will be made available to everyone residing or employed in the area served by the facility. This assurance is required even if the Financing Authority may not be otherwise involved in the financing. The corporation must agree to notify those using the facility, the public, and the facility's staff of this obligation and potential eligibility of patients for Medi-Cal and Medicare benefits. Govt C §15459.1(a), (d).

The status of various permits, licenses, and approvals under state law also may affect a financing because the corporation must expect to spend proceeds of the bonds within a finite period of time. See §18.27. Thus, any delay in obtaining necessary permits, licenses, and authorizations may delay a financing. In addition, if a project to be financed requires an environmental impact report under the California Environmental Quality Act (CEQA) (Pub Res C §§21000-21177), some issuers will be unable to undertake a financing, which may be considered part of the project subject to the report, until that process is complete. However, certain issuers, such as the California Health Facilities Financing Authority, are exempt from CEQA requirements in connection with a financing of projects otherwise subject to CEQA. Govt C §15455. See Practice Under the California Environmental Quality Act, chap 5 (2d ed Cal CEB 2008).

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§18.34 VI. FINANCING STRUCTURES

Revenue bonds. Nationwide, a financing for a nonprofit corporation is most often accomplished by using revenue bonds, which are issued by a governmental entity and are generally payable solely from payments made by the corporation from revenues. In California, the revenue bond structure is often used because of statutory authorization for an issuer to issue the bonds for a particular purpose. See, *e.g.,* the California Health Facilities Financing Authority Act (Govt C §§15430-15462.5); Health & S C §§52100-52106 (permitting issuance of revenue bonds to finance multifamily residences to be acquired or built by nonprofit corporations).

Certificates of participation. California and other jurisdictions also use a structure known as a "certificate of participation" in which the issuer purchases the facility to be financed from the corporation and sells or leases it back to the corporation, assigning the payment rights under the sale agreement to a trustee. The payment rights are evidenced by these certificates of participation, which are executed by the trustee. The certificates are sold to the public, which derives the same tax-free benefit as from a revenue bond. This structure, while specifically recognized in some statutes (see, *e.g.,* Govt C §5921(a)), derives principally from an issuer's ability to purchase and sell or lease property. Title to the facilities that are purchased and sold is normally vested in the nonprofit corporation immediately on consummation of the financing, not when all the debt is repaid.

NOTE: For both revenue bonds and certificates of participation, the issuer enters into a trust indenture or trust agreement with the trustee, which sets forth the duties of the issuer and the trustee, the rights of the bondholders, and the form of the bonds or certificates of participation.

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§18.35 A. Revenue Bonds

Under the revenue bond structure, the issuer usually enters into a loan agreement with the corporation under which the bond proceeds are lent to the corporation and the corporation agrees to make payments to the issuer from revenues. The corporation's payments include all amounts required to pay principal and interest on the bonds when they become due, plus amounts sufficient to pay ongoing trustee fees, issuer fees, rebate compliance fees, and other charges. Alternatively, the corporation's obligation to the issuer may also be evidenced by an installment sale or a lease obligation when title to the facilities being financed may pass to the corporation at the end of the financing. See, *e.g.,* Govt C §15438. The loan agreement, however, is by far the most common form of agreement evidencing the corporation's obligation to the issuer.

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§18.36 B. Certificates of Participation

California municipalities have used the certificate of participation structure to finance equipment or other capital expenditures, usually on a lease or installment sale basis, if issuing a revenue bond is not feasible because of lack of statutory authority or inability to meet the statutory requirements for issuing revenue bonds. The structure has been adapted to financings for nonprofit corporations.

Purchase and sale agreements. In a certificate of participation financing, an agreement is made between the original owner of the facilities (the corporation) and the issuer by which the issuer purchases the facilities, obligating itself to pay for the facilities over time. This is usually called a "purchase agreement." A second agreement is also made between the issuer and the corporation by which the corporation purchases the facilities back from the issuer, also obligating itself to pay over time. This is usually called a "sale agreement" to distinguish it from the purchase agreement by which the issuer acquires the facilities.

Parties' duties. The issuer's obligation, as in the revenue bond structure (see §18.35), is limited to what it receives from the corporation under the sale agreement. The corporation's obligation under the sale agreement mirrors the issuer's payments under the purchase agreement but also includes payments to the trustee and issuer, and other charges. The purchase and sale obligations carry with them a principal component and an interest component. The interest on the issuer's obligations under its purchase agreement is tax-exempt.

Exemption. The SEC has recognized a Securities Act exemption for certificates of participation, with the result that certificates of participation are treated in a similar manner to revenue bonds for purposes of the registration provisions of the Securities Act. See §18.35. See also *Kelling & Co.*, SEC No-Action Letter (Oct. 22, 1984).

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§18.37 C. Security Interests

The collateral to be provided to the bondholders or credit enhancer is an important factor in structuring any tax-exempt financing. On occasion, no collateral is required because of the corporation's relatively strong credit or the combined credit of a related group of nonprofit corporations. What is required depends on many factors, including the following:

- What the underwriter may advise is necessary to market the bonds or what the provider of credit enhancement may request;
- What assets the corporation owns that are not already encumbered by prior mortgages or pledges; and
- What the corporation is able to negotiate, given its credit standing.

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§18.38 1. Revenue Pledge

A common type of collateral is a pledge of the corporation's revenues to secure the financing. This revenue pledge often includes creating a present security interest in a deposit account, called a gross revenue fund, and all its receivables and other monies. The corporation is free to make withdrawals from the account for its corporate purposes as long as no default exists under the financing documents. The financing documents provide that the trustee or credit enhancer is empowered to take possession of the revenues and the account, if a default occurs, to ensure that payments are made to the bondholders or provider of credit enhancement.

A more extreme form of this arrangement is a lock-box, under which revenues flow into an account controlled by the trustee or credit enhancer so that payments on the bonds and associated fees are paid first and any remaining monies are then made available to the corporation. In another form, the trustee or credit enhancer takes a security interest in the accounts receivable, without attempting to control an account unless a default occurs.

Health care institutions. If the financing involves a health care institution and Medicare or Medicaid receivables are to be pledged, an analysis must be made under the Assignment of Claims Act (31 USC §3727 and 41 USC §15), the Medicare statutes (42 USC §§1395g(c), 1395u(b)(6)), and relevant state law or state Medicaid rules on how a security interest in these receivables may be created without violating those statutes.

A security interest in a bank or securities account may be created and perfected through what is known as a control agreement. Com C §9104. Because these types of control agreements require payment of money into an account that can be completely blocked by a lender (or a trustee for the bonds) in the event of a default, provisions causing payments under Medicare or Medicaid programs to be paid directly into such an account may violate the Medicare statutes.

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§18.39 2. Deeds of Trust and Security Interests

Another common form of collateral is a deed of trust on the corporation's real property and a security interest in its personal property (both tangible and intangible). Issues commonly arise regarding assets that cannot be liened, such as a hospital license, and prior liens that are not being released in connection with the tax-exempt financing. Unreleased prior liens may preclude a lien in connection with the financing or lessen its value because of the priority of the other lender.

PRACTICE TIP: Well before a deed of trust is considered, corporation counsel should advise the corporation to conduct a review of its real property to ascertain the existence of prior liens, including liens that have expired but not yet released, and determine the obstacles of—and the potential solutions for—granting a deed of trust in the real property as collateral for the bond financing.

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§18.40 3. Endowment Funds and Other Cash Collateral

An endowment fund, such as one established by a nonprofit college or university, or other similar fund provides a convenient type of collateral. Pledging a fund for bond repayment, however, could lead to investment yield restrictions on the fund unless it is a reasonably required reserve fund as described in §18.41. See also §18.22.

Therefore, any request for cash collateral should be carefully reviewed with bond counsel to learn whether any investment restrictions may adversely affect the corporation's endowment. A negative pledge of assets (*i.e.,* a promise by the corporation not to permit a lien on an asset) meeting certain requirements does not lead to this result, but it too should be reviewed with bond counsel.

Additionally, the corporation should determine whether and under what conditions a pledge of the corporation's endowment fund is permitted by the applicable endowment law (*e.g.,* the California Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob §§18501-18510), discussed in §§16.11-16.17).

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§18.41 4. Reserve Fund

A reserve fund is a common security feature of bond issues. It is often funded from bond proceeds, although it need not be. This fund is held by the trustee and is used to pay principal and interest on the bonds if the corporation does not make the required payments under its agreement (*i.e.,* loan, sale, or lease agreement) with the issuer. Withdrawals from the reserve fund must be made up from the periodic payments made under the loan, sale, or lease agreement. If the reserve fund is not funded by bond proceeds, it may be funded by periodic payments from the corporation over a specified period of time. In some financings, a surety bond or letter of credit is used instead of a reserve fund. Although such credit enhancement devices entail additional financing costs, their use decreases the amount of bonds that might otherwise be required to be issued to fund the reserve fund.

Materially higher yield investments. Amounts in a reserve fund meeting the requirements specified below may be invested in securities that have a yield materially higher than that of the bonds, and such an investment does not result in the bonds being treated as arbitrage bonds (see §18.22). Treas Reg §1.148-2(f). The size of the reserve fund must not exceed the least of the following:

- 10 percent of the bond proceeds;
- The bonds' maximum annual principal and interest payments; or
- 125 percent of the bonds' average annual principal and interest payments.

Earnings on a reserve fund in excess of the yield on the bonds are generally subject to rebate to the federal government. See §18.23.

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§18.42 D. Restrictive Covenants

A corporation can expect to be subject to a variety of restrictive covenants. Many typical covenants, such as maintaining IRC §501(c)(3) status and complying with the law, will not change the corporation's ability to conduct business.

Covenants related to tax-exempt status. Other covenants may be required by bond counsel to support its opinion on the bonds' tax-exempt status. These covenants generally include promises to rebate arbitrage earnings to the federal government (see §18.23) and not to enter into contracts or arrangements with for-profit companies or persons engaged in a trade or business in a manner that would result in the bonds' being characterized as nonexempt private activity bonds (see §18.12). As such, these types of covenants merely restrict the corporation from acting in a manner that could result in a loss of tax-exempt status on the bonds.

Long-term restrictive covenants. Finally, certain covenants, including those made by the corporation to the credit enhancer, may affect the corporation adversely over the years. These covenants might include monitoring debt or revenue levels and limitations on the ability to incur additional debt, pledge assets (a negative pledge; see §18.40), sell assets, or make capital expenditures.

PRACTICE TIP: These restrictive covenants must be carefully analyzed *at the time of the financing* so as to lessen their adverse effect as much as possible. Although the burden of this analysis falls on the corporation's financial officer and financial adviser, counsel to the corporation can be of assistance in raising the issue.

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VII. FINANCING PROCESS

§18.43 A. Timing Considerations

The first step in a financing is to ascertain whether the corporation and project are eligible for tax-exempt financing. The second is to identify the issuer, financial adviser (if any), underwriter, credit enhancement provider (if any), the financing structure, and the collateral. After these are specified, the schedule for the financing depends on the following:

- How quickly the necessary documents, including the disclosure document, can be prepared, negotiated, and agreed on;
- How expeditiously issuer and other necessary approvals can be obtained; and
- Market conditions, if the financing will be a public offering.

Another factor that can affect timing is the need to secure consents from lenders or other parties to existing loan agreements, leases, or other contracts that may preclude or inhibit incurring indebtedness by the corporation. Modifications to these documents may have to be negotiated or the agreements may have to be terminated in order to obtain a release.

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§18.44 B. Disclosure

Corporate disclosure must be prepared. This disclosure, necessary in any public bond offering and in many private placements, usually describes the corporation's business, including risks and challenges affecting the business, and important statistical and other information that may affect the corporation's revenues. Financial information, including the corporation's most recent audited and unaudited financial statements, is included. The audited statements will include a report from the corporation's independent accountants, who will therefore need to be involved in formulating the disclosure document. A description of the corporation's governance, brief biographies of principal executive officers, and a listing of the board of directors or other governing body are also typically set forth. On federal securities law requirements, see §18.31.

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§18.45 C. Approvals

Approvals by the corporation's governing body and the appropriate governmental units may come at different times in the document preparation process, although most issuers do not approve documents unless they are in substantially final form. On possible consents from financial institutions, see §18.43.

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§18.46 1. Issuer

Although some issuers require their boards to adopt both a preliminary and a final resolution, most issuers take action on the financing only once. Some issuers meet once a month, while others meet weekly or more often, depending on the type of issuer and its size. Authorities established to accommodate financings may meet less frequently, although some are flexible about their meetings in order to accommodate financings. Each issuer has an agenda deadline by which a form of resolution and the form of documents must be presented to it for distribution to its members. The agenda deadlines and meeting schedules can add large amounts of time to the schedule.

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§18.47 2. TEFRA Approval

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (Pub L 97-248, §215, 96 Stat 324) first imposed the requirement of public approval on certain types of tax-exempt bonds. This requirement must be met before a governmental entity may issue bonds on behalf of an IRC §501(c)(3) corporation. To qualify for tax-exempt status, bonds must be approved by a governmental unit having jurisdiction over the area in which any facility that is financed with the bonds is located. If the facilities to be financed are not located entirely within the issuer's geographic area, the bonds must also be approved by the "host" governmental agency.

Notice and public hearing. Approval can be by either voter referendum or, usually, by the elected legislative body or the highest elected representative, after reasonable notice and a public hearing (the TEFRA hearing). IRC §147(f). The applicable elected representative may be the legislative body of the governmental entity, such as a city council, or the chief elected executive officer, such as a mayor. This approval must be obtained before the bond issuance but not more than 1 year before the issue date. Notice of the public hearing is presumed reasonable if it is published at least 14 days before the public hearing in a newspaper of general circulation in the jurisdiction where the hearing will be held. Temp Treas Reg §5f.103-2(g)(3). The public hearing may be held by either the governing board of the issuer or by an individual to whom that responsibility has been delegated.

Depending on the identity of the issuer and the location of the facility to be financed, the issuer's approval may constitute governmental approval; otherwise, an additional approval may have to come from another governmental unit because of the location of the facilities. Sometimes this hearing and approval occurs early in the financing process, before any documents have been produced. The primary requirements are that the corporation, the maximum principal amount of bonds, the project, and its location be identified in the notice of the hearing.

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3. Governing Body Approval

§18.48 a. Reimbursement Resolution

Early in the financing, the corporation's board should consider adopting a resolution indicating its desire to accomplish the tax-exempt financing and identifying the project or projects to be financed. This process provides a basis for bond counsel to confirm that projects undertaken and paid for before the financing is completed can be properly financed with the bond proceeds. This procedure is commonly known as a "reimbursement resolution" or "official intent" and is usually prepared by bond counsel. For a reimbursement resolution form, see §18.49.

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§18.49 b. Form: Reimbursement Resolution

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

REIMBURSEMENT RESOLUTION

WHEREAS, the corporation desires and intends to finance the costs of financing the acquisition, construction, and rehabilitation of various facilities at _ _[*specify location of project*]_ _ (collectively, the Project);

WHEREAS, the indebtedness (the Debt) to be issued by _ _[*name of issuer*]_ _ (the Issuer) will constitute a conduit financing issuance in that the Issuer will provide the proceeds of the Debt to the corporation through a financing lease, loan agreement, or similar financing arrangement to be entered into by and between the Issuer and the corporation;

WHEREAS, the corporation is authorized to adopt an "official intent" as a conduit borrower under Treasury Regulation §1.150-2;

WHEREAS, before the issuance of the Debt the corporation has spent and expects to continue to spend moneys (other than moneys derived from the issuance of bonds) on expenditures relating to the Project, which expenditures will be properly chargeable to a capital account under general federal income tax principles;

WHEREAS, the corporation reasonably expects that such capital expenditures will be reimbursed from the proceeds of the Debt;

WHEREAS, the corporation expects that the maximum principal amount of Debt that will be issued to pay for the costs of the Project and related issuance costs will be _ _[*dollar amount*]_ _;

WHEREAS, at the time of the reimbursement, the corporation will cause the reimbursement to be evidenced in a writing that identifies the allocation of the proceeds of the Debt to the corporation in order to reimburse the corporation for capital expenditures made before the issuance of the Debt;

WHEREAS, the corporation expects that the reimbursement allocation will be made no later than 18 months after the later of (1) the date on which the earliest original expenditure is paid, or (2) the date on which the Project is placed in service (or abandoned), but in no event later than 3 years after the date on which the earliest original expenditure is paid;

WHEREAS, the corporation will not, within 1 year after the reimbursement allocation, use the proceeds of the Debt received in the reimbursement allocation in a manner that results in the creation of replacement proceeds of the Debt or another issue (*e.g.,* the corporation will not pledge or use the proceeds received to pay debt service on the Debt or another issue, except that the proceeds of the Debt can be deposited in a bona fide debt service fund); and

WHEREAS, this Resolution is intended to be a "declaration of official intent" in accordance with Treasury Regulation §1.150-2:

THEREFORE, IT IS RESOLVED THAT, in accordance with Treasury Regulation §1.150-2, the corporation declares its intention to use a portion of the proceeds of the Debt to reimburse itself for capital expenditures relating to the Project made before the issuance of the Debt.

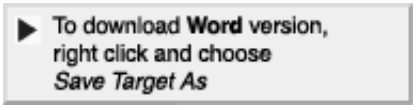
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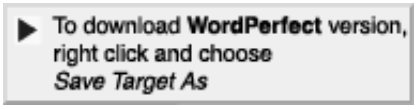
§18.50 c. Approving Resolution

The corporation's board should also approve execution of the documents that are required to be executed and delivered by the corporation in the financing, including any security agreements or mortgages. This approval may be referred to as an "approving resolution." In an approving resolution, the board may delegate to an executive or other committee or certain officers the authority to proceed with the financing if certain cost parameters are met, such as those relating to interest rates, fees paid to the underwriter, maturity of the bonds, or cost savings (if a refinancing is involved). Some boards prefer to approve the financing completely in one meeting. For a resolution suitable for a revenue bond financing with a loan agreement secured by a deed of trust and security interest in personal property, see §18.51.

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§18.51 d. Form: Approving Resolution





RESOLUTIONS

WHEREAS, to provide funds for _ _[*describe project***]_ _, it has been proposed that the _ _[***Board of Trustees/Directors***]_ _ of the corporation approve a financing with _ _[***name of issuer***]_ _ (the Issuer) for the issuance and sale of no more than _ _[***dollar amount***]_ _ aggregate principal amount of the Issuer's _ _[***name of bonds***]_ _ (the Bonds) and for the loan of the proceeds of the Bonds to the corporation, which loan shall be secured by substantially all the real and personal property of the corporation; and**

WHEREAS, there has been discussed at this meeting: (1) a form of loan agreement (the Loan Agreement) between the Issuer and the corporation, under which the proceeds of the Bonds will be borrowed by the corporation; (2) a form of a deed of trust (Deed of Trust) in favor of _ _[*name of trustee under deed of trust***]_ _; (3) a security agreement (the Security Agreement), between _ _[***name of bond trustee***]_ _ (the Trustee) and the corporation, which shall secure the obligations of the corporation under the Loan Agreement; (4) a form of bond purchase contract (the Purchase Contract) among _ _[***name of underwriter***]__ (the Underwriter), the corporation, and the Issuer, under which the Underwriter will purchase the Bonds and which contract will set forth certain representations of the corporation; (5) a form of continuing disclosure agreement (the Disclosure Agreement) between the corporation and the Trustee, which agreement provides for reporting by the corporation of certain annual information while the Bonds are outstanding; (6) a form of indenture (the Indenture) between the Issuer and the Trustee, which indenture sets forth the terms and conditions of the Bonds and under which the Issuer will assign substantially all its rights under the Loan Agreement to the Trustee; _ _[***and***]_ _ (7) a form of preliminary official statement relating to the Bonds (the Preliminary Official Statement), which statement makes certain disclosures to potential purchasers of the Bonds _ _[***add any other major documents relating to the bonds, such as documents between the corporation and a provider of credit enhancement***]_ _:**

THEREFORE, IT IS RESOLVED THAT the terms and conditions of the Loan Agreement, the Deed of Trust, the Security Agreement, the Purchase Contract, the Disclosure Agreement _ _[*add other agreements listed in recitals to which corporation is a party***]_ _ (Documents), and the Indenture and the form of the Preliminary Official Statement are hereby approved.**

IT IS RESOLVED FURTHER THAT the officers of the corporation, _ _[*name specific officers, e.g., the president, vice president, and secretary***]_ _, be, and _ _[***each of them hereby is/any two of them hereby are***]_ _, authorized on the corporation's behalf and in its name to execute and deliver each Document _ _[***, subject to the approval of the committee described in the following paragraph; see §18.52***]_ _ with such changes as the _ _[***officer/officers***]__ executing the Documents may deem necessary and appropriate; such execution and delivery to be conclusive evidence of approval of such changes _ _[***, provided, however, that in no event shall the average annual interest rate payable with respect to the Bonds exceed __ percent per annum***]_ _.**

[*If applicable, add either of the options in §18.52]*

[*Continue*]

IT IS RESOLVED FURTHER THAT the distribution of the Preliminary Official Statement and the final Official Statement for the Bonds (Official Statement) by the Underwriter is authorized and approved.

IT IS RESOLVED FURTHER THAT the execution of the Official Statement by _ _[*any officer/name specific officer***]_ _ of the corporation is authorized and approved.**

IT IS RESOLVED FURTHER THAT the officers of the corporation be, and each of them hereby is, authorized on behalf of the corporation to execute and deliver any and all instruments and documents and to take any and all actions that they deem necessary or appropriate in order to consummate the issuance and sale of the

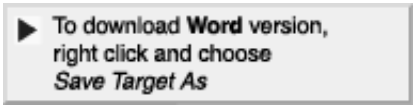
Bonds and the loan of the bond proceeds to the corporation and otherwise to effectuate the purposes of the Documents and the foregoing resolutions.

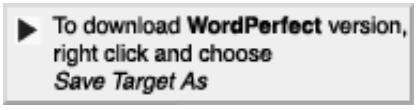
IT IS RESOLVED FURTHER THAT the actions of the officers of the corporation taken before the adoption of these resolutions in furtherance of the foregoing are hereby ratified, confirmed, and approved.

Comment: The list of documents in the second paragraph of the recitals is illustrative; it is not exhaustive. If an executive committee or other committee is empowered to fix the interest rate, the initial offering price, or other details to be fixed in the future, a resolution such as that in §18.52 should be added after the second resolution of this form (naming officers authorized to execute and deliver documents). This form is suitable for adoption by a corporation's board of directors or board of trustees. It should be modified if the entity is something other than a corporation.

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§18.52 e. Form: Committee Approval





[*If applicable, add one or more of the following options*]

[*Option 1: Approval by named individuals]*

IT IS RESOLVED FURTHER THAT a committee of this Board of Trustees composed of _ _[*names of individuals*]**_ _ is authorized and empowered to fix the interest rate or interest rates on the Bonds and the initial price at which the Bonds will be sold _ _**[*and the fee to be paid*]**_ _ to the Underwriter.**

[*Option 2: Approval by executive or other committee]*

IT IS RESOLVED FURTHER THAT _ _[*the executive committee/name other standing committee*]**_ _ of this Board of Trustees is authorized and empowered to fix the interest rate or interest rates on the Bonds and the initial price at which the Bonds will be sold _ _**[*and the fee to be paid*]**_ _ to the Underwriter.**

[*Continue*]

Comment: These clauses are optional but one of them should be used if a committee is empowered to fix the interest rate, the initial offering price, or other details to be fixed in the future. It should be added after the second resolution in §18.51 (naming officers authorized to execute and deliver documents). Option 1 is suitable if a committee is to be formed of named individuals; Option 2 is appropriate when an executive committee or other standing committee is to be used.

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§18.53 D. Pricing and Closing

Once all issuer and corporation approvals are completed, the financing can proceed to closing and funding. In a public offering of bonds, the underwriter typically circulates the preliminary official statement (see §18.31), which, pursuant to SEC Rule 15c2-12 (17 CFR §240.15c2-12), the issuer and the corporation must deem final, except for pricing information. After circulating the preliminary official statement, the underwriter prices and sells the bonds. If the interest rate and other features, such as redemption dates and premiums, satisfy the corporation, then the corporation, the issuer, and the underwriter execute a bond purchase contract. This agreement sets forth the underwriter's commitment to buy the bonds and the terms and conditions of closing, including the opinions to be provided at closing by corporate counsel and other counsel. The corporation's approval of the terms may be evidenced by a board or committee resolution or by an officer's approval. See §18.51.

Closing. A closing is then scheduled within 1-3 weeks, at which all remaining documents are executed and delivered, legal opinions exchanged, and other certifications rendered. Typically, most of the closing documents (including certifications and representations as to compliance with federal tax restrictions) are prepared by bond counsel, although opinions on the corporation's behalf, certified copies of board resolutions, and similar certificates are often prepared by corporate counsel.

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VIII. TASKS FOR CORPORATE COUNSEL

§18.54 A. In General

The number of parties involved and the technical nature of the laws on tax-exempt financings result in a complex set of documents. Although many of these are prepared by counsel to parties other than the corporation, the corporation's counsel has a key role in several aspects of the financing. It is important that, early in the financing, corporate counsel do the following:

- Help ascertain the corporation's eligibility under state law and its articles and bylaws to undertake the financing, including confirming that the corporation is an IRC §501(c)(3) entity;
- Discuss with the corporation the advisability of adopting a reimbursement resolution (see §18.49);
- Examine any lease, loan agreement, or other contracts to which the corporation is a party that could restrict its ability to participate in the financing, including contracts for the use or management of any portion of the corporation's facilities;
- Help identify existing liens, if any, on property that may be used to secure the corporation's performance under the bond documents;
- If required, verify that all necessary licenses, permits, and other governmental approvals are current; and
- Negotiate appropriate consents.

Renegotiations of contracts with certain for-profit entities may be required before the transaction can proceed. See §18.18. In addition to preparing resolutions for the board, advising the board, and reviewing and negotiating documents prepared by other counsel in the transaction, counsel to the corporation can assist in the tasks discussed in §§18.55-18.58.

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§18.55 B. Disclosure and Due Diligence Investigation

A disclosure document is essential in a public offering of bonds and in many private placements. See §§18.31, 18.44. Corporate counsel may be in the best position to help decide what should be disclosed about the corporation, particularly with respect to litigation, regulatory restrictions, and regulatory proceedings affecting the corporation's business. Other counsel, particularly counsel to the underwriter, will assist their clients to investigate the corporation's business and finances in order to comply with obligations under the federal securities laws.

Corporation counsel should expect to participate in and perhaps help structure this investigation in order to

- Aid the corporation on proper disclosure;
- Lessen the disruption of the business, which may not be accustomed to having third parties review its files; and
- Become aware of issues that emerge from the investigation.

This participation helps corporation counsel advise the corporation and lay a foundation for the disclosure opinion, commonly referred to as a "Rule 10b-5 opinion," that is normally sought from corporate counsel regarding the official statement. See §18.58.

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§18.56 C. Overall Transaction Advice

Corporation counsel is frequently called upon to take the following actions:

- Advise the corporation on the terms of the transaction documents (*e.g.,* the loan, lease, or installment sale agreement with the issuer, the reimbursement agreement with the credit enhancer, the security instruments with either the issuer or the credit enhancer, as applicable, the bond purchase agreement with the underwriter, and the remarketing agreement with the remarketing agent);
- Negotiate the transaction documents on the corporation's behalf; and
- Assist the corporation with the closing of the financing.

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§18.57 D. Liens

Corporation counsel can also expect to play a role in ensuring that any liens securing the financing are in place by the time the financing closes. Bond counsel or counsel to the credit enhancer prepares the security documents, but corporation counsel should review them. Corporation counsel can be instrumental in ensuring that any prior liens are terminated.

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§18.58 E. Opinion

An opinion of counsel to the corporation is an important document to be delivered at the closing of the transaction. Corporation counsel is often asked for an opinion on the following matters:

- The status of the corporation as a nonprofit public benefit corporation;
- The corporation's IRC §501(c)(3) status;
- The corporation's licensing status;
- The authorization, execution, and enforceability of the documents to which the corporation is a party;
- The validity and perfection of the pledge and security interests that the corporation has granted;
- The corporate disclosure (the Rule 10b-5 opinion);
- The status of litigation; and
- Compliance with existing debt instruments.

The Rule 10b-5 portion (see §18.55) of the opinion typically states that counsel is unaware of any material misstatements or omissions in the official statement and that the statement is not intended to be an opinion that facts stated in the opinion are accurate. On the responsibilities of a lawyer rendering an opinion in connection with an offering of bonds on behalf of a corporation, see National Association of Bond Lawyers, *Statement Concerning Standard Applied in Rendering the Federal Income Tax Portion of Bond Opinions* (1993).

The peculiarities of California and federal law affecting legal opinions and the scope of examination are addressed in the following publications:

- 2005 Report, Corporations Committee, State Bar of California, Business Law Section, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (May 2005, rev'd Oct. 2007), available on the State Bar website at http://www.calbar.ca.gov;
- TriBar Opinion Committee, *Third-Party "Closing" Opinions*, 53 Bus Law 592 (1998), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050303000003.pdf;
- ABA Committee on Legal Opinions, *Legal Opinion Principles*, 53 Bus Law 831 (1998), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050120000000.pdf; and
- ABA Committee on Legal Opinions, *Guidelines for the Preparation of Closing Opinions*, 57 Bus Law 875 (2002), available on the ABA website at http://www.abanet.org/buslaw/tribar/materials/20050120000001.pdf.
- Legal Opinion Accord of the ABA Section of Business Law (1991), as modified by the Report on Adaptation of the Legal Opinion Accord of the Section of Business Law of the American Bar Association for Real Estate Secured Transactions of the Section of Real Property, Probate & Trust Law of the American Bar Association and the American College of Real Estate Lawyers.
- 1995 California Real Property Legal Property Report, as supplemented by the First Supplement to 1995 California Real Property Legal Opinion Report.

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Source: Business Law/Advising California Nonprofit Corporations/18 Tax-Exempt Financing for Nonprofit Corporations/ §18.59 F. Table: Time and Responsibility Schedule

§18.59 F. Table: Time and Responsibility Schedule

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This sample schedule assumes that the bonds will be offered to the public by an underwriter and will be enhanced by a letter of credit issued by a bank, which will require collateral in the form of real and personal property. It also assumes that the corporation has already completed its own due diligence with respect to an analysis of the proposed project and its expected costs. The entire process may be completed within 3 months, although a variety of factors—including availability of audited financial information, formulation of appropriate disclosure, third party consultants, and government permits and approvals—may substantially lengthen the process.

TIME AND RESPONSIBILITY SCHEDULE FOR ISSUING TAX-EXEMPT BONDS

Participants

Identity	Abbreviations
Corporation	C
Underwriter	U
Letter of Credit Bank	B
Issuer	I
Bond Counsel	BC
Underwriter's Counsel	UC
Letter of Credit Bank Counsel	LCC
Corporation Counsel	CC

Time Frame Date	Task	Responsibility
Week 1	Adopt official intent resolution.	C, BC, CC
	Prepare any applications to issuer.	C, I, U
	Submit any necessary information to letter of credit bank for credit review purposes.	C
	Review corporation's articles of incorporation, bylaws, licenses, and existing debt agreements and determine whether any issue regarding third party consents or charter documents will affect the timing of the financing.	C, CC
Week 2	Begin preparation of bond documents.	BC
	Begin preparation of disclosure document (official statement).	UC, C, CC
	Analyze any liens or security interests on property to be pledged as collateral.	C, CC
	Begin review of contracts for use or	

	management of facilities to be financed Begin determination of use of proceeds and amount and maturity of bonds to be issued.	BC, CC C, U, BC
Week 3	Receive commitment from letter of credit bank. Begin preparation of letter of credit documentation. Order preliminary title report and UCC search. Begin due diligence process.	C, B LCC CC C, CC, UC, BC
Week 4	Distribute first draft of bond documents, TEFRA hearing notice, disclosure documents, bond purchase agreement, and related underwriting documents.	BC, UC
Week 5	Meet to negotiate draft documents and approve draft TEFRA notice. Publish TEFRA notice. Appoint trustee.	All hands BC C, U
Week 6	Revise and recirculate bond documents and disclosure documents Distribute first draft of letter of credit documents and related security documents. Submit documents to issuer and form of approving issuer resolution. Prepare approving board resolution.	BC, UC LCC BC C, CC
Week 7	Meet to discuss revised drafts of documents. Board meets to approve documents and financing. Complete due diligence process. Determine any necessary payoffs of prior loans secured by collateral and arrange for releases from creditors necessary for closing.	All hands C, CC C, CC, UC, BC C, CC
Week 8	TEFRA hearing. Issuer meeting to approve bond documents. Circulate final drafts of bond and underwriting documents and revised drafts of letter of credit documents. Print and mail preliminary official statement.	I, BC, C I, BC, C BC, UC, LCC U

Week 9	Price bonds and sign bond purchase agreement.	U, I, C
	Finalize and mail final official statement.	U, UC
	Begin preparation of closing documents and legal opinions.	BC, UC, LCC
Week 10 or 11	Preclose and close bond issue.	All hands

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19

Legislative and Political Activities

Gregory L. Colvin
Rosemary E. Fei
Eric K. Gorovitz
Lance H. Olson

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I. SCOPE OF CHAPTER

§19.1 A. Introduction

Some nonprofits choose to—or find that they must—become involved with our political system to accomplish their goals. This is true not only for activist organizations and advocacy groups whose missions are directed at government and governmental change, but also for nonprofits whose goals have no obvious relationship to legislation or government but whose activities are either government-regulated or funded at the local, state, or federal level. Nonprofits engaged in legislative or political activities subject themselves both to a variety of rules generally applicable to anyone who engages in political activities and to special tax law rules restricting political activities by tax-exempt nonprofits.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.2 B. Lobbying and Candidate Electioneering

§19.2 B. Lobbying and Candidate Electioneering

Broadly, there are two types of activities that a nonprofit's legal counsel should scrutinize:

- Activities directed at influencing legislation (called "lobbying" in this chapter); and
- Activities directed at influencing the outcome of candidate elections for public office (called "candidate electioneering" in this chapter).

"Candidate electioneering" is a more precise term than "political activities" or "electioneering" because the Internal Revenue Code distinguishes between influencing the election of candidates for public office and influencing election campaigns to pass or defeat ballot measures, which is regarded as a form of lobbying.

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§19.3 C. Chapter Organization

This chapter addresses the rules governing the lobbying and candidate electioneering activities of California nonprofit organizations. The chapter is organized around two basic principles: (1) the rules governing lobbying differ from those governing candidate electioneering; and (2) within each of these areas, charities and noncharities are subject to different rules. Further, each type of activity and organization is affected by federal and state laws concerning tax, elections, and other areas.

Part II addresses lobbying activities, with the most extensive discussion focusing on the relatively complex federal tax law rules that apply to lobbying by charities (see §§19.5-19.32). This is followed by briefer discussions of the less-restrictive federal tax law rules governing lobbying by noncharities (see §§19.33-19.36); California tax law rules governing lobbying by California nonprofit organizations (see §19.37); and nontax law rules affecting lobbying by nonprofits (see §§19.38-19.46).

Part III follows a similar structure, again focusing first and most extensively on federal tax law rules governing candidate electioneering by charities (see §§19.48-19.68). This is followed by discussions of federal tax law rules governing candidate electioneering by noncharities (see §§19.69-19.82); California tax law rules governing candidate electioneering by California nonprofit organizations (see §19.83); and nontax law rules concerning candidate electioneering (see §§19.84-19.93).

Part IV (§19.94) provides a brief introduction to the use of multi-entity structures to comply with the complex interaction between various applicable laws while maximizing an organization's voice in public affairs.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.4 D. Table of Organizations and Activities

§19.4 D. Table of Organizations and Activities

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Tax-Exempt Organizations, Public Policy Activities			
Internal Revenue Code Section	**501(c)(3)**	**501(c)(4), (c)(5), (c)(6), (c)(7), and others**	**527**
Type of organization	Charitable	Social welfare, labor union, trade associations, social clubs, and other noncharitable organizations	Political
Tax Characteristics			
Tax on operating surplus	0	0	0
Net investment income tax	0, but[1]	0, but[1]	35%
Unrelated business income tax	Corporate rates	Corporate rates	35%
Charitable deduction for donations	Yes	No	No
Business deductions for dues	Yes, but[2]	Yes, but[2]	No
Gift tax exemption	Yes	Unclear[3]	Yes
Public disclosure of donors	No	No	Yes
Restrictions on Public Policy Activities			
Public education and advocacy	Unlimited	Unlimited	Must be candidate-related
Direct lobbying, including ballot measures	Up to 20% if IRC §501(h) is elected	Unlimited	Must be candidate-related
Grassroots lobbying	Up to 5%, within the 20%	Unlimited	Must be candidate-related
Participation in candidate campaigns	Prohibited	OK if secondary	Must be dominant

		activity[1]	purpose[4]

[1]Beware of the IRC §527(f) tax. See §19.81.

[2]Beware of the IRC §§162(e) and 6033(e) proxy tax. See §19.72.

[3]Rev Rul 82-216, 1982-2 Cum Bull 220. See §19.33.

[4]Non-candidate-related expenditures must be insubstantial. See §19.74.

Comment: This table necessarily simplifies some rules.

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II. LOBBYING

§19.5 A. Federal Tax Law: IRC §501(c)(3) Charities

An entity qualifies for federal tax exemption as a charity under IRC §501(c)(3) only if "*no substantial part* of the [charity's] activities… is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h))." (Emphasis added.) IRC §501(c)(3). This language implies the two distinct alternative regimes that may govern a charity's lobbying activities: the "substantial part" test (see §§19.6-19.9) and the IRC §501(h) election (see §§19.10-19.30). An organization that engages in excessive lobbying under either of these tests will constitute an "action organization," and consequently will not qualify for exemption under IRC §501(c)(3). Further, if an organization's main or primary objectives cannot be attained without the passage or defeat of legislation, and the organization advocates for such objectives in ways that do not qualify as nonpartisan analysis, study, or research (see §19.19), the organization will also constitute an "action organization" and will not qualify for exemption under IRC §501(c)(3). However, an action organization may qualify for exemption under IRC §501(c)(4). Treas Reg §1.501(c)(3)-1(c)(3).

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§19.6 1. "Substantial Part" Test

Under the substantial part test, a charity can lose its tax-exempt status if a substantial part of its activities consists of lobbying. In addition, charities whose tax exemptions have been revoked for substantial lobbying (other than churches, certain church affiliates, and sometimes also their managers) are subject to an excise tax equal to 5 percent of the lobbying expenditures. IRC §4912. This tax does not apply to IRC §501(c)(3) charities that have elected to be governed by IRC §501(h). See §§19.10-19.30.

The two most important issues in advising a charity that lobbies but has not made the §501(h) election are the following:

(1) What activities constitute lobbying (see §19.7); and

(2) How much lobbying is substantial (see §19.8).

Unfortunately, large areas of uncertainty persist in regard to both questions. The courts have developed little guidance, nor has the IRS developed regulations on the issues. Practitioners have little choice but to apply case law to their own fact situations on a case-by-case basis. The IRS's internal training materials for its staff are an excellent resource for predicting the IRS's position on these issues. See Kindell & Reilly, Lobbying Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997, p 261. The program material is available on the IRS website at http://www.irs.gov/pub/irs-tege/eotopicp97.pdf.

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§19.7 a. What Constitutes Lobbying

Some charitable activities intended to influence public policy can safely be eliminated from further scrutiny because lobbying is defined as influencing "legislation." See IRC §4912(d)(1). The regulations and rulings of an administrative agency are not legislation, nor are executive decisions of the president, a state governor, or a mayor. Influencing legislators to take nonlegislative action, such as asking them to conduct investigations or intervene with a government agency, can also be disregarded. Litigation to enforce or clarify law is also outside the definition of lobbying.

Beyond these clear situations, any activity by a charity relating to proposed or pending legislation or molding public opinion on legislative matters could qualify. The most difficult problems involve drawing a line between prohibited lobbying and permissible educational activities. See, *e.g.*, *Kuper v Commissioner* (3d Cir 1964) 332 F2d 562; *League of Women Voters v U.S.* (Ct Cl 1960) 180 F Supp 379.

In *Fund for the Study of Economic Growth & Tax Reform v IRS* (D DC 1998) 997 F Supp 15, aff'd (DC Cir 1998) 161 F3d 755, the court denied the IRC §501(c)(3) exemption of an organization set up to raise funds for a tax reform commission, partly because it was an "action organization," with a primary objective attainable only through legislation for which it advocated, in violation of Treas Reg §1.501(c)(3)-1(c)(3). The district court stated that specific legislation need not be mentioned for attempts to influence public opinion to be treated as attempts to influence legislation. The Court of Appeals for the District of Columbia upheld the lower court's interpretation of the "action organization" regulations (which involved the so-called "Kemp Commission") and held that an organization's activities do not fall within the exception for "nonpartisan analysis, study, or research" when it "assumes a conclusion with respect to a highly public and controversial legislative issue and then goes into the business of selling that conclusion." 161 F3d at 760 n9.

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§19.8 b. How Much Lobbying Is "Substantial"

The courts and the IRS have struggled even harder to decide what level of lobbying activity is considered substantial than they have to decide exactly what lobbying is. In one early case, *Seasongood v Commissioner* (6th Cir 1955) 227 F2d 907, the court held that spending less than 5 percent of an organization's time and effort on legislative *and* political activities was insubstantial (candidate electioneering activities were not then prohibited by IRC §501(c)(3)). But in *Christian Echoes Nat'l Ministry v U.S.* (10th Cir 1972) 470 F2d 849 and *Haswell v U.S.* (Ct Cl 1974) 500 F2d 1133, the courts rejected any strict percentage approach, adopting a vague facts and circumstances analysis, which the IRS followed in GCM 36148 (Jan. 28, 1975).

Under this analysis, the organization must consider not only direct expenditures for lobbying but also volunteer and other no-cost activities, the quality as well as the quantity of activity, and any other relevant facts. One court's holding suggests that publishing a single official position statement could constitute substantial activity if developing that position internally consumed substantial organizational effort. See *Kuper v Commissioner* (3d Cir 1964) 332 F2d 562. The cumulative result of these diverse findings is a certain degree of uncertainty for the charity and its advisers.

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§19.9 c. Reporting Lobbying Activities to IRS

A charity that lobbies and that has not made an IRC §501(h) election must indicate whether it uses volunteers to lobby and report its lobbying expenses in several categories on its annual information return, IRS Form 990, Schedule C, Part II-B. Other lobbying activities must be explained in detail, expenses reported, and volunteer activities described. Part II-B of Schedule C also requires the organization to conclude, under penalty of perjury, whether or not its lobbying activity caused it to violate IRC §501(c)(3).

PRACTICE TIP: Most charities that lobby and that are eligible to elect IRC §501(h) treatment should do so because of the vagueness and uncertainties of the "substantial part" test and the severity of the sanctions for violating it, which include loss of tax-exempt status and possible imposition of a 5-percent excise tax (see §19.6). Nevertheless, only a fraction of eligible charities have made the election, owing to persistent myths about audit flags, excessive recordkeeping obligations, and simple lack of awareness.

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§19.10 2. IRC §501(h) Election

Congress recognized the valuable role charities can play in public policy and the chilling effect of the uncertain "substantial part" test (see §19.6) on charitable input in public policy matters and enacted IRC §§501(h) and 4911, which permit eligible charities to elect to have their lobbying activities limited solely on the basis of their lobbying expenditures. For small and mid-sized organizations, the IRC §501(h) dollar limits on lobbying are much more liberal than the "substantial part" test. Furthermore, IRC §501(h)(7) prohibits a nonelecting charity from taking advantage of the extensive and detailed definitions found in the regulations and some of the exceptions to lobbying that are available to an electing charity. See Treas Reg §§1.501(h)-1(a)(3), 56.4911-0—56.4911-10. For a brief discussion on subjects treated in detail in the regulations, see §§19.11-19.30. For more details, see Kindell & Reilly, Lobbying Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997. This publication is available from the IRS website at http://www.irs.gov/pub/irs-tege/eotopicp97.pdf.

On reasons to make or not make a §501(h) election, see §19.30.

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§19.11 a. Charities Eligible to Make Election

All IRC §501(c)(3) charities listed in §501(h)(4) and not excluded by §501(h)(5) may make a §501(h) election. The net result is that the following charities are ineligible for an IRC §501(h) election:

- Churches and their affiliates;
- Governmental units described in IRC §170(b)(1)(A)(v);
- Organizations described in IRC §509(a)(4) formed to do public safety tests;
- Organizations described in IRC §509(a)(3) supporting an organization that is tax-exempt under IRC §501(c)(4), (5), or (6); and
- Private foundations.

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§19.12 b. Procedure for Making or Revoking Election

A charity files IRS Form 5768, a one-page check-the-box form, to make an IRC §501(h) election. (The form is available on the IRS website at http://www.irs.gov/formspubs/.) Filing the form does not affect the charity's IRC §501(c)(3) status in any way. The form can be filed any time before the end of the first tax year for which it will be effective, so a charity can wait to see how its lobbying develops during the year before deciding to file. Once filed, however, the election remains in effect for the subsequent year and indefinitely, unless the charity revokes the election, also by using IRS Form 5768. A revocation is effective for the first tax year *after* the year in which the revocation is filed. A charity can elect, revoke, and reelect as often as it wishes. The charity should keep a copy of the Form 5768 with its tax records because the IRS does not acknowledge its receipt.

A new charity may file Form 5768 concurrently with its exemption application, but a copy of the form should be attached to the application because, at present, the original form is filed at a different IRS address from where the exemption application is filed.

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§19.13 c. Spending Limits

Determine exempt purpose expenditures. An electing charity must first ascertain its "exempt purpose expenditures," as defined in IRC §4911(e) and Treas Reg §56.4911-4, to calculate what it is allowed to spend on lobbying. Exempt purpose expenditures are the total of all amounts paid or expenses incurred by the charity to accomplish its charitable purposes. These expenses include administrative expenses and the lobbying expenditures themselves, but they exclude the following:

- Payments to vendors primarily for fundraising or costs associated with a separate fundraising unit within the charity;
- Costs associated with generating unrelated business income;
- Capital expenditures, including land acquisitions (but depreciation may be included); and
- Investment management expenses.

Calculate lobbying limit. The lobbying limit is 20 percent of the first $500,000 in exempt purpose expenditures, 15 percent of the next $500,000, 10 percent of the next $500,000, and 5 percent of all exempt purpose expenditures over $1.5 million to a maximum limit of $1 million. IRC §4911(c)(2). In effect, the total lobbying expenditures limit stops increasing once the charity's exempt purpose expenditures exceed $17 million. The decreasing percentage of funds available for lobbying as income increases has the effect of disproportionately limiting the funds that large charities can spend on lobbying. Within this limit, the charity is subject to another restriction: No more than 25 percent of the total lobbying limit amount may be spent on grassroots lobbying, defined in §19.15. IRC §4911(c)(3)-(4).

EXAMPLE: A charity with $2 million of exempt purpose expenditures will have a total lobbying limit of $250,000 (12.5 percent) and, within that, a grassroots lobbying limit of $62,500 (3.125 percent).

Same-year expenditures. Note that the lobbying limit for a given tax year is based on the exempt purpose expenditures *in that same year*, which cannot be precisely known until the year has closed. Therefore, the electing charity must project its exempt purpose expenditures for the year to reach an estimated lobbying limit and must closely monitor both its actual exempt purpose expenditures and its lobbying expenditures throughout the year and make adjustments as needed.

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§19.14 d. Penalties for Exceeding Limits

Lobbying expenditures in excess of the applicable IRC §501(h) limit result in a tax equal to 25 percent of the excess but do not result in revocation of exempt status. If both the total lobbying and the grassroots lobbying limits have been exceeded in 1 year, the tax is on whichever excess is greater, but not both. This tax is payable with the filing of the electing charity's IRS Form 990, using IRS Form 4720 to report the tax. If an electing charity spends an amount equal to more than 150 percent of either of its lobbying limits aggregated over a 4-year period, it automatically loses its IRC §501(c)(3) status. Furthermore, it is prohibited from converting to an IRC §501(c)(4) social welfare organization at that point.

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§19.15 e. Activities Defined as Lobbying

The ease or difficulty for a charity in staying within the IRC §501(h) limits depends on exactly how well lobbying activities are defined under IRC §4911. Many activities that are commonly viewed as lobbying fall outside the §4911 definitions, while other activities that are covered by the general definitions of lobbying fall within one or more statutory exceptions.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.16 (1) Direct and Grassroots Lobbying

§19.16 (1) Direct and Grassroots Lobbying

Internal Revenue Code §4911(d)(1) defines two types of activities as lobbying, which have different spending limits as described in §19.13. Treasury Regulation §56.4911-2(b) defines the elements necessary for direct and grassroots lobbying:

- **Direct lobbying** is any attempt to influence legislation through communication with legislators and their staffs or any government official who participates in the formulation of legislation. It requires (a) a communication, (b) with a legislator or a government official who has a role in formulating legislation, (c) that refers to specific legislation, and (d) that reflects a view on the legislation.
- **Grassroots lobbying** is any attempt to influence legislation by attempting to affect the opinions of the general public or a segment of the public. It requires (a) a communication, (b) with the public or a segment of the public, (c) that refers to specific legislation, (d) that reflects a view on specific legislation, and (e) that, in most circumstances, includes a call to action, asking the recipient, expressly or by implication, to contact a legislator or government official. There are four types of "calls to action" listed in Treas Reg §56.4911-2(b)(2)(iii). On when a call to action is not necessary for a communication to be classified as grassroots lobbying, see §§19.24-19.25.

If any element is missing from a communication, it is not lobbying for purposes of IRC §501(h).

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§19.17 (2) Excluded Activities

The precise §501(h) definitions exclude many activities that might be treated as lobbying under the "substantial part" test. For example, the "call to action" requirement for grassroots lobbying means that a charity can direct-mail a legislative bulletin, expressing its views on pending legislation, without having lobbied at all, as long as it avoids encouraging readers to contact legislators. It could also ask recipients to contribute money, join a chapter, or volunteer. Moreover, because §501(h) limits affect only expenditures, a charity can use volunteers to lobby without limitation or can obtain extensive free press coverage of its position statement on pending legislation while making only minimal expenditures that count against the cap.

PRACTICE TIP: The rules defining when a lobbying communication has occurred apply to electronic forms as well, including e-mail, listserve, and website posting of legislative information. For instance, a link on a charity's website that connects the viewer to a means of contacting a legislator by one click of a mouse may constitute a "call to action." The IRS asked for comments on such questions in 2000, and may issue rulings in this area. See IRS Announcement 2000-84, 2000-2 Cum Bull 385.

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§19.18 (3) Meaning of "Specific Legislation"

Perhaps the most difficult element of the lobbying definitions to interpret is the requirement that a communication refer to "specific legislation." The regulations make it clear that specific legislation includes the following (see Treas Reg §56.4911-2(d)):

- Introduced bills;
- Proposals for legislation;
- Legislation in foreign countries;
- Any action to amend or repeal laws;
- Nonbinding resolutions passed by legislative bodies; and
- Initiatives and other ballot measures.

EXAMPLE: Government budgets and appropriations, required senatorial approvals of treaties, and confirmations of presidential appointments to government offices qualify as specific legislation.

Treasury Regulation §1.162-29(b)(7), Example 6, gives a sample of "specific legislation" for business corporations, saying, in effect, that a proposal no more detailed than "lower the capital gains tax rate" is a specific legislative proposal. Although these regulations are expressly inapplicable for purposes of the definitions of lobbying by charities, they may still indicate how broadly the IRS might be prepared to interpret "specific legislation."

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§19.19 f. Exceptions to Definitions

There are five exceptions to the general definition of lobbying (IRC §4911(d)(2)):

(1) Making available the results of nonpartisan study, research, and analysis (Treas Reg §56.4911-2(c)(1)(iv));

(2) Providing technical advice to a governmental body or committee in response to a written request (Treas Reg §56.4911-2(c)(3));

(3) Communicating with a legislative body about a decision that could affect the charity's existence, powers and duties, tax-exempt status, or deductibility of contributions to it (the "self-defense" exception; Treas Reg §56.4911-2(c)(4));

(4) Making certain communications with its members on legislation of interest to the charity (Treas Reg §56.4911-5(b)); and

(5) Making a communication with a nonlegislative government official or employee that does not have influencing legislation as its principal purpose (Treas Reg §56.4911-2(b)(1)(i)).

PRACTICE TIP: Careful use of these exceptions can significantly stretch an electing charity's ability to affect public policy while staying within the IRC §501(h) limits. Although some of these exceptions have common law analogues under the "substantial part" test (see §19.6), a nonelecting charity cannot safely rely on these regulatory exceptions to decide whether an activity is lobbying. For developments that may affect the scope of the "nonpartisan analysis" exception, see §19.7.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.20 g. Special Rules

§19.20 g. Special Rules

There are a variety of special rules in the Internal Revenue Code and regulations addressing specific situations regarding the IRC §501(h) election. Some of the most important are discussed in §§19.21-19.25. These special rules highlight the need for close scrutiny and careful planning in advising a charity under §501(h).

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§19.21 (1) Ballot Measures

Communication with public. Communication with the public on ballot measures (also called referendums or initiatives) is treated as direct lobbying, rather than grassroots lobbying, because on a ballot measure the electorate essentially is the legislature. Treas Reg §56.4911-2(b)(1)(iii). This distinction is beneficial for charities that wish to comment on ballot measures, initiatives, and referendums because the grassroots lobbying limit is so much more restrictive (see §19.13) and communicating with the public can be expensive. Also, although grassroots lobbying occurs only if a communication to the public reflects a view on specific legislation *and* contains a call to action, a communication to the public reflecting a view on a *ballot measure* counts as direct lobbying, even without a call to action. In the case of ballot measures put on the ballot through a petition process, no specific legislation exists until the petitions are first circulated for signature. Treas Reg §56.4911-2(d)(1)(ii). Therefore, communications to the public about the subject of the measure before then are ordinarily not lobbying of any kind.

WARNING: Some ballot measures are placed before the voters by the legislature and governor. Influencing the legislation to place the measure on the ballot would be lobbying. In addition, communications with the public on ballot measures can trigger registration and reporting as a political committee under California law. See §19.41.

Electioneering prohibition inapplicable. Because a ballot measure is clearly legislative in nature, lobbying on a ballot measure is not barred by the candidate electioneering prohibition, even though the vote on most ballot measures occurs at the same time and on the same ballot as the election of candidates.

Further guidance. Charities interested in ballot measure lobbying should consult Colvin & Finley, Seize the Initiative (1996). Northern California Grantmakers has published two guides: The Private Foundation's Guide to the California Initiative Process and The Public Charity's Guide to the California Ballot Initiative Process, both by Rosemary Fei, Diane Fishburn, and Barbara Rhomberg; these guides cover the intersection of tax law and election law, and both guides are available at the Northern California Grantmakers website at http://www.ncg.org.

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§19.22 (2) Communicating With Members

A charity's communication urging its bona fide members to contact their legislators is direct lobbying. Treas Reg §56.4911-5(c)-(d). If, however, the charity urges its members to urge others to call their legislators, that is grassroots lobbying. A single communication with members that mixes a grassroots and direct lobbying message counts entirely as grassroots lobbying, with no allocation between direct and grassroots activities.

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§19.23 (3) Affiliated Charities

The sliding-scale spending limits discussed in §19.13 disproportionately limit spending on lobbying by large charities. Internal Revenue Code §4911(f) and Treas Reg §56.4911-7 limit a charity's ability to avoid the spending limits by forming a series of smaller charities. If more than one charity's lobbying activities are under common control, they are treated as a single entity for purposes of the IRC §501(h) limits.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.24 (4) Mass Media Rule

§19.24 (4) Mass Media Rule

Certain paid mass media advertisements that do *not* meet the definition of grassroots lobbying because they do not contain any call to action or refer to specific legislation as defined by the regulations (see §19.15) are, nevertheless, presumptively treated as grassroots lobbying if (Treas Reg §56.4911-2(b)(5)(ii)):

- The legislative matter the advertisement refers to is highly publicized; and
- The advertisement runs within 2 weeks before the legislation comes up for a vote.

PRACTICE TIP: Because it is often impossible to predict exactly when a specific piece of legislation will come up for a vote, charities should be cautious when this rule might come into effect. The charity can also try to rebut the presumption.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.25 (5) Subsequent Use Rule

§19.25 (5) Subsequent Use Rule

The regulations address the preparation of nonlobbying materials later used in a grassroots lobbying communication. See Treas Reg §56.4911-2(b)(2). For example, assume that a charity uses substantial staff time and incurs substantial costs to prepare and reproduce an illustrated position paper that reflects a view but does not contain a call to action on pending legislation. Then the charity's president takes a few minutes to write a one-paragraph letter, which does contain a call to action, to be sent to the public with the paper.

The letter is clearly lobbying. However, this use of the letter may convert the enclosed nonlobbying materials into a lobbying communication unless the charity meets one of two safe harbors (Treas Reg §56.4911-2(b)(2)):

(1) The charity can demonstrate a primary nonlobbying purpose, such as by making a substantial nonlobbying distribution of the paper at the same time as or before the lobbying use; or

(2) The charity paid all expenses for the nonlobbying paper at least 6 months before the lobbying use occurred.

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§19.26 h. Tracking Lobbying Expenditures

Once the charity determines that a particular activity is either direct or grassroots lobbying, it must decide what expenditures associated with that activity must be reported as lobbying expenditures. All out-of-pocket expenses must be counted (*e.g.,* travel, printing, long distance telephone charges, payments to lobbyists), as well as internal costs directly associated with the lobbying activities (*e.g.,* staff time for research, drafting, reviewing, distribution), plus an appropriate allocation of overhead (*e.g.,* rent, utilities, employee benefits). See Treas Reg §56.4911-3.

Staff involved in lobbying are advised to keep time sheets, which can then be used to allocate the individual's salary and benefits, and, on an aggregate basis, the organization's overhead. The regulations contain some rules on allocation of mixed purpose expenditures, transfers, and other subjects. See Treas Reg §56.4911-3. When there is no regulation on point, charities are advised to be reasonable and consistent in how they decide what expenses and overhead are attributable to lobbying. Although the accounting rules for lobbying by business taxpayers in Treas Reg §§1.162-28 and 1.162-29 do not directly apply to charitable lobbying, some of them may apply by analogy.

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§19.27 (1) Donations to Other Entities

In general, grants and contributions by one charity to another earmarked for lobbying result in reportable lobbying expenditures by the grantor and grantee. Grants to a charity for general support, or earmarked for nonlobbying projects or purposes, are not lobbying expenditures by the payor, even if the payee engages in lobbying. Treas Reg §56.4911-4(d)(2). In a 2009 private letter ruling, the IRS determined that a grantmaker that is not a private foundation may rely on the special regulations governing grants by private foundations to determine whether the grant is earmarked for lobbying. IRS Letter Ruling 200943042, available at http://www.irs.gov/pub/irs-wd/0943042.pdf. See §19.31.

The IRS treats such grants to a noncharitable entity that lobbies as lobbying expenditures by the grantor unless the grantor charity makes what is called a "controlled grant," which expressly limits use of the grant to a specific nonlobbying activity of the recipient, and documents that limitation. Treas Reg §§56.4911-3(c)(3), 56.4911-4(d)(3).

A resource for private foundations is Fei, Fishburn & Rhomberg, The Private Foundation Guide to the California Initiative Process (2003), published by Northern California Grantmakers (see http://www.ncg.org).

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§19.28 (2) Mixed Purpose Communications

The regulations contain extensive, detailed rules for allocating expenditures associated with a communication with a mixed purpose (such as lobbying and nonlobbying, or grassroots and direct lobbying). The rules generally turn on whether the audience consists primarily (over 50 percent) or only (85 percent or more) of members and whether the allocation is between lobbying and nonlobbying, or between direct and grassroots lobbying. See Treas Reg §56.4911-5(e).

Lobbying and nonlobbying content. If a communication contains both lobbying and nonlobbying content and it is made primarily to members, the charity can use any reasonable basis to allocate between the two purposes (such as column-inches in a publication). See Treas Reg §56.4911-3(a)(2)(ii). But if a communication is made primarily to nonmembers, then anything on the same specific subject as the legislation must be treated as part of the lobbying communication. Treas Reg §56.4911-3(a)(2)(i).

Direct and grassroots lobbying. If a communication includes both direct and grassroots lobbying, the regulations on allocation are complicated and the details are beyond the scope of this chapter. Frequently, such mixed communications must be completely allocated to grassroots lobbying. Treas Reg §56.4911-3(a)(3).

For more information on allocating expenses, see Harmon, Ladd & Evans, Being a Player: A Guide to the IRS Lobbying Regulations for Advocacy Charities (1995), available at the Alliance for Justice website at http://www.afj.org/for-nonprofits-foundations/resources-and-publications/pay-for-publications/being-a-player-1.html.

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§19.29 i. Reporting Lobbying Expenditures to IRS

All charities must annually report, in Part IV of IRS Form 990, whether they engaged in lobbying. If so, they must complete Schedule C, Part II-A (for electing charities) or Part II-B (for non-electing charities). Electing charities must report totals for direct and grassroots lobbying expenditures, plus calculations of the lobbying limits and any excess lobbying expenditures subject to tax. Part II-A also requires electing charities to report 3 years of historical summary information to determine whether the charity's exempt status should be automatically revoked.

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§19.30 j. Pros and Cons of Making §501(h) Election

The benefits to electing charities of making an IRC §501(h) election are significant, because of the relatively generous expenditure limits for small groups, the favorable narrow definitions of what constitutes lobbying, the ability to use low-cost, high-impact methods, such as Internet communications, and to disregard volunteer efforts, and the virtual elimination of any risk of inadvertently losing tax-exempt status because of lobbying. Most charities that lobby and are eligible to do so should make the §501(h) election. The only exceptions might be extremely large charities for whom total lobbying expenditures over $1 million or grassroots lobbying over $250,000 could realistically be considered insubstantial, or charities that want to conduct only grassroots lobbying but in an amount that would exceed their §501(h) limit and would still likely be considered less than a substantial part of its activities in the absence of much or any direct lobbying activity.

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§19.31 3. Lobbying Prohibition on Private Foundations

Private foundations cannot make the IRC §501(h) election (see §19.11) and are absolutely prohibited from engaging in or earmarking funds for any lobbying activity by IRC §4945(d)(1), which makes lobbying activities a taxable expenditure, as discussed in §4.44.

Exceptions. Internal Revenue Code §4945(e), which governs private foundations, tracks the general definitions of direct and grassroots lobbying for electing public charities under IRC §4911(d)(1). It also gives private foundations the benefits of the technical advice request exception; the self-defense exception; and the nonpartisan study, analysis, and research exception. On similar exceptions available to public charities, see §19.19.

General support grants. A grantor foundation may give general support (*i.e.,* unrestricted) grants to public charities without generating taxable expenditures to the grantor foundation, even if the charity actually uses the grant for lobbying. Treas Reg §53.4945-2(a)(6)(i). A foundation, however, makes a prohibited taxable expenditure if the grant agreement (oral or written) governing the private foundation's grant requires the public charity to use the grant for specific purposes (called "earmarking") and if those activities are lobbying.

Grants earmarked for specific project. A special rule applies to a private foundation's grants earmarked for a specific project of an electing public charity if the project includes both lobbying and nonlobbying activities. The foundation's grant is not taxable as a lobbying expenditure as long as the foundation's grant or grants for the project do not exceed its budget for the project's nonlobbying activities. Treas Reg §53.4945-2(a)(6)(ii). The foundation is entitled to rely on budget information provided to it by the grantee if it has been properly certified by an officer of the grantee, unless the foundation has reason to doubt its accuracy. The foundation's right to rely on the grantee's budget is not affected by knowledge that other private foundations are relying on the same information in making their grants, even if the total of all private foundation funding for the project will exceed the nonlobbying portion of the project's budget.

Statement in grant agreement. A statement in the grant agreement that "there is no agreement, oral or written, that directs that the grant funds be used for lobbying activities" will satisfy the IRS that no earmarking for lobbying has occurred. IRS General Information Letter to Charity Lobbying in the Public Interest (Dec. 9, 2004); see http://www.clpi.org.

PRACTICE TIP: Practitioners often overlook a lobbying exception available only to private foundations: A foundation may exchange information with government officials regarding a program that is or may be jointly funded by the foundation and the government. Treas Reg §53.4945-2(a)(3).

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.32 4. Deductibility of Contributions

§19.32 4. Deductibility of Contributions

Donations made to an IRC §501(c)(3) organization are not deductible as charitable contributions if earmarked for lobbying. Rev Rul 80-275, 1980-2 Cum Bull 69.

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B. Federal Tax Law: Noncharitable Organizations

§19.33 1. Comparison With Charitable Organizations

Fewer restrictions. Generally speaking, noncharitable tax-exempt organizations face fewer federal tax law restrictions on lobbying and candidate electioneering activities than charities do. Noncharitable organizations are exempt under provisions other than IRC §501(c)(3). For example, social welfare organizations are exempt under IRC §501(c)(4), labor unions under IRC §501(c)(5), trade or professional associations under IRC §501(c)(6), and political organizations under IRC §527. Several articles published in the Exempt Organizations Continuing Professional Education (CPE) Technical Instruction Program for Fiscal Year 2003 (available on the IRS website at http://www.irs.gov/charities/article/0,,id=101915,00.html) address some of the lobbying and political tax issues for IRC §501(c)(4), (5), and (6) organizations.

For a table comparing the tax advantages and advocacy limitations that apply to charitable and noncharitable tax-exempt organizations, see §19.4.

Ineligible to receive tax-deductible contributions. For the most part, Congress has chosen to make noncharitable IRC §§501(c) and 527 organizations ineligible to receive tax-deductible charitable contributions under IRC §170(c)(2) because they may have no or much less charitable activity and they have more latitude to influence legislation and candidate elections. One notable exception is IRC §501(c)(19), applying to veterans' organizations, which may receive deductible charitable gifts under IRC §170 and conduct unlimited lobbying and substantial candidate electioneering activities. See *Regan v Taxation With Representation* (1983) 461 US 540, 76 L Ed 2d 129, 103 S Ct 1997.

Gift tax. Contributions to charities are free of gift tax under IRC §2522 but contributions to noncharitable IRC §501(c) groups may be subject to gift tax under IRC §2501(a)(1). See Rev Rul 82-216, 1982-2 Cum Bull 220 (stating IRS position in aftermath of *Carson v Commissioner* (10th Cir 1981) 641 F2d 864 and *Stern v Commissioner* (5th Cir 1971) 436 F2d 1327). Very large donors wishing to avoid gift tax may prefer to give to a charity or even to an IRC §527 political fund, which, surprisingly, is exempt from gift tax under IRC §2501(a)(1), rather than giving to an IRC §501(c)(4) social welfare organization. See IRS Letter Ruling 9652026. The annual gift tax exemption in 2009 is $13,000 for a single taxpayer, $26,000 for a married couple. See IRC §2503(b). For an extensive analysis, see Rhomberg, *Constitutional Issues Cloud the Gift Taxation of Section 501(c)(3) Contributions*, 15 J Tax'n Exempt Orgs 176 (Jan./Feb. 2004). See also Rhomberg, *The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions*, 15 J Tax'n Exempt Orgs 62 (Sept./Oct. 2003).

WARNING: Many ballot measure campaign committees are organized as IRC §501(c)(4) organizations. Individual donors making large donations in support of or in opposition to a ballot measure campaign committee may be exposed to gift tax under IRC §2501(a)(1), although evidence of IRS enforcement is sparse and anecdotal.

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§19.34 2. Scope of Lobbying

Exempt purpose. For any tax-exempt organization, the starting point for determining the scope of legislative activities is the exempt purpose of the organization. This purpose may appear in its articles of incorporation, bylaws, or other governing documents.

A noncharitable organization may engage in an unlimited amount of lobbying activity as long as the effort furthers the organization's exempt purpose, which means that the IRS may require the organization to demonstrate the nexus between the legislative goal and the exempt purpose. For example, it may be outside the purpose of a land conservation coalition to lobby for civil rights legislation.

Social welfare and other organizations. Groups formed to promote social welfare (IRC §501(c)(4)), labor (IRC §501(c)(5)), or businesses or professions (IRC §501(c)(6)) frequently devote most or all their efforts to lobbying. Prominent and powerful examples of IRC §501(c)(4) groups are the American Association of Retired Persons, the Sierra Club, the National Rifle Association, Common Cause, MoveOn.org Civic Action, and the NAACP local branches. The AFL-CIO is an IRC §501(c)(5) labor organization, and examples of IRC §501(c)(6) organizations are the United States Chamber of Commerce, the National Association of Manufacturers, and the American Medical Association.

Public interest organizations are often created under §501(c)(4), precisely because of their unlimited lobbying ability, as affiliates of existing IRC §501(c)(3) charities. On affiliated organizations, see §19.94. Free-standing public interest organizations created for a specific lobbying purpose, such as a coalition to support or oppose a specific bill in Congress or the state legislature, or a committee formed to sponsor, support, or oppose a ballot measure proposed to be adopted by a vote of the electorate, should generally qualify for IRC §501(c)(4) tax status. Ballot measure committees affiliated with an existing labor union or trade association can operate under their parent's IRC §501(c)(5) or §501(c)(6) tax-exempt status.

Social clubs and other organizations. Social clubs (IRC §501(c)(7)), fraternal societies (IRC §501(c)(8)), cemetery companies (IRC §501(c)(13)), and other IRC §501(c) organizations generally devote most or all of their expenditures to operating their programs and facilities, with little or no lobbying activity. However, the need to lobby can arise at any time, as when an organization has to obtain a zoning variance from a city council in order to construct a new building.

No reporting requirement. Unlike IRC §501(c)(3) organizations, noncharitable groups need not report their lobbying activities or expenditures to the IRS, except in connection with the nondeductibility of member dues and the proxy tax. Form 990, Schedule C, Part III. See §19.36. However, some states, including California, impose reporting of lobbying activities by both charities and noncharitable organizations. See §19.46.

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3. Deductions: Disclosure and Tax

§19.35 a. No Charitable Deduction; Required Statement in Solicitations

Noncharitable organizations (most IRC §501(c) categories, as well as IRC §§501(d) and 527 entities) with annual gross receipts that usually exceed $100,000 must include an express statement (in a conspicuous and easily recognizable format) in all fundraising solicitations that contributions or gifts "are not deductible as charitable contributions for federal income tax purposes." IRC §6113.

The disclosure is strictly required even if the payor does not expect to be making a charitable contribution, such as dues statements sent to members of a trade association who may, to some extent, be able to claim a business expense deduction for their payments under IRC §162. Details and safe harbors are described in IRS Notice 88-120, 1988-2 Cum Bull 454.

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§19.36 b. Business Deduction and Proxy Tax

Expenditures by taxable entities related to ballot initiatives and grassroots lobbying are nondeductible. Business taxpayers may not deduct payments for lobbying at the state and federal level as a business expense. Local direct lobbying expenditures and most forms of executive branch lobbying remain deductible. IRC §162(e).

Dues income. Disclosure burdens have been placed on many lobbying activities conducted by IRC §501(c)(6) trade and professional associations because they use dues income from business members. Some IRC §501(c)(4) and nonlabor IRC §501(c)(5) groups are also affected. These associations are required to tell their members what portion of their dues is used for lobbying and electioneering (see §19.72), and warn them not to take that portion as a deductible business expense. IRC §6033(e)(1). If the association does not do so, the members can take a full business expense deduction, but the association must pay a proxy tax on its lobbying and electioneering expenditures at the maximum corporate tax rate. IRC §6033(e)(2). Some associations, however, have found that the proxy tax is less expensive (or less provocative) than the disclosure.

Exception re dues income. If 90 percent of the organization's dues income comes from members that pay $101 (for 2010) or less annually, or who are not able to use the business deduction, the organization can avoid the tax pursuant to Rev Proc 98-19, 1998-1 Cum Bull 547. See Rev Proc 2009-50, 2009-45 Int Rev Bull 617. The IRS has issued accounting rules and definitions for business association lobbying that differ significantly from the provisions applicable to charitable organizations. Treas Reg §§1.162-28—1.162-29. For a more complete discussion, see Colvin, *Final Regulations and a Revenue Procedure Set the Business Lobbying Rules*, 7 J Tax'n Exempt Org 126 (Nov./Dec. 1995).

A constitutional challenge to the proxy tax regime failed at the federal district court level. See *American Soc'y of Ass'n Executives v U.S.* (D DC 1998) 23 F Supp 2d 64. The court of appeals upheld the district court, pointing out that the plaintiff IRC §501(c)(6) organization could split into two entities, one conducting lobbying and political activities and the other one not, and thus avoid any disadvantage under IRC §§162(e) and 6033(e). See *American Soc'y of Ass'n Executives v U.S.* (DC Cir 1999) 195 F3d 47.

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§19.37 C. California Tax Law

In almost every respect, the Revenue and Taxation Code follows federal tax law on lobbying and candidate electioneering. A few notable exceptions are mentioned below.

Provisions governing charitable organizations. Charitable organizations described in Rev & T C §23701d have the same basic "no substantial part" limitation on lobbying and the same absolute prohibition on candidate electioneering as in IRC §501(c)(3). Revenue and Taxation Code §§23704.5 and 23740 parallel IRC §§501(h) and 4911, allowing most public charities the option to report lobbying on an expenditure basis. Filing IRS Form 5768 with the IRS is sufficient to make the Rev & T C §23704.5 election under state law, but the Franchise Tax Board asks all charitable organizations that conduct lobbying or political activities to fill out and attach California FTB Form 3509 to the annual FTB Form 199 filing. On filing Form 199, see §§12.31-12.32. FTB Form 3509 asks for copies of any lobbying materials and a schedule of lobbying expenditures, but it is unclear whether that requirement applies to charities electing to lobby under IRC §501(h) (see §19.10). There is, however, no state excise tax on excess lobbying expenditures.

Provisions governing other IRC §501(c) organizations; proxy tax. Social welfare organizations exempt under IRC §501(c)(4) are subject to Rev & T C §23701f, labor unions are subject to Rev & T C §23701a, and trade associations are subject to Rev & T C §23701e. Organizations qualifying under a particular federal tax category ordinarily qualify for the state tax exemption in the parallel state category. So far, there is no proxy tax provision for business associations parallel to IRC §6033(e), but IRC §162(e), disallowing deductions for state and federal lobbying, applies to California taxpayers. Rev & T C §24343.

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§19.38 D. Nontax Laws Affecting Lobbying

In addition to state and federal tax law rules, other federal, state, and local rules aimed at "good government," transparency, and political reform may apply to the lobbying activities of nonprofit organizations. See §§19.38-19.36. Those rules generally either impose additional limits on efforts to influence public policy or establish reporting obligations.

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1. Federal

§19.39 a. Lobbying Disclosure Act (LDA)

Requirements of LDA. The Lobbying Disclosure Act of 1995 (LDA) (2 USC §§1601-1614) requires charities, and other exempt and nonexempt organizations, to register with the Secretary of the Senate and the Clerk of the House of Representatives and file quarterly reports if they employ a lobbyist (whether staff member or independent contractor) and expect to or do incur lobbying expenses of $10,000 or more in a calendar quarter. See 2 USC §§1603(a), 1604(a). The Honest Leadership and Open Government Act of 2007 (HLOGA) (Pub L 110-81, 121 Stat 735) amended the LDA and other rules relevant to federal lobbyists, increasing the frequency and detail of reporting by lobbyists and lobbyist employers covered by the LDA, and raising the penalties for noncompliance.

The organization must continue to file quarterly and semiannual reports until it stops all lobbying efforts, with no intent to resume them. The HLOGA also expanded the LDA's reporting requirements for certain members of coalitions that engage in federal lobbying, and imposed new limits on giving gifts to, and paying travel expenses of, federal legislators and their staffs.

Definition of "lobbyist." Under the LDA, as amended by HLOGA, a "lobbyist" is defined as someone who makes at least two lobbying contacts in a calendar quarter and spends at least 20 percent of his or her time lobbying. See 2 USC §1602(10).

Application of LDA. The LDA applies only to direct lobbying of federal legislators and some federal administrative officials, but a public charity that has made the IRC §501(h) election (see §19.10) may use its calculation of lobbying expenditures under IRS rules (which include grassroots as well as state and local lobbying) as an alternative method of reporting under the Act. The lobbying definitions and exceptions under §501(h) and the LDA differ significantly, so the choice of preferred reporting method will vary, depending on the organization's circumstances.

PRACTICE TIP: The Office of the Clerk of the United States House of Representatives publishes on its website additional guidance concerning the interpretation and implementation of the LDA. See http://lobbyingdisclosure.house.gov.

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§19.40 b. Rules Applicable to Federal Grantees

Audit rules developed by the federal Office of Management and Budget (OMB) dictate that federal grant funds cannot be used to influence ballot measure elections at the federal, state, or local level. Direct and grassroots lobbying on federal or state legislation with federal funds is prohibited, but local lobbying is not barred, presumably to allow grantees to lobby local governing bodies for supplemental funds. Technical advice and other exceptions exist that differ from the exceptions under IRC §501(h). OMB Circular A-122, 48 CFR §31.205-22 (obtainable from the OMB website at http://www.whitehouse.gov/omb).

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§19.40A c. Executive Order

Shortly after taking office, President Obama issued an Executive Order imposing strict limits on interactions between his administration and individuals who have, within the previous 2 years, been registered lobbyists under the Lobbying Disclosure Act of 1995 (LDA) (2 USC §§1601-1614). Executive Order No. 13490 (Jan. 21, 2009) (74 Fed Reg 4673). One consequence of these new ethics rules is that an exempt organization employee who registers under the LDA may be ineligible for a political appointment in the Obama Administration (and possibly future administrations, if the Executive Order remains in place). Exempt organization staff interested in a future federal political appointment may want to consider whether to engage in activities that require registration under the LDA.

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2. California

§19.41 a. Ballot Measures

Many provisions of the Political Reform Act of 1974 (Govt C §§81000-91014) affect nonprofit organizations involved in ballot measure campaigns. Nonprofit organizations that raise or spend over certain amounts related to ballot measures are required by state law and sometimes local law to register and file campaign finance disclosure statements. These laws may affect how the organization raises money, what must be said in advertisements and mailings, and other campaign activities. The following are some particular provisions that nonprofit advisers frequently encounter.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.42 (1) Financial Disclosure Reports

§19.42 (1) Financial Disclosure Reports

An organization that spends money to help qualify, support, or oppose a ballot measure, or that contributes to a ballot measure committee, must file financial disclosure reports if the filing threshold amount is reached. The reports, on forms issued by the Fair Political Practices Commission (FPPC), must be filed with the Secretary of State and with local election offices in three basic situations:

(1) For independent expenditures expressly advocating for or against one or more ballot measures, the threshold is $1000 or more in a calendar year. See Govt C §82013(b).

(2) For contributions to one or more ballot measure committees, the "major donor" threshold is $10,000 or more in a calendar year. See Govt C §82013(c).

(3) Recipient committee reports are typically required from groups that *raise* $1000 or more for or against a ballot measure. See Govt C §82013(a).

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§19.43 (2) Recipient Committee Reports

A "recipient committee" report may be required from a nonprofit organization that makes political contributions or expenditures of as little as $1000 in a calendar year, if the organization has a history of election-related contributions or expenditures within the past 4 years. See Govt C §82013(a); 2 Cal Code Regs §18215. The Ninth Circuit Court of Appeals has upheld this regulation from a challenge brought by a nonprofit organization that alleged the nonprofit should not be required to disclose its donors merely as a result of establishing a history of making independent expenditures in support of or opposition to California ballot measures. See *California ProLife Council, Inc. v Randolph* (2007) 507 F3d 1172. This requirement can arise when the campaign expenditure is traceable to dues and contributions from members and donors rather than other nondonor sources. Efforts to raise funds earmarked for a ballot measure campaign should be conducted by a separate recipient committee, which must file a statement of organization within 10 days after receiving its first $1000 in contributions and must file periodic reports thereafter. See Govt C §84101(a).

Triggering recipient report requirement. Current Fair Political Practices Commission (FPPC) interpretations suggest that a nonprofit organization that has no history over the prior 4 calendar years of making political contributions or expenditures will not qualify as a recipient committee if it makes contributions or expenditures in the current year. However, multiple contributions totaling $1000 or more made to a ballot measure committee within the same calendar year by a nonprofit organization using donor funds will trigger disclosure by the nonprofit of its donors and contributors, even if the nonprofit has no history over the prior 4 calendar years of making political contributions or expenditures. The determination can be complex and is highly dependent on specific facts.

Efforts by the FPPC to require a multi-purpose nonprofit with a history of making contributions or independent expenditures related to California ballot measures to register as a recipient committee were struck down in *California ProLife Council, Inc. v Randolph, supra,* although the Ninth Circuit still found that disclosure of donors and contributors was constitutional. In response to the decision, the FPPC has adopted a regulation providing for disclosure of donors by multi-purpose nonprofits that make independent expenditures in connection with California ballot measures. See 2 Cal Code Regs §18413.

For an enforcement action brought by the FPPC before the *California ProLife* case against a nonprofit organization for failure to register as a political committee and disclose its donors, see *Fair Political Practices Comm'n v American Civil Rights Coalition, Inc.* (2004) 121 CA4th 1171, 18 CR3d 157, superseded by statute as stated in *Hall v Time Warner, Inc.* (2007) 153 CA4th 1337, 1349, 63 CR3d 798.

Even a nonprofit organization with no history of making contributions or independent expenditures in California may still have to file reports as an independent expenditure committee ($1000 threshold) or as a major donor committee ($10,000 threshold). Cal FPPC Advice I-99-126 (June 2, 1999), WL 551062.

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§19.44 (3) Reporting Staff Time

Organizations need not report compensated staff time for employees who spend 10 percent or less of their time during a calendar month on election-related activities, including gathering signatures. 2 Cal Code Regs §18423. However, IRC §501(c)(3) organizations must report all compensated employee lobbying time to the IRS, which time counts toward the organization's lobbying limitations. See §19.26. For further information, contact the Fair Political Practices Commission (FPPC) through its website at http://www.fppc.ca.gov/.

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§19.44A (4) Reporting Member Communications

Organizations need not report expenditures for communications to members, employees, or families of members and employees, nor do such expenditures count toward the threshold for registration as a recipient committee. Govt C §85312. However, an organization's communications with its members may be treated differently under federal tax law. See §§19.22, 19.81.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.45 (5) Electronic Filing Requirements

§19.45 (5) Electronic Filing Requirements

Independent expenditure committees, major donors, and recipient committees active in state ballot measure campaigns must file campaign disclosure reports electronically (along with paper copies) with the Secretary of State once they reach a $50,000 cumulative threshold. Govt C §84605. Only vendor-approved software may be used. For a list of approved software vendors, check the Secretary of State's website at http://www.sos.ca.gov/.

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§19.46 b. Other Lobbying

Organizations employing lobbyists and organizations that spend $5000 or more in any calendar quarter to influence legislative or administrative action, subject to certain exceptions, must report their expenditures to the Secretary of State on Fair Political Practices Commission (FPPC) forms under the Political Reform Act of 1974 (Govt C §§81000-91014). Govt C §§86100-86300. Because this law covers administrative agency lobbying, IRC §501(c)(3) organizations having no legislative lobbying expenditures to report under IRS rules may nevertheless be required to file administrative lobbying reports in California.

Employees of organizations will be considered lobbyists if they spend one-third or more of their compensated time in any calendar month engaging in direct communication with one or more qualifying public officials for the purpose of influencing legislative or administrative action. See Govt C §82039; 2 Cal Code Regs §18239.

Lobbying coalitions are also subject to special reporting rules. California law requires lobbyists, lobbying firms, and lobbyist employers to file reports electronically if their reportable payments or expenses are $5000 or more in a calendar quarter. Govt C §84605. For further information, contact the FPPC through its website at http://www.fppc.ca.gov/.

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§19.47 III. CANDIDATE ELECTIONEERING

Charities are the most restricted of nonprofits with respect to their lobbying and candidate electioneering activities. Generally, a charity may engage in strictly limited amounts of lobbying but is absolutely prohibited from candidate electioneering. See Treas Reg §1.501(c)(3)-1(c)(3) ("action organization" regulations).

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§19.48 A. Federal Tax Law: IRC §501(c)(3) Charities

Charities exempt under IRC §501(c)(3) may not "participate in, or intervene (including the publishing or distributing of statements), in any political campaign on behalf of (or in opposition to) any candidate for public office." IRC §501(c)(3). There is virtually no legislative history to accompany this provision nor is there any comprehensive and detailed scheme of regulations. What is clear, however, is that the candidate electioneering prohibition is absolute—*any* candidate electioneering is grounds for revoking a charity's tax-exempt status. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, pp 335, 352 (2002 CPE Handbook). This publication is available through the IRS website at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

Additional grounds for revoking status of political organizations. The IRS has successfully pursued a second doctrinal basis for revoking a politically partisan organization's IRC §501(c)(3) status. An exemption for an organization that trained Republican campaign workers was revoked because the training conferred a "more than incidental" private benefit on Republican candidates and entities. *American Campaign Academy* (1989) 92 TC 1053. Similarly, in *Fund for the Study of Economic Growth & Tax Reform v IRS* (D DC 1998) 997 F Supp 15, aff'd (DC Cir 1998) 161 F3d 755, the court found that advancing a particular political message (the flat tax) in support of the Republican agenda in the 1996 elections was a "substantial non-exempt purpose" in violation of the requirement that charitable organizations be "operated exclusively" for exempt purposes. The Court of Appeals for the District of Columbia upheld this decision on grounds of improper lobbying alone, without discussing the candidate electioneering issues. See 2002 CPE Handbook, App II, p 452 (available online at http://www.irs.gov/pub/irs-tege/eotopici02.pdf).

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§19.49 1. Scope of Prohibition: Speech and Attribution

Although the prohibition on candidate electioneering by charities is absolute in the sense that there is no de minimis permitted amount of such activity, this does not mean that charities have no role or legitimate interest in elections.

Charities cannot, for example, do the following (see *Association of the Bar v Commissioner* (2d Cir 1988) 858 F2d 876; IRS Letter Ruling 9635003):

- Endorse or oppose any candidate;
- Contribute money or resources to any candidate's campaign or political party; or
- Rank candidates, even if ranking is the result of a neutral and unbiased process without regard to political affiliation.

There are, however, numerous activities involving elections in which a charity may engage in furtherance of its charitable purposes. See §§19.50-19.51.

PFF Investigation. Serious questions about IRS views on the scope of the political prohibition were raised by a February 3, 1999, Technical Advice Memorandum upholding the charitable exemption of the Progress and Freedom Foundation (PFF) (unnumbered but available from PFF, which may be contacted online at http://www.pff.org). The IRS ruling concluded that the content of PFF's televised course (featuring former Speaker of the House of Representatives Newt Gingrich) was educational and nonpartisan, that the course was widely distributed to the general public as well as to Republican groups, that the course was not timed or targeted to influence elections, and that PFF was properly separated from GOPAC (an IRC §527 political action group, headed by Newt Gingrich) consistent with the United States Supreme Court's decision in *Regan v Taxation With Representation* (1983) 461 US 540, 76 L Ed 2d 129, 103 S Ct 1997 (see §19.94). The IRS had a great deal of evidence showing that Speaker Gingrich had articulated political goals for the conduct and dissemination of the course. However, because he was not a director or officer of PFF, and his statements were not made in his capacity as teacher of the course, the IRS did not attribute his statements to PFF. On acts of others attributed to a charity, see §19.54.

The PFF letter ruling, along with another case involving the Abraham Lincoln Opportunity Foundation (ALOF), present important considerations for practitioners. For further analysis, see Colvin, *Looking for the Lessons of the Gingrich Affair*, 11 J Tax'n Exempt Orgs 82 (Sept./Oct. 1999).

Critics have charged that the IRS has leaned more heavily on the political activities of conservative groups in recent times. After a lengthy study, the Joint Committee on Taxation of the United States Congress found "no credible evidence" of any such bias in IRS enforcement. JCS-3-00, Feb. 25, 2000.

NAACP and All Saints Investigations. During the 2004 election season, the IRS received numerous complaints about partisan activity conducted by churches and other IRC §501(c)(3) organizations. The Service commenced a political intervention enforcement program of inquiries and audits directed to many of the alleged violators, including the National Association for the Advancement of Colored People (NAACP) (speech by Julian Bond at annual convention) and All Saints (Episcopal) Church in Pasadena (sermon by guest pastor). In August 2006, the IRS closed its examination of the NAACP after reviewing video footage of Bond's speech to its 2004 national convention and concluding, without specific analysis, that political intervention did not occur. In September 2007, the IRS closed the All Saints investigation, concluding that political intervention had occurred, but that All Saints retained its tax-exempt status.

PRACTICE TIP: The most authoritative and recent IRS guidance on the political rules for charitable organizations is presented in Rev Rul 2007-41, the first precedential guidance the IRS has provided on the subject in many years. Rev Rul 2007-41, 2007-25 Int Rev Bull 1421. This ruling, which provides 21 examples illustrating the application of the facts and circumstances considered in determining whether a §501(c)(3) charitable organization participated or intervened in any political campaign, updates the nonprecedential Fact Sheet 2006-17, issued as part of the IRS's Political Activity Compliance Initiative (PACI).

United Church of Christ Investigation. In 2008, the IRS closed an investigation into a speech given in June 2007 by then-candidate Barack Obama at a large gathering of members of the United Church of Christ (UCC), an IRC §501(c)(3) church. The IRS concluded that the appearance did not violate the prohibition on candidate electioneering, noting specifically the presence of the following factors: Sen. Obama was invited to speak before he had announced his candidacy for public office; the topic of his speech was the intersection of Obama's private faith with his public life; the audience was notified orally at the event that Obama was participating as a member of the church, not as a candidate, and that the audience should not attempt to engage in any political activities; the church's legal counsel had advised Obama's campaign of the ground rules for the speech; campaign activity conducted by Obama campaign volunteers at the time of the speech occurred without authorization from the church and on public property not within the control of the church; the church's legal counsel advised church leaders of the existence of Rev Rul 2007-41, 2007-25 Int Rev Bull 1421; and the church's website included a link to IRS information about the limits on political activity by IRC §501(c)(3) organizations. The IRS reached this conclusion despite the fact that Obama's speech included two references to his candidacy. See 2008 Tax Notes Today 100-24.

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2. Permissible Election-Oriented Activities

§19.50 a. Voter Education

Certain nonpartisan activities directed at improving the electoral process are deemed to promote or facilitate democracy for the benefit of the public, a proper IRC §501(c)(3) charitable purpose, rather than constituting intervention for or against any candidate. Charities can engage in activities such as registering voters, conducting candidate debates, distributing general voter education information (including information about the candidates), or running get-out-the-vote operations on election day as long as these activities are conducted in a nonpartisan manner. On the IRS's construction of "nonpartisan," see §19.52. On specific activities that may be carried out in a nonpartisan manner, see §§19.55-19.63.

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§19.51 b. Issue Advocacy

Charities may also take advantage of heightened public awareness of certain issues during candidate campaigns for their own charitable purposes, draw attention to their agendas, and educate the public about the importance of their concerns. Rev Rul 2007-41, 2007-25 Int Rev Bull 1421. The issue advocacy must be conducted in a "nonpartisan manner" as the courts and the IRS interpret that concept. Issue advocacy differs from the more general voter education efforts by highlighting the charity's views and furthering the charity's substantive agenda, rather than simply improving the functioning of democracy. See §19.50.

WARNING: Issue advocacy can easily cross over into regulated candidate electioneering. Some of the more difficult questions raised by issue advocacy in the context of an election are discussed in §§19.52-19.63. Certain issue ads referring to candidates in California elections may trigger reporting, contribution limits, and donor disclosure requirements under campaign finance laws. See §19.93. Targeted issue ads referring to federal candidates within 30 or 60 days before an election or caucus may require disclosure under the Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81). See 2 USC §434(f). See also §19.84.

For a comparison of issue advocacy and candidate electioneering, see §19.64.

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§19.52 (1) "Nonpartisan" Defined

For both voter education and issue advocacy election-related activities, the definition of "nonpartisan" is crucial. Unfortunately, the definition is unclear and under debate both among practitioners and between practitioners and the IRS. "Nonpartisan" means much more than merely avoiding "express advocacy" (*e.g.,* "Vote for Candidate X" or "Reject your Senator"). Further, "nonpartisan" in this context does not refer only to political parties. One might think that "nonpartisan" means not tending to help or hurt the electoral chances of any candidate or group of candidates, directly or indirectly. There are, however, several examples of activities permitted by the IRS that nevertheless may tend to help or hurt one or more candidates. See §§19.56-19.57.

NOTE: Several observers have argued that often the only supportable rationale for distinguishing between prohibited partisan activity and permissible nonpartisan activity is to consider evidence of the charity's intent or purpose for engaging in the conduct in question. See Colvin, C*an a Section 501(c)(3) Organization Have a Political Purpose?*, 10 J Tax'n Exempt Orgs 40 (July/Aug. 1998); Yablon & Coleman, *Intent Is Not Relevant in Distinguishing Between Education and Politics*, 9 J Tax'n Exempt Orgs 156 (Jan./Feb. 1998).

The IRS has not clarified, in any official publication, whether partisan intent is irrelevant to a determination that a charity violated the prohibition. The discussion in Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 350 (available through the IRS website at http://www.irs.gov/pub/irs-tege/eotopici02.pdf), illuminates but does not resolve the question of the relevance of evidence of partisan intent.

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§19.53 (2) "Candidate" and "Public Office" Defined

A "candidate" includes not only declared, official candidates for public office, but anyone who offers himself or herself, or is proposed by others, as a contestant. Treas Reg §1.501(c)(3)-1(c)(3)(iii). This definition is substantially broader than the definition used by the Federal Election Commission and in most state election laws. See 11 CFR §100.3.

Similarly, the IRS definition of a "covered public office" exceeds the scope of federal and many state election laws. It includes any position filled by a vote of the people at the national, state, or local level, elective party offices (such as state party chair), and so-called nonpartisan offices (such as elected judicial positions), in which no party affiliation may be declared. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 339, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

Efforts by charities to influence *appointments* to public office are not covered by the candidate electioneering prohibition, although they constitute lobbying if the appointment requires a confirmation vote from a legislative body. See §19.15.

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§19.54 (3) Acts of Others Attributed to the Charity

Whether an act is the act of the charity at all is a threshold issue in determining whether a candidate-related activity is permissible. This raises the question of when the actions of individual spokespeople or volunteers will be attributed to the charity.

Revenue Ruling 2007-41, 2007-75 Int Rev Bull 1421 provides some precedential guidance regarding the circumstances under which the actions of an individual will be attributable to a charity to which the individual is connected. The ruling states that an organizational leader is free to participate in political activities in his or her individual capacity. However, for the organization to remain tax exempt under IRC §501(c)(3), the leader cannot make partisan comments in official organization publications or at official functions of the organization. The ruling illustrates this principle with four examples.

In IRS Letter Ruling 200044038, presidential candidate Bob Dole was found to be acting as a fundraising agent when he signed direct mail solicitations for his Heritage Foundation. Because the content of the letters was politically partisan and they were timed to coincide with the 1996 election, the Foundation was found in violation of the IRC §501(c)(3) prohibition on candidate electioneering. Contrast this result with the treatment of Newt Gingrich and PFF described in §19.49.

The ban on candidate electioneering does not prevent charity spokespersons or officials from being involved personally in a political campaign as long as the charity's financial resources, facilities, or personnel are not used, and the individual clearly and unambiguously shows that his or her actions are not those of the charity.

Individual political activity by religious leaders is discussed in IRS Pub 1828, Tax Guide for Churches and Religious Organizations, pp 7-8 (June 2008).

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§19.55 3. Specific Activities

Charities concerned about whether the IRS will view proposed activities as candidate electioneering may apply to the IRS for a private letter ruling, setting forth their proposal. In appropriate cases, the IRS will send a ruling on how the proposed activities will be treated, although the process can be prolonged. Letter rulings do not bind the IRS as to other parties, but they do provide an insight into the IRS's analysis of the issues from which practitioners can extrapolate how the IRS might deal with similar issues.

Specific types of election-oriented activities are discussed in §§19.56-19.63. For additional information, see Colvin & Finley, The Rules of the Game: An Election Year Legal Guide for Nonprofit Organizations (1996), available on the Alliance for Justice website at http://www.afj.org/for-nonprofits-foundations/resources-and-publications/pay-for-publications/being-a-player-1.html.

NOTE: Charities that engage in nonpartisan activities are generally not required to register and disclose those activities on federal and state campaign reports.

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§19.56 a. Voter Registration and Get-Out-the-Vote Efforts

A charity can operate a nonpartisan voter registration program or get-out-the-vote (GOTV) drive, if the operation is carried out in a nonpartisan manner, with no evidence of bias for or against any candidate or party. Rev Rul 2007-41, 2007-25 Int Rev Bull 1421. But see §19.84 on fundraising to support these activities. Who the target audience will be is a key decision determining permissibility in both voter registration and GOTV efforts. Neutral selection criteria, such as targeting low-income, minority, low-turnout, homeless, or student populations or a preexisting constituency, such as members, clients, patients, or neighbors in a vicinity, may be acceptable even if the targeted group is statistically more likely to vote for one candidate over the other. Targeting populations based on party affiliation, or using messages targeted at, *e.g.,* "conservative," "liberal," "pro-life," or "green" voters, are generally not acceptable. To decide whether a particular effort was conducted in a fully nonpartisan manner, the IRS considers not only the targeted population but all the facts and circumstances surrounding a charity's voter registration or GOTV effort, including the following (Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, pp 378):

- Board meeting minutes;
- Internal and external correspondence;
- Timing; and
- The format and content of materials used.

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§19.57 b. Publishing Voting Records and Voter Guides

When permitted. Many charities regularly publish a voting record or legislative scorecard, compiling incumbent legislators' votes on specific legislation over a period of time to show how incumbents in a particular area have voted on legislation of interest to their members. As long as charities publish such materials regularly, regardless of whether an election is pending, and do not vary the manner or volume of distribution near election time, it is not prohibited, even if the range of issues is quite narrow and tailored to the charity's legislative agenda. Rev Rul 80-282, 1980-2 Cum Bull 178. The IRS may find a charity in violation, however, if the distribution is directed to the public rather than the charity's members or if materials are published only in an election year. It is safer for the charity to continue a preexisting program using legislative scorecards than to start publishing scorecards during an election. Most importantly, scorecards should not be targeted to close races.

Voter guides. A voter *guide,* unlike a voting *record,* focuses on candidates, rather than incumbents, and generally features head-to-head comparisons of the candidates' positions on various issues. The IRS has offered one model for a nonpartisan voter guide that a charity could publish; it is in See Rev Rul 78-248, 1978-1 Cum Bull 154, Situation 2. To stay within this framework, the charity must solicit from each candidate for a given office a brief statement of his or her position on a wide variety of issues selected solely on the basis of their importance and interest to the electorate as a whole. Neither the questions nor the published guide, in content or structure, may contain any evidence of bias or preference for or against the views of any candidate. All responses must be published. Although varying from this single model should certainly be possible, legal advice must rest heavily on the judgment of individual practitioners and the client's tolerance of risk.

On at least one occasion, the IRS has informally approved of an online candidate debate. These were the circumstances: The Federal Election Commission (FEC) had issued an Advisory Opinion (FEC AO 1990-25), which approved a website (http://www.congress.org/congressorg/home) sponsored by the IRC §501(c)(3) League of Women Voters. The website contained an interactive online voter guide that compared the candidates' views on various questions and included a sampling of newspaper endorsements. In public remarks, Marcus Owens, then IRS Exempt Organizations Division Director, reacted to the AO by stating that the standards set forth in the AO were a "pretty good fit" under IRS rules as well. Stokeld, *Exempts' Online Voter Education Project Gets FEC Approval*, 26 Exempt Org Tax Rev 371 (Dec. 1999).

The IRS indicated that "a neutral, unbiased, and complete compilation of all candidates' positions," even in the absence of a questionnaire, might be acceptable. IRS Pub 1828, Tax Guide for Churches and Religious Organizations, pp 10-11 (June 2008).

Further analysis. Further analysis of voting records and voter guides from the IRS appears in Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 370 (2002 CPE Handbook), available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf. That handbook indicates that voter guides distributed during an election campaign may have a narrow issue focus but must avoid inviting the audience to compare the candidates' positions with the organization's own views. See 2002 CPE Handbook, p 375.

For a discussion of the settlement between the IRS and the Christian Coalition International which involved its IRC §501(c)(4) tax exemption and the nonpartisanship of the voter guides it publishes and distributes through churches, see Colvin, *IRS Gives Christian Coalition a Green Light for New Voter Guides*, 50 Exempt Org Tax Rev 353 (Dec. 2005). The settlement imposed a set of standards that other organizations may wish to emulate, especially affecting the interaction between the Coalition and the candidates who are asked to respond to a questionnaire.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.58 c. Candidate Forums and Debates

§19.58 c. Candidate Forums and Debates

A charity may sponsor a debate between or among candidates for an office if the debate meets the following criteria (see Rev Rul 86-95, 1986-2 Cum Bull 73; see also Rev Rul 2007-41, 2007-25 Int Rev Bull 1421):

- All qualified candidates are invited;
- The questions are prepared by an independent panel;
- A broad range of topics is covered;
- Each candidate receives an equal opportunity to give his or her views; and
- The moderator is a neutral party who acts in an unbiased manner and states at the beginning and end of the program that the views expressed are not those of the charity.

Variations on this model are acceptable if the variations do not impair the principles of neutrality it embodies. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, pp 372, 377, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

For an example of an online candidate debate approved by the FEC, and informally by a top IRS official, see FEC AO 1990-25, discussed in §19.57.

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§19.59 d. Efforts to Influence Candidates or Parties

Charities may try to influence candidates' stands on the issues or party platforms on a nonpartisan basis. A charity may call, visit, or provide materials to all candidates or all major parties on its own initiative. If requested to provide materials by a candidate, it should respond in the same manner and with the same materials it would provide to any inquiring member of the public. If a charity testifies before party platform committees, it should provide the testimony to all major parties, and include a disclaimer stating that testimony is provided for educational purposes only.

A charity may not ask a candidate to make a pledge, to the charity, to support or oppose a certain policy position, because this would imply that the charity endorses those who agree and opposes those who do not. Rev Rul 76-456, 1976 Cum Bull 151. If a candidate chooses to publicly announce his or her support for the charity's position, the charity should maintain its neutrality and disclaim any endorsement of the candidate if the circumstances warrant it, such as when press reports portray the charity as endorsing a candidate.

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§19.60 e. Organizer or Candidate Training

Charities may educate organizers and even potential candidates about the electoral process if nonpartisan requirements are met. The training program must be nonpartisan in its recruitment of instructors and students, the content of its curriculum, its placement services, and all other operational aspects. Programs should be open and widely publicized, although they may target groups historically underrepresented in the electoral process, such as low-income, minority, or disabled persons. For an example of a program that failed the nonpartisan standard and thus lost its tax-exempt status, see *American Campaign Academy* (1989) 92 TC 1053, in which the basis for revocation was that the organization operated for the benefit of the Republican Party. See also Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, pp 335, 352, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

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§19.61 f. Fundraising

On the one hand, charities should avoid sponsoring joint fundraising events with candidates or political groups. On the other hand, charities often use politicians as fundraisers for charitable causes, which is acceptable as long as it is clear that any contribution is strictly dedicated to the charity's purposes. Problems can easily arise if there is a return benefit to the politician in exchange for his or her assistance in solicitations or if charitable funds are intentionally used to benefit one political party or candidate over its rivals. Fundraising materials can and should be a charity's opportunity to promote its accomplishments. Obviously, these accomplishments cannot include having engaged in prohibited candidate electioneering. Less obviously, the IRS found that fundraising solicitations *in themselves* can constitute candidate electioneering if they show a preference for a particular candidate. See IRS Letter Rulings 200044038, 9609007. But see IRS Letter Ruling 200602042 (allowing charitable fundraising letters signed by incumbent candidates as long as letters were not mailed to jurisdiction in which candidate sought re-election).

WARNING: California law requires state and local candidates, including incumbent elected officers, to file a "behested payment" report when soliciting donations on behalf of charities within 30 days following the date on which payments equal or exceed $5000 in the aggregate from the same source in the same calendar year. Govt C §80215(b)(2)(B)(iii). For a discussion of the Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) limitations on political party (including officers and agents) and federal candidate involvement in fundraising, see §§19.88, 19.90.

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§19.62 g. Relationship to Candidates and Political Organizations

Political action committees; mailing lists. A charity is not permitted to have a political action committee that supports or opposes candidates, although individuals associated with a charity may form a committee independently. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 366, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf. A charity should be cautious in sharing resources (such as office space or employees) with a political organization, bearing in mind that charities may not subsidize the activities of political organizations. A completely arm's-length transaction is permissible, absent indications of the charity's intent to affect the electoral outcome through the transaction, although it may result in unrelated business income to the charity. See chap 17. For example, a charity may sell or rent its mailing list to a candidate or a party as long as it charges the full fair market value and makes the list available to the other candidates or parties on the same basis. See Rev Rul 2007-41, 2007-25 Int Rev Bull 1421. See also IRS Letter Ruling 200044038, described in §19.65.

PRACTICE TIP: The charity should consider using a list broker to establish fair market value. A written contract may also help to document the arm's-length nature of the transaction. The use of a list broker will not protect the organization from the appearance of impropriety, however, if the charity's list rentals seem to involve one party disproportionately.

In 1999, several IRC §501(c)(3) public television stations were excoriated in congressional hearings (although no IRS rules appeared to have been violated) for allowing their lists to be sold or traded by brokers for use in Democratic Party fundraising. The Corporation for Public Broadcasting now prohibits public television station grantees from engaging in sales, rentals, or exchanges of member or donor names with any candidate or political entity. Almeras, *CPB Issues Report on Mailing List Swapping*, 26 Exempt Org Tax Rev 9 (Oct. 1999).

Appearances by candidates. Charities may sponsor appearances by candidates if all the facts and circumstances indicate the nonpartisan nature of the event. If the candidate is invited in some capacity other than as a candidate for public office, the charity should make all reasonable efforts to prevent the appearance from turning into a campaign event, such as by avoiding references to the person's candidacy and asking (preferably in writing) that the person not promote his or her election during the event. If the candidate is invited to appear as a candidate, the charity must give other candidates an equivalent opportunity to appear. Political fundraising should be prohibited, and the charity should make it clear that it cannot support or oppose any candidate. See Rev Rul 2007-41, 2007-25 Int Rev Bull 1421.

WARNING: The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81), defining "coordination" with federal candidates, may further constrain these contacts and relationships. See §19.84.

A charity may be affiliated with a noncharitable exempt organization, such as a social welfare organization, labor union, or trade association, that engages in candidate electioneering or has an affiliate that does so. See IRS Letter Ruling 200103048; §19.94.

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§19.63 h. Internet Activities

In general, the IRS treats Internet communications in the same way as it treats communications distributed via any other mechanism. The content of an organization's website or e-mails, for example, will be subject to the same analysis as the content of the organization's printed material or oral communications. Rev Rul 2007-41, 2007-25 Int Rev Bull 1421.

Applying this principle, the IRS recently determined that a charity had intervened in a political campaign when the charity's banner, logo, links, disclaimer, and copyright notice appeared on a page of the charity's website that was paid for by a social welfare organization affiliated with the charity, and that included the social welfare organization's candidate questionnaires and endorsements of candidates for public office. The IRS concluded that, as a result of this presentation, the charity "is considered to have distributed those candidate questionnaires and endorsements," and thereby intervened in a political campaign. IRS Letter Ruling 200908050.

IRS guidance issued for 2008 election cycle. However, the Internet's unique interactive features create special circumstances about which the IRS has provided additional guidance. Specifically with respect to web links, the IRS announced that during the 2008 election cycle, in part due to constitutional concerns, it would distinguish between cases involving unrelated organizations and those involving related organizations. See *Regan v Taxation With Representation* (1983) 461 US 540, 76 L Ed 2d 129, 103 S Ct 1997. The IRS announcements for its 2008 "Political Election Compliance Initiative" (PACI) were as follows; the IRS has not indicated how it will handle such investigations after the 2008 elections:

- **Links to unrelated organizations.** For links on an IRC §501(c)(3) organization's website to that of an unrelated, noncharitable organization (whether tax-exempt or not), the IRS will pursue an investigation if the facts and circumstances suggest that the charity is "promoting, encouraging, recommending or otherwise urging viewers to use the link to get information about specific candidates and their positions on specific issues." The IRS will also pursue such cases if the facts and circumstances, which may include the content of the linked-to website, suggest that the charity is using the link "to indirectly communicate a message that could well be a violation of law were it done directly." IRS 2008 PACI Program Letter to EO Employees, available online at http://www.irs.gov/pub/irs-tege/2008_paci_program_letter.pdf.
- **Links to related organizations.** On the other hand, when there is a link on a §501(c)(3) organization's website to the home page of a related §501(c)(4) organization, the IRS will not investigate the case regardless of what may appear on the (c)(4) organization's home page. IRS Field Directive T:EO:E 14-2008 (July 28, 2008), available at http://www.irs.gov/pub/irs-tege/internetfielddirective072808.pdf. See also Rev Rul 2007-41, 2007-25 Int Rev Bull 1421.

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§19.64 4. Comparing Candidate Electioneering With Issue Advocacy

Broader test. The IRS applies a "facts and circumstances" test to determine whether a charity has carried out an activity in a nonpartisan manner. See §19.52. Although statements that would be express advocacy in support or opposition to a candidate under the Federal Election Campaign Act of 1971 (2 USC §§431-457) are clearly prohibited, the IRS applies a much broader test, which also prohibits any "implied" endorsement or opposition. Implied advocacy can occur when "code words" substitute for references to a specific candidate or group of candidates coupled with a discussion of the candidacy or the election. See Rev Rul 2007-41, 2007-25 Int Rev Bull 1421.

For a description of a narrow, issue-based communication that the IRS, in a nonprecedential analysis, determined did not constitute political campaign intervention, see *Catholic Answers, Inc. v U.S.* (SD Cal 2009) 2009-2 USTC ¶50,697, 104 AFTR2d 6894. While examining the activities of a charitable California religious corporation, the IRS reviewed a publication that did not identify any candidates, but that highlighted five specific issue positions for voters to use to determine which candidates to support in any election. On examination, the IRS determined that the publication, standing alone, did not constitute candidate electioneering, but that political campaign intervention did occur when the publication was distributed with a separate message referring to a specific candidate.

Special election-year problems. Issue advocacy presents a special problem for charities engaged in it in an election year, especially charities involved in narrow, high-profile ("wedge") issues, because advocacy on these issues is easily interpreted as candidate-related. For example, since virtually every candidate in recent years has been forced to take a position on abortion, a charity's pro-life or pro-choice advocacy may be intended—or may be seen as intended—to influence voters to support or oppose specific candidates, even if the charity never identifies the candidates by name. In this situation, as part of assessing all the facts and circumstances, the IRS will consider the charity's track record on advocating on the particular issue. If the charity has consistently advocated for its position in nonelection periods using the same means and scope, the IRS is more inclined to conclude that no candidate electioneering has occurred. Rev Rul 2007-41, 2007-25 Int Rev Bull 1421.

Another problem is that the narrower the charity's agenda, the more likely it is that that agenda is identified with specific candidates, making it difficult for single-issue groups to take advantage of an election to publicize their concerns. Some charitable environmental, civil rights, or family values groups may find their agendas too narrow to safely engage in election-year issues advocacy. A wide range of topics, or a single but broad topic (*e.g.,* taxation, health care, or the economy) is much easier to present in a nonpartisan fashion. Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 375 (2002 CPE Handbook), available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

Educational issue advocacy. Note that issue advocacy can be educational, as defined by the IRS, and still violate the candidate electioneering ban. See 2002 CPE Handbook, p 349. With the publication of Rev Rul 2007-41, 2007-25 Int Rev Bull 1421, the IRS has made a substantial effort to identify positive and negative factors that distinguish candidate electioneering and nonpartisan issue advertising. This ruling identifies factors similar to those presented in Rev Rul 2004-6, 2004-4 Int Rev Bull 328, which applies specifically to activities conducted by noncharitable IRC §501(c) organizations that may be political "exempt functions" under IRC §527(e)(2) (see §§19.74, 19.81). Taken together, these two rulings roughly define the contours of candidate electioneering.

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§19.65 5. Consequences of Violating Prohibition

Revocation of tax exemption. If a charity engages in any amount of prohibited candidate electioneering, it may lose its tax-exempt status under IRC §501(c)(3) and the IRS can revoke its tax exemption retroactively for as far back as it deems the organization was not so qualified, subject to the applicable statute of limitations.

Tax on electioneering expenditures. The IRS may also tax a charity's candidate electioneering expenditures. IRC §4955. The initial tax is 10 percent of the improper expenditure, and the IRS may also impose a 2½-percent tax on the charity's managers who approved the electioneering activities, up to a maximum of $5000. IRC §§4955(a)(1)-(2), (c)(2). If not corrected within the taxable period (see IRC §4955(f)(4)), a second tax may be imposed equal to 100 percent of the expenditure on the organization, and 50 percent on the managers, up to a $10,000 cap. IRC §§4955(b)(1)-(2), (c)(2), (f)(4). In IRS Letter Ruling 200044038, the Heritage Foundation managers avoided this tax because they relied on advice from legal counsel. Treas Reg §53.4955-1(b)(7).

Penalties may be combined. The tax may be imposed in addition to, as well as in lieu of, revocation. The IRS will consider imposing the §4955 tax *instead of* revocation only when the violation was unintentional, involved only a small expenditure, and the organization later corrected the violation and adopted procedures to prevent any future violations. If the IRS finds revocation alone to be ineffective as a penalty (as when the organization immediately ceases operations after an election), the Service can revoke the charity's status *and* impose the tax on both the organization's assets and the individual managers involved. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 353, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

Income tax acceleration; injunction. The IRS, on finding a violation of the candidate electioneering prohibition, may immediately calculate the amount of income tax and IRC §4955 tax due, and make that amount immediately due and payable. IRC §6852. The IRS may also seek an injunction against a charity that does not immediately cease flagrant electioneering activities after receiving notice from the IRS. IRC §7409.

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6. Particular Organizations

§19.66 a. Special Rules for Private Foundations

The discussion of prohibited candidate electioneering in §§19.48-19.65 is generally applicable to all IRC §501(c)(3) charities. However, private foundations are subject to a different enforcement scheme and to more stringent rules in some areas.

Tax on taxable expenditures. Under IRC §4945, a tax is imposed on private foundations' taxable expenditures. The term "taxable expenditure" includes any amount paid or incurred by a private foundation to "influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive," *except* for grants to certain broadly supported §501(c)(3) charities that pursue nonpartisan voter registration activities in more than one election cycle in at least five states and that do not accept grants earmarked for use in a specific election cycle or geographic area. IRC §4945(f). A public charity that meets this definition and that wants private foundation funding to support these activities may apply to the IRS for a letter ruling. Obtaining a ruling eliminates the risk and is a wise precaution for a private foundation to require, although it is not a legal condition for the foundation to avoid making a taxable expenditure.

Funding for other programs. Private foundation funding for other types of nonpartisan programs, such as "get-out-the-vote" activities, voter education, and candidate forums, are not subject to the same limitations that apply to voter registration. IRS General Information Letter to Charity Lobbying in the Public Interest (Dec 9, 2004); see http://www.clpi.org.

Activities taxed under IRC §4955. An activity taxed under IRC §4955 (see §19.65) is exempt from tax as a taxable expenditure under §4945, thus eliminating the possibility of taxing private foundations twice on the same candidate electioneering expenditure. IRC §4955(e). The possibility of loss of tax-exempt status, however, is the same for private foundations as for all other organizations exempt under §501(c)(3).

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§19.67 b. Special Rules for Churches

Although the IRC and the regulations do not substantially differentiate between churches and other types of public charities in the candidate electioneering prohibition, the religious nature of churches may give them certain defenses against an IRS prosecution of an electioneering violation. Churches have attempted to argue that their First Amendment religious freedoms are unconstitutionally infringed by IRS attempts to enforce the IRC §501(c)(3) ban on candidate electioneering. A case testing this proposition, *Branch Ministries v Rossotti* (DC Cir 2000) 211 F3d 137, involved revocation of the church's tax-exempt status for running a newspaper advertisement warning Christians to beware of Bill Clinton in the 1992 election. The court affirmed a summary judgment order against the church.

NOTE: The IRS has not issued any recent guidance on the effect of political activity on a participating church's tax-exempt status, and the boundaries of permissible church participation in elections remains unclear. In 2009, however, two additional suits challenging the prohibition on candidate electioneering by churches were filed in federal courts. While one was dismissed on procedural grounds (*Catholic Answers v U.S.* (SD Cal 2009) 2009-2 USTC ¶50,697, 104 AFTR2d 6894), the other (*Christian Coalition of Florida, Inc. v U.S.* (MD Fla, No. 5:2009cv00144, filed April 3, 2009)) has not resulted in judicial action, as of February 2010.

The IRS must follow specific, stringent procedures, including review by "an appropriate high-level Treasury official," before it may open an investigation into the tax-exempt status of a church. IRC §7611. See *U.S. v Living Word Christian Center* (D Minn., Jan. 30, 2009, Civ. No. 08-mc-37 (ADM/JJK)) 2009 US Dist Lexis 6902 (rejecting IRS contention that Director of Exempt Organizations, Examinations, is "appropriate high-level Treasury official"). In response to this ruling, the IRS proposed amendments to 26 CFR §301.7611-1 which would assign responsibility for evaluating potential church investigations to a more senior official, the Director of Exempt Organizations. See 74 Fed Reg 39003 (2009).

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.68 7. Reporting to the IRS

§19.68 7. Reporting to the IRS

All exempt organizations that file the annual IRS Form 990 must report, in Part IV of the Core Form 990, whether they engaged in any direct or indirect political campaign activities on behalf of or in opposition to any candidates for public office. Organizations that did engage in such activity must describe and quantify the expenditures and volunteer hours devoted to those activities in Part I-A of Form 990, Schedule C. On Part I-B of Schedule C, the charity must report any excise tax due on such political activities under IRC §4955 and describe any corrections made. See §19.65.

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B. Federal Tax Law: Noncharitable Organizations

§19.69 1. Comparison With Charitable Organizations

As with lobbying activities, noncharitable organizations face fewer federal tax law restrictions on candidate electioneering activities than charities do.

For a table comparing the tax advantages and advocacy limitations that apply to charitable and noncharitable tax-exempt organizations, see §19.4, and the more extended discussion in §19.33.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.70 2. Deductions: Disclosure and Tax

§19.70 2. Deductions: Disclosure and Tax

Congress and the IRS have placed additional disclosure burdens on noncharitable entities so that donors, members paying dues, and other supporters are warned not to take improper tax deductions, including those payments related to political activities.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.71 a. No Charitable Deduction; Required Statement in Solicitations

§19.71 a. No Charitable Deduction; Required Statement in Solicitations

For rules on written disclaimers regarding the charitable deduction, see §19.35.

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§19.72 b. Business Deduction and Proxy Tax

Expenditures related to all forms of candidate electioneering are nondeductible. Business taxpayers may not deduct payments for candidate electioneering, at any level of government, as a business expense. IRC §162(e). The business deduction and proxy tax rules for candidate electioneering are the same as for lobbying expenditures, which are discussed in §19.36.

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§19.73 3. Limits on Candidate Electioneering

The noncharitable tax-exempt organization should analyze its governing documents to determine whether support of or opposition to candidates for elective office furthers the group's tax-exempt purposes. If candidate campaign activity is prohibited in the articles or bylaws, they can be amended to permit such activity in the future.

Must be secondary activity. A social welfare organization (IRC §501(c)(4)) that wishes to engage in candidate electioneering must be aware that social welfare programs must be primary, and electioneering can be no more than a secondary activity. Rev Rul 81-95, 1981-1 Cum Bull 332. If candidate electioneering is primary in any tax year, the organization's §501(c)(4) tax status may be revoked. For example, the IRS denied §501(c)(4) status to the National Policy Forum in 1997 because it appeared primarily to serve the interests of Republican candidates.

Demonstrating secondary activity. To demonstrate that candidate electioneering is secondary, expenditures on that activity should be no more than a minority fraction of total program expenses. Volunteer hours, publicity, recipient populations, and other measurements of program size should also show that electioneering is secondary to lobbying and other social welfare activities. Even though an organization's IRC §501(c)(4) status may be intact, the organization needs to be aware of federal election law rules, including the Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81). See §19.84.

Range of secondary activities. The range of candidate electioneering activities that must remain secondary is quite broad. Such activities include all forms of campaign intervention and partisan private benefits (not limited to express advocacy of a candidate's election or defeat) that would be prohibited for an IRC §501(c)(3) organization. Even grassroots lobbying, if pursued for a primarily political purpose, would be subject to the secondary limitation. In Field Service Advice 200037040, the Service suggested that an IRC §501(c)(4) organization that allows its political intervention to become primary will be treated as an IRC §527 political entity. Ironically, if the organization maintains a substantial level of lobbying in addition to its primary political activities, it may fall into a no-man's land where the heavy disclosure rules of IRC §527 apply and almost all of its income is taxable at the highest federal corporate tax rate. See §19.75.

Rule for other noncharitable organizations. For IRC §501(c)(5) (labor union) and IRC §501(c)(6) (trade association) organizations, and most other noncharitable tax-exempt categories, the same rule applies—candidate electioneering must be secondary to the organization's primary purpose. See Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 433, available at http://www.irs.gov/pub/irs-tege/eotopici02.pdf.

Segregating revenues and expenditures. Many noncharitable tax-exempt organizations choose to segregate revenues and expenditures used for candidate electioneering in a separate bank account or separate legal entity. Federal tax law, as well as federal and state campaign finance laws, strongly favors such "separate segregated funds." See §19.74.

ABA report. The Exempt Organizations Committee of the Tax Section of the American Bar Association established a task force to study the tax regulation of politically active IRC §501(c)(4) entities and make recommendations for improvements. The group's final report is available on the American Bar Association Tax Section website at http://www.abanet.org/tax/pubpolicy/2004/040525exo.pdf.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.74 4. Political Organizations, Funds, and PACs

§19.74 4. Political Organizations, Funds, and PACs

Organizations or funds devoted to candidate electioneering, including political parties, candidate campaign committees, and political action committees (PACs), are governed by IRC §527. This section applies to free-standing committees; committees established by business corporations, labor unions, trade associations, and other interest groups; committees regulated by the Federal Election Commission (FEC), and similar state agencies. "Soft money funds" that connect issues with candidates in the voters' minds without expressly advocating the election or defeat of specific candidates have been recognized. IRS Letter Rulings 9652026, 9725036, 9808037.

WARNING: Reacting to many allegations of abuse during the 2004 elections, the FEC stepped up its enforcement against IRC §527 organizations expending unlimited "soft money" to influence federal elections through issues ads when those organizations failed to register as political committees under federal law. On December 13, 2006, the FEC announced settlement of enforcement cases against three §527 organizations (League of Conservation Voters 527, MoveOn.org Voter Fund, and Swiftboat Veterans and POWS for Truth) for a combined $630,000 in civil penalties for violating various provisions of federal campaign finance laws, including failure to register as federal political committees and abide by contribution limits. Similar announcements followed in February 2007 ($750,000 against the Progress for America Voter Fund) and June 2007 ($75,000 against the National Association of Realtors Fund).

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§19.75 a. Taxation of PACs; Exempt Function Income

The basic theory behind the taxation of political action committees (PACs), also known as IRC §527 entities, is that political donations and other traditional forms of political revenue (referred to as "exempt function income") should not be taxed if received for political purposes, kept segregated, and used solely for permitted political purposes (referred to as "exempt functions"). However, net investment income and all forms of unrelated business income (with no exceptions) are taxed at the maximum federal corporate income tax rate. Principal campaign committees of candidates for Congress, however, are taxed at graduated corporate rates. IRC §527(h).

Determining whether certain revenues are "exempt function income" properly segregated for exempt functions can be tricky. The IRS has found that proceeds from the sale of raffle tickets failed to qualify as exempt income (see IRS Letter Ruling 9847006) and that proceeds from the sale of art reproductions were not exempt function income (Rev Rul 80-103, 1980-1 Cum Bull 120). It has retreated somewhat from its position on raffles, however, saying that income from raffles held in connection with traditional political events would not be taxable. 27 Exempt Org Tax Rev 173 (Jan. 2000).

The permissible exempt function of a §527 organization is statutorily defined as "attempting to influence the selection, nomination, [or] election… of any individual to any Federal, State, or local public office or office in a political organization." IRC §527(e)(2). The concept of an exempt function includes expenditures of an officeholder, after being elected, if allowable as a deductible business expense under IRC §162(a).

Distinguish exempt function from IRC §501(c)(3) exemption. "Exempt function" should not be confused with the exemption under IRC §501(c)(3). Functions that are exempt for a §527 entity are prohibited for a charitable organization, with one exception: influencing appointments of individuals to public office. Influencing appointments, which is not prohibited for §501(c)(3) organizations, is treated as a form of lobbying in which a legislative body votes to confirm the appointment. IRS Announcement 88-114, 1988-37 Int Rev Bull 26; GCM 39694 (Jan. 21, 1988).

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.76 b. Educational and Lobbying Activities as Exempt Functions

§19.76 b. Educational and Lobbying Activities as Exempt Functions

The IRC §527 exempt function does not include nonpartisan educational activities nor does it include lobbying activities, such as campaigns to pass or defeat ballot propositions. Educational or lobbying activities, however, may qualify under IRC §527(e)(2) if they have a sufficiently close nexus to one or more candidate election campaigns. See IRS Letter Ruling 199925051 (extensive articulation of the possible connections between a ballot measure campaign and candidate electioneering) and IRS Letter Rulings 9725036, 9652026, 9130008. If no nexus exists, nonexempt function expenditures may still be made if they do not exceed an insubstantial level in any tax year. Treas Reg §1.527-2(b)(1) (explained in Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 410). A §527 entity with excess funds may make unlimited transfers to another §527 organization, to (or for the use of) a §501(c)(3) public charity, or to a governmental entity, but other transfers are limited by the insubstantial level rule. IRC §527(d).

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§19.77 c. Incorporating a PAC

It is not necessary that a §527 entity incorporate. A registration statement filed by a political action committee (PAC) with a state or federal election commission is usually sufficient to form the entity. A special bank account for political purposes will be recognized by the IRS as a separate entity for tax purposes, although it may legally be a part of a nonprofit corporation. Organizations subject to §527 do not apply to the IRS for tax-exempt status, but should obtain a federal employer identification number (EIN), even if affiliated with an existing noncharitable nonprofit organization, by filing IRS Form SS-4 (see §13.4) and may have to register with the IRS by filing IRS Form 8871. See §§13.2-13.5, 19.78. Public disclosure and reporting rules under IRC §527 are discussed in §19.78. Filing requirements for political entities are summarized in §19.80.

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d. Public Disclosure Rules

§19.78 (1) Reporting Requirements

Internal Revenue Code §527 imposes a reporting regime on political entities, including parties, candidate committees, independent and sponsored political action committees (PACs), and "soft money" funds. See IRC §§527(i)-(j). See also *Mobile Republican Assembly v U.S.* (11th Cir 2003) 353 F3d 1357 (disclosure requirements are constitutional).

For a good explanation of the rules in question-and-answer format, see Rev Rul 2003-49, 2003-20 Int Rev Bull 903. Because the reporting system has been largely implemented through the Internet, a good starting point is the IRS website at http://www.irs.gov/charities/political. The website provides an overview of the law and the filing requirements, as well as updates from the IRS.

These reporting requirements apply only to organizations described in IRC §527(e)(1) that have gross annual receipts of at least $25,000. They do not apply to IRC §501(c) entities that engage in political activities directly, even though these groups may be required to file IRS Form 1120-POL and pay tax under IRC §527(f) (see §19.81).

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§19.79 (2) Forms to Be Filed

Political organizations with gross receipts equal to or greater than the $25,000 threshold must file four different forms, although many exceptions exist (see §19.80):

(1) IRS Form 8871, Political Organization Notice of Section 527 Status, must be filed electronically within 24 hours of formation or on the next business day after formation, whichever is later. Before filing, the organization must obtain its own federal employer identification number (EIN) using IRS Form SS-4. The organization must file an amended Form 8871 within 30 days after a change in name or address, termination, or other material change from a notice previously filed.

(2) IRS Form 8872, Political Organization Report of Contributions and Expenditures, is used to report information concerning contributors who donate $200 or more in a year and recipients of at least $500 in expenditures in a year. The frequency of reporting varies from twice a year (in nonelection years) to as often as 12 times a year for groups that choose to file on a monthly basis.

(3) Annual information income tax returns similar to those filed by IRC §501(c) groups (IRS Form 990) must be filed by certain organizations on or before the 15th day of the fifth month after the end of the organization's fiscal year. Donor information on these returns is not protected from public disclosure.

(4) Annual income tax returns specific to IRC §527 political entities must be filed to report and pay 35-percent tax on net investment and unrelated business income (IRS Form 1120-POL). The return is due on or before the 15th day of the third month after the end of the organization's fiscal year, 2 months earlier than required for IRS Form 990.

PRACTICE TIP: Excellent information is available on the IRS website, and it is unnecessary to repeat it here; however, the following practice tips may be helpful:

- Political action committees (PACs) sponsored by an existing labor union, trade association, or other parent entity may not have obtained their own federal EIN. Such PACs should obtain a separate EIN before filing IRS Form 8871. For the period prior to filing Form 8871, the tax status of the PAC may be in doubt because either (1) it was operating as a part of its parent entity, exposing the parent to the IRC §527(f) tax if the parent had net investment income, or (2) it was truly operating as a separate tax entity, but because Form 8871 was filed late (more than 24 hours after formation) the PAC is subject to a 35-percent federal tax on all of its gross income. IRC §527(i)(4).
- Multiple PACs set up under the laws of various states and localities may be able to report jointly under one EIN, or separately to take advantage of the $25,000 filing threshold.
- Entities that file disclosure forms under the Federal Election Campaign Act of 1971 (FECA) (2 USC §§431-457) are exempt from filing IRS Forms 8871 and 8872 under IRC §527(i)(6), as are state and local candidate and party committees. State and local committees not affiliated with a party or candidate must file Form 8872, although those that "qualify" by filing comparable state or local disclosure reports may be exempt. IRC §527(j)(5)(C). See §19.80. California's complex campaign disclosure requirements meet the IRS exemption.
- The IRS has not yet provided any guidance to answer numerous questions regarding the reporting of contributions and expenditures on IRS Form 8872, including the treatment of loans and repayment of loans, credit card charges, advances and refunds, and in-kind transactions.
- The consequences of noncompliance are quite severe in many cases, but the law allows abatement for mistakes due to reasonable cause. IRC §527(k). Many obvious examples of late or improper filing can be viewed on the IRS website, and the future prospects for IRS enforcement are uncertain.

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Source: Business Law/Advising California Nonprofit Corporations/19 Legislative and Political Activities/§19.80 e. Table: Filing Requirements for Political Entities

§19.80 e. Table: Filing Requirements for Political Entities

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Type of Entity	Obtain EIN by filing IRS Form SS-4	File IRS Form 8871	File IRS Form 8872	File IRS Form 1120-POL if over $100 taxable income	File IRS Form 990 or Form 990EZ
IRC §501(c) organization with investment income and political expenditures, *e.g.,* union	Yes	No	No	Yes	Yes
Organization reasonably anticipating gross receipts under $25,000/year	Yes	No	No	Yes	No
Political committee reporting under FECA	Yes	No	No	Yes	No
Political committee of state candidate	Yes	No	No	Yes	No
State committee of political party	Yes	No	No	Yes	No
Political committee of local candidate	Yes	No	No	Yes	No
Local committee of political party	Yes	No	No	Yes	No
Caucus or association of state or local officials	Yes	Yes	Yes	Yes	No
"Qualified" state or local political organization, including those filing under California law	Yes	Yes	No	Yes	Yes, unless gross receipts under $100K/year
All other political entities: *e.g.,* entities involved with federal elections not reporting under FECA; nonqualified state or local PACs	Yes	Yes	Yes	Yes	Yes
Organizations granted discretionary exception by Secretary of Treasury	Yes	Yes	Yes	Yes	No

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§19.81 5. Political Spending Tax on IRC §501(c) Groups

Separate segregated funds. Internal Revenue Code §527(f)(3) addresses the common situation in which a noncharitable IRC §501(c) organization establishes a separate segregated fund for candidate electioneering purposes (an IRC §527(f)(3) fund). Separate segregated funds, sponsored by noncharitable entities, which are encouraged or mandated by state or federal election laws, are also encouraged under federal tax law. If a §501(c) organization makes candidate-related exempt function expenditures from its general treasury, it is required to pay the IRC §527(f) tax (35 percent) on the lesser of those expenditures or its net investment income, thus losing its tax exemption on investment income to the extent of its political expenditures.

Collective bargaining agreements. An IRC §501(c)(3) organization may not establish or sponsor a political action committee (PAC), but it may be required by a collective bargaining agreement to use payroll deductions to collect union dues, including PAC donations, from its employees and transfer such amounts to the §501(c)(5) union. IRS Letter Ruling 200151060.

Non-§501(c)(3) parent organizations. An IRC §501(c) parent organization that is not a (c)(3) may receive dues and other payments earmarked for its sponsored committee without tax consequences if it promptly transfers such funds to the committee. Transfers of nonearmarked, general treasury funds to the committee are subject to tax. Treas Reg §1.527-6(e); *Alaska Pub. Serv. Employees Local 71*, TC Memo 1991-650. But see IRS Letter Ruling 9622002, in which a §501(c)(5) union was allowed to fund its PAC using dues income on an "as needed" basis.

The IRS currently allows the following expenditures to be paid by either the §527(f)(3) fund or the parent §501(c) organization, without tax consequences:

- Costs of internal communications with members (Treas Reg §1.527-6(b));
- Costs of establishment, administration, and solicitation of contributions to the separate fund (Treas Reg §1.527-6(b));
- An unspecified, potentially wide range of indirect expenditures that support direct IRC §527(e) expenditures (Treas Reg §1.527-6(b)); and
- Costs of attempts to influence the confirmation of judges and other appointed officials (Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p 397 n 27).

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§19.82 6. Reporting to the IRS

All exempt organizations that file IRS Form 990 must report, in Part IV of the Core Form 990, whether they engaged in any direct or indirect political campaign activities on behalf of or in opposition to any candidates for public office. Organizations that did engage in such activity must describe and quantify those activities in Part I-A of Form 990, Schedule C, and noncharitable §501(c) groups must also complete Part I-C. For extended remarks by Greg Colvin on Schedule C, see 13 EO Tax Journal, No 6 (Nov.-Dec. 2008).

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§19.83 C. California Tax Law

In almost every respect, the Revenue and Taxation Code follows federal tax law on candidate electioneering.

Charitable organizations, described in Rev & T C §23701d, have the same prohibition on candidate electioneering as in IRC §501(c)(3). The Franchise Tax Board asks all charitable organizations that conduct lobbying or political activities to fill out and attach FTB Form 3509 to the annual FTB Form 199 filing. See §§11.12-11.13. Political organizations in California are described in Rev & T C §23701r, which is parallel to IRC §527 (see §19.61), but California law does not impose an investment income tax analogous to that imposed by IRC §527(f) on IRC §501(c) organizations making expenditures for candidate electioneering from general treasury funds. Political organizations subject to Rev & T C §23701r need not file FTB Form 3500 to apply for state tax exemption from the Franchise Tax Board. A simple letter will do. Whether incorporated or not, §23701r organizations must file annual tax returns using FTB Form 100, but, as with the federal return, no tax is due unless taxable income exceeds $100.

For addition information, see §19.37.

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D. Nontax Laws on Candidate Electioneering

1. Federal Law

§19.84 a. Federal Election Law

The Federal Election Campaign Act of 1971 (FECA) (2 USC §§431-457), administered by the Federal Election Commission (FEC), governs the participation of nonprofit as well as for-profit entities in federal elections. The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) substantially modified federal law with respect to federal candidates, political parties, and nonprofits. In *McConnell v FEC* (2003) 540 US 93, 157 L Ed 2d 491, 124 S Ct 619, the Supreme Court upheld nearly all of the provisions of BCRA 2002, including the ban on "electioneering communications" prohibiting any identification of a federal candidate in broadcast ads just before an election by all corporations, including nonprofits. However, 4 years later, in *FEC v Wisconsin Right to Life, Inc.* (2007) 551 US 449, 168 L Ed 2d 329, 127 S Ct 2652, the Supreme Court found the "electioneering communications" provisions unconstitutional as applied to grassroots issues ads featuring Senator Feingold that were broadcast in Wisconsin within 60 days of the general election in which Feingold appeared on the ballot.

On January 21, 2010, the Supreme Court decided a major case, *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766, which overruled the portion of *McConnell v FEC, supra* (as modified by *Wisconsin Right to Life, supra)* upholding a prohibition on corporate broadcast communications just before an election which appeared to urge the election or defeat of a federal candidate. *Citizens United* also overruled the decision in *Austin v Michigan State Chamber of Commerce* (1990) 494 US 652, 108 L Ed 2d 652, 110 S Ct 1391, which upheld the federal ban on corporate independent expenditures in connection with federal elections.

The immediate effect of *Citizens United* is to permit nonprofit and for-profit corporations to engage in unlimited independent spending on behalf of federal candidates whether the message to voters contains express advocacy or merely mentions a federal candidate. Organizations engaging in such independent spending are still subject to FECA registration and reporting requirements. The federal prohibition on corporate contributions (including nonmonetary contributions such as coordinated communications to voters) remains in effect, although many observers believe this provision will ultimately be struck down by the Supreme Court leaving corporations subject to contribution limits similar to individuals and other permissible sources of federal contributions.

NOTE: California does not prohibit corporations from making expenditures and contributions in connection with state elections so there is no immediate impact on state elections as a result of *Citizens United*. See Political Reform Act of 1974 (Govt C §§81000-91014), discussed in §19.93.

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§19.85 (1) Prohibition on Expenditures to Influence Campaigns

Before *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766 (see §19.84), Title 2 USC §441b prohibited *all* corporations, including nonprofits, from making expenditures from their general treasury funds to influence federal campaigns. This prohibition included corporate expenditures for both direct contributions to federal candidates and independent expenditures for communications advocating the election or defeat of a clearly identified federal candidate. In *FEC v Beaumont* (2003) 539 US 146, 156 L Ed 2d 179, 123 S Ct 2200, the Court held that the prohibition on direct contributions could be constitutionally applied to a nonprofit advocacy corporation. However, in *Citizens United*, the Supreme Court struck down the prohibition on independent expenditures by corporations. Thus, nonprofit corporations are free to independently expend treasury funds to influence a federal election, but still may not contribute to federal candidates.

The prohibition on corporate contributions includes in-kind or nonmonetary contributions of goods and services made to federal candidates. The FEC has adopted regulations providing that certain "coordinated communications" may constitute in-kind contributions that would be prohibited if made by a corporation, including a nonprofit. The regulations provide for a three-part test that, if met, results in an in-kind contribution. The test requires that (11 CFR §§109.20-109.23):

(1) The communication be paid by a third party other than the federal candidate;

(2) The communication meets certain "content" standards (*e.g.,* express advocacy, electioneering communication); and

(3) The communication meets certain "conduct" standards (*e.g.,* the candidate requests the communication, use of common vendors).

The FEC's efforts to define "coordinated communications" has been subject to ongoing litigation (see *Shays v FEC* (DC Cir 2008) 528 F3d 914) as well as continuing rulemaking. The FEC is still engaged in adopting further regulations defining the term to comply with court decisions.

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§19.86 (2) Electioneering Communications

The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) extended the prohibition on influencing federal elections to corporations, including nonprofits, that engage in "electioneering communications." Electioneering communications are "targeted" broadcast ads that refer to a clearly identified federal candidate within 60 days before a general election or within 30 days before a primary election or caucus of a political party that has the authority to nominate a candidate. 2 USC §§434(f)(3), 441b(c)(6).

The broadcast ads did not have to include express advocacy. Thus, BCRA 2002 prohibited any broadcast ads that mentioned a federal candidate just before an election if made by a corporation, including a nonprofit, using general treasury funds. However, the Supreme Court's decision in *FEC v Wisconsin Right to Life, Inc.* (2007) 551 US 449, 168 L Ed 2d 329, 127 S Ct 2652, severely undermined the viability of the electioneering communication ban, particularly as applied to nonprofit grassroots issue advocacy. The Supreme Court's ruling in *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766 (see §19.84) invalidated the electioneering prohibition on corporations even as limited by *Wisconsin Right to Life, supra,* as long as the communications are made independently of any federal candidate.

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§19.87 (3) Independent Expenditures for Election of Federal Candidates

In *FEC v Massachusetts Citizens for Life, Inc.* (1986) 479 US 238, 93 L Ed 2d 539, 107 S Ct 616, the Supreme Court invalidated the corporate prohibition on independent expenditures advocating the election or defeat of federal candidates for certain ideological nonprofit corporations. However, the Supreme Court's ruling in *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766 (see §19.84) has extended to all corporations the right to make independent expenditures in support of or opposition to candidates for elective office.

NOTE: Section 501(c)(3) organizations remain subject to IRC rules prohibiting all candidate electioneering. See §19.48.

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§19.88 (4) Prohibition on Soliciting Funds for Organizations That Make Expenditures for Federal Election Activity

The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) also prohibits a national, state, or local political party committee and its officers and agents from soliciting any funds for, or making or directing any contributions to, any IRC §501(c) organization, including charities, if that organization makes expenditures or disbursements in connection with an election for federal office, including expenditures for "federal election activity." Pub L 107-155, §101(a), 116 Stat 81. Federal election activity includes the following (2 USC §431(20)):

- Voter registration (including nonpartisan) within 120 days before an election at which a federal candidate will appear on the ballot;
- Voter identification and get-out-the-vote activities that do not refer to a federal candidate by name conducted in connection with an election in which a federal candidate will appear on the ballot; and
- Public communications that promote, support, attack, or oppose a federal candidate, regardless of whether the communication expressly advocates a vote for or against a candidate. The terms "promote, support, attack or oppose" are not defined. The term "public communication" includes broadcasts, mass mailings, newspaper and magazine ads, and telephone bank calling.

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§19.89 (5) Prohibition on Soliciting Funds for IRC §527 Organizations

The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) prohibits a national, state, or local party committee and its officers and agents from soliciting any funds for, or making or directing any contributions to, an IRC §527 organization, regardless of whether the organization makes expenditures for federal election activities. In finding the BCRA 2002 provisions constitutional, the Supreme Court narrowed the §§501(c) and 527 restrictions so as not to apply to federal "hard" dollars solicited, directed, or contributed by a political party committee. *McConnell v FEC* (2003) 540 US 93, 157 L Ed 2d 491, 124 S Ct 619.

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§19.90 (6) Restrictions on Fundraising by Federal Candidates

The Bipartisan Campaign Reform Act of 2002 (BCRA 2002) (Pub L 107-155, 116 Stat 81) further restricts efforts by federal candidates to raise money for IRC §501(c) nonprofits that engage in "federal election activity." The restrictions limit fundraising by federal candidates for nonprofits engaging in public communications that promote, support, attack, or oppose a federal candidate to contributions that comply with the limitations and prohibitions of the FECA. Fundraising for nonprofits engaged in voter registration and get-out-the vote activities must be directed only at individuals, and solicitations cannot exceed $20,000 annually.

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§19.91 (7) Complying With Federal Election Law

Noncharitable nonprofit corporations may form separate segregated political action committees (PACs) (IRC §527 PACs) in compliance with the Federal Election Campaign Act of 1971 (FECA) to conduct most federal campaign activities, including the making of electioneering communications. Although *Citizens United v FEC* (Jan. 21, 2010, No. 08-205) 2010 US Lexis 766 (see §19.84) now permits independent expenditures using corporate general treasury funds, the prohibition on corporate contributions remains in effect. For this reason, noncharitable nonprofit corporations that wish to make contributions to federal candidates will need to establish a PAC and comply with FEC regulations. The nonprofit corporation may send partisan campaign information to its members and may solicit members for contributions to the PAC. Regulations define "members" to include all persons who satisfy membership requirements of the organization; affirmatively accept the membership organization's invitation to join; and (1) have some significant financial attachment to the organization, (2) pay membership dues at least annually of a specified predetermined amount, or (3) have a significant organizational attachment that includes annual affirmation of membership and direct participatory rights in governance. 11 CFR §114.1(e)(2). Alternatively, the officers of the corporation may, acting as individuals, form a "nonconnected" federal PAC to solicit donations from the public. See FEC Advisory Opinions 1984-12 and 1997-15. Federal campaign contributions are governed by a series of dollar amount ceilings. 2 USC §441a.

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§19.92 b. Rules Applicable to Federal Grantees

The Office of Management and Budget (OMB) audit rules prohibit any state, federal, or local candidate electioneering with federal grant funds. OMB Circular A-122, 48 CFR §31.205-22, available from the OMB website at http://www.whitehouse.gov/omb. Specific programs, such as Head Start or Community Development Block Grants, may be subject to additional rules affecting even nonpartisan activities, such as voter registration.

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§19.93 2. California Law

The Political Reform Act of 1974 (Govt C §§81000-91014) does not prohibit corporate contributions to state or local candidate election campaigns in California. (Some local ordinances do impose restrictions on contributions within the local jurisdiction. In *Lincoln Club v City of Irvine* (9th Cir 2001) 292 F3d 934, the court invalidated a local ordinance prohibiting independent expenditures by a nonprofit organization using funds donated by individuals in violation of the ordinance's contribution limits.)

The Act attempts to bolster the role of political parties by imposing no limits on what parties expend on behalf of their endorsed candidates. The Act provides disclosure rules for state candidates and ballot measure committees. It also imposes contribution limits on state candidates and requires such candidates to accept or reject voluntary expenditures limits before commencing fundraising. For further information, contact the FPPC at http://www.fppc.ca.gov/.

The Act also directly regulates "issue advocacy" by requiring electronic reporting by organizations expending $50,000 or more for issue advocacy. In addition, the expending organization must disclose its donors of $5000 or more and may not accept more than $25,000 from any one entity for the purpose of paying the issue advocacy ads. Issue advocacy is defined as "a communication that clearly identifies a candidate for elective state office, but does not expressly advocate the election or defeat of the candidate, and that is disseminated, broadcast, or otherwise published within 45 days of an election." Govt C §85310(a).

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§19.94 IV. USE OF AFFILIATED ORGANIZATIONS

Charitable organizations that want to go beyond the legal limits for an IRC §501(c)(3) organization may set up a separate but affiliated organization with a different tax-exempt status.

Congress has conditioned the privilege of access to tax-deductible contributions on the charity's avoidance of substantial lobbying or any amount of political intervention. *Regan v Taxation With Representation* (1983) 461 US 540, 76 L Ed 2d 129, 103 S Ct 1997. The charity, however, can exercise its constitutional rights by setting up a non-§501(c)(3) affiliate. The IRS requires only two things for an affiliate relationship: (1) separate incorporation and (2) adequate records to demonstrate that tax-deductible contributions are not being used to support the political or lobbying activities. See 461 US at 544 n6.

How much overlap is permitted? A frequent question that arises is how much overlap is permitted between the board of directors of the IRC §501(c)(3) organization and its IRC §501(c)(4) affiliate. There is no hard and fast answer to this question. The most important thing is to keep the money separate, make sure the §501(c)(4) organization pays for its share of staff time, and avoid having the §501(c)(3) group subsidize the §501(c)(4) organization in any way, except perhaps in a grant for a specific charitable project to be conducted by the §501(c)(4) organization. It is also important that the (c)(3) organization be able to demonstrate that the (c)(4) organization is not acting as an arm, agent, or integral part of the (c)(3) organization. It is possible to have a complete overlap between the two boards, if the organizations have different executive directors; but if the two organizations share the same staff, some difference in the composition of the two boards is desirable to show that the staff is serving two separate governing bodies. For additional information, see Fei & Colvin, *How to Set Up and Maintain an Action Fund Affiliated with a Charity*, 15 J Tax'n Exempt Orgs 184 (Jan./Feb. 2004).

Independent PAC. Although an IRC §501(c)(3) organization may not establish an IRC §527 political action committee, it is clear that individuals acting on their own can establish an independent PAC. It is also common for the affiliated §501(c)(4) to set up a PAC, if it can be kept sufficiently separate from the §501(c)(3) group. *Branch Ministries v Rossotti* (DC Cir 2000) 211 F3d 137.

Examples of affiliate arrangements. The excellent article, Kindell & Reilly, Election Year Issues, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY2002 (available at http://www.irs.gov/charities/article/0,,id=101915,00.html), discusses affiliated organizations at pp 365, 441. It includes 12 examples of permissible and impermissible affiliate arrangements. See also Thomas & Kindell, *Affiliations Among Political, Lobbying and Educational Organizations*, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000, p 255 (1999) (available at http://www.irs.gov/pub/irs-tege/eotopics00.pdf) on permissible relationships among affiliated entities pursuing public policy goals. For a summary of the salient points made in the IRS article, see Colvin, *CPE Text Surveys Affiliated Charitable, Lobbying, and Political Organizations*, 11 J Tax'n Exempt Orgs 1744 (Jan./Feb. 2000).

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Corporate Changes

Lisa A. Runquist

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§20.1 I. SCOPE OF CHAPTER

This chapter discusses corporate changes, including mergers, dissolutions, sales, and conversions, that affect the actual structure of nonprofit public benefit, mutual benefit, and religious corporations. For example, the chapter covers the applicable procedures for dissolving a nonprofit corporation. The chapter further addresses the reporting requirements that accompany these changes.

Changes that do not result in an entire corporate restructuring or dissolution are covered elsewhere in this book. See, *e.g.,* amendments to articles in §§6.34-6.46 and amendments to bylaws in §§7.111-7.122.

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§20.2 II. MAKING CORPORATE CHANGES

The members or the board of directors of a nonprofit corporation may determine that the corporation should or can no longer function under its current organizational structure and may therefore wish to change the corporation's structure or operations. If the members or directors find that it is no longer appropriate to operate the organization as a separate entity, they may choose either to merge the organization into another entity (see §§20.41-20.82) or to dissolve the corporation and distribute its assets (see §§20.83-20.136). Alternatively, they may want to keep the corporate shell, but change its functions; if so, they may choose to sell the current assets or to convert the corporation from one type of corporation to another (*e.g.,* from a public benefit to a business corporation, a mutual benefit corporation, or a religious corporation; see §§20.25-20.40). Any of these options involve several considerations, which are discussed below.

Some or all of a nonprofit's assets may be subject to a charitable trust. The trust may limit the choices as to the actual disposition of the assets. Corp C §§5142, 7142, 9142. Assets of a nonprofit corporation that is exempt from taxation under IRC §501(c)(3) (most public benefit and religious corporations) must be dedicated to the purposes for which the exemption was given. A change in nature or activities requires a conveyance of the assets or their value to a similar nonprofit exempt organization.

WARNING: Counsel must examine the tax laws and, if appropriate, obtain preapproval from the Internal Revenue Service and the Franchise Tax Board (FTB) before making fundamental changes. Any corporate action resulting in a change in corporate structure can adversely affect the corporation's continued tax-exempt status. In particular, serious consequences for the corporation and its officers and directors may result if the corporate purposes or activities are changed from those described in its tax-exemption applications filed with the IRS and the FTB. See §§3.60-3.71.

NOTE: As discussed in chap 12, the IRS has redrafted Form 990 and made changes to Form 990-EZ. As noted more specifically in §§20.18, 20.82, 20.136, organizations required to file Form 990 or 990-EZ must attach Schedule N (see §12.19) to the form to advise the IRS of many of the corporate changes covered by this chapter. For more information, see IRS Publication 4779, which is reproduced in §20.5A. The applicable Form 990 must also be filed with the California Attorney General.

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§20.3 A. Statutory Scheme

Although the provisions governing changes to or dissolution of nonprofit public benefit, mutual benefit, and religious corporations are similar, there are some differences. The overall statutory scheme for conversions, mergers, and dissolution consists of two parallel series of Corporations Code sections:

(1) **Public benefit corporation or religious corporation**

- Amendment of articles (see Corp C §§5810-5820, incorporated by reference for religious corporations in Corp C §§9620-9621);
- Mergers (see Corp C §§6010-6022, incorporated by reference for religious corporations in Corp C §9640);
- Dissolution (see Corp C §§6510-6721; incorporated by reference for religious corporations in Corp C §9680); and

(2) **Mutual benefit corporation**

- Amendment of articles (see Corp C §§7810-7820);
- Mergers (see Corp C §§8011-8022);
- Dissolution (see Corp C §§8510-8724).

NOTE: Corporations Code §§9620-9621 (which govern amendments of articles of religious corporations), §9640 (which governs mergers of religious corporations), and §9680 (which governs dissolutions of religious corporations) incorporate by reference the relevant provisions of the public benefit corporation law, along with a list of exceptions. General provisions that apply to all three types of nonprofit corporations are in Corp C §§5002-5080.

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§20.4 B. Choosing Method of Restructuring or Dissolution

Dissolution is the most extreme of the corporate changes considered in this chapter. Whether voluntary or involuntary, it is the process of terminating the existence of a corporation in an orderly manner. Mere suspension or cessation of activities is not equivalent to dissolution. *California Labor Sch. v Subversive Activities Control Bd.* (DC Cir 1963) 322 F2d 393. Dissolution is often chosen as a way to wind up the affairs of a nonprofit corporation whose purpose is no longer relevant and cannot be changed or whose activities can no longer be financially supported. In addition, a nonprofit corporation that has a fixed term of existence (see Corp C §§5132(a)(1), 7132(a)(1), 9132(a)(1)) must be wound up and dissolved when the term ends (see Corp C §§6510(b)(7), 8510(b)(7), 9680) if it does not amend its articles to extend or eliminate the term. If the corporation is insolvent, recourse to the bankruptcy court (see Corp C §§6110, 8110, 9650) or some agreed-on debt restructuring may be necessary. An automatic stay of proceedings against the debtor is available if a bankruptcy petition is filed. 11 USC §362. Although insolvency proceedings are beyond the scope of this chapter, many procedures available in an involuntary dissolution resemble those of insolvency proceedings. See, *e.g.,* §§20.137-20.148.

Membership disputes. In other instances, particularly in mutual benefit corporations, dissolution may be necessary as an ultimate means of resolving membership disputes. See Corp C §8510(b)(3). Dissolution may be the only court-aided means of resolving membership disputes in religious corporations. See, *e.g., Watson v Jones* (1872) 80 US 679, 724, 20 L Ed 666, 675.

Amendment alternative. Before undertaking to dissolve a nonprofit corporation, the practitioner should consider whether an alternative will accomplish the desired result. The articles of incorporation and bylaws may be amended to resolve membership disputes or alter corporate purposes. The new purposes must be charitable if the corporation is a public benefit corporation or if it holds assets subject to a charitable trust. The doctrine of cy pres should be kept in mind, as well as the role of the California Attorney General (see §20.9). See Corp C §§5820, 7820. In the rare situation of articles of incorporation containing a fixed term, the articles may be amended to delete that provision. See Corp C §§5810, 7810, 9621.

NOTE: For discussion of amending articles, see §§6.34-6.46; for discussion of amending bylaws, see §§7.111-7.122.

Merger alternative. It may be that a merger can be worked out that would permit continuation of the corporate purpose. Some of the existing members (or directors if there are no members) may serve in the resulting new corporation, thus continuing their oversight of the assets of the original enterprise. Merger may be especially desirable for charities such as schools or hospitals that need a stronger capital base to survive. Mergers are also beneficial if the merging corporation has a large number of bequests, because the surviving entity will be the recipient of those bequests. Corp C §§6022, 8022. There is no similar provision allowing a corporation receiving a dissolving corporation's assets to be the recipient of such bequests.

Other forms of reorganization, short of a merger, are also possible. For example, another group or corporation can "take over" by succeeding to a majority of the board positions or a majority of the membership, depending on the corporate structure.

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§20.5 C. Attorney General Intervention

The Attorney General considers public benefit corporations, by their nature, to hold assets in charitable trust. The Attorney General has broad powers to supervise charitable trusts both under the common law and under specific statutory provisions, including but not limited to several statutes cited in Govt C §12598. Section 12598 also authorizes the Attorney General to recover reasonable attorney fees and actual costs of an enforcement action involving a charitable trust from the defendant charity if the court finds that the Attorney General's action either resulted in pecuniary benefits to the organization or corrected a breach of trust. If there is more than one defendant, the court is directed to divide the costs among them in a fair and equitable manner. Govt C §12598(c). The court may award the defendant charity the costs of the action if it finds that a lawsuit filed by the Attorney General was frivolous or in bad faith. Govt C §12598(d).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.5A D. Form: IRS Publication 4779 (Facts About Terminating or Merging Your Exempt Organization)

§20.5A D. Form: IRS Publication 4779 (Facts About Terminating or Merging Your Exempt Organization)



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Publication 4779
(May 2009)
Catalog Number 53287F

Facts about Terminating or Merging Your Exempt Organization

Most tax-exempt organizations that end their operations, either through shutting down, transferring their assets or merging with another tax-exempt organization, must inform the IRS about the details of the action.

Organizations Other Than Private Foundations

How You Should Inform the IRS

Usually this is done by filing a final Form 990, 990-EZ or e-Postcard (990-N). Which of these the organization files depends largely on its gross receipts and assets.

For the 2008 tax year returns (filed in 2009 or 2010) the filing guidelines are:

- Gross receipts normally less than or equal to $25,000, file the e-Postcard (990-N)
- Gross receipts greater than $25,000 and less than $1 million, and total assets less than $2.5 million, the organization can choose to file Form 990-EZ or 990
- Gross receipts $1 million or more or total assets greater than or equal to $2.5 million, file Form 990

A summary table is at IRS.gov/charities.

When the Return is Due

If you are terminating your organization or effectively going out of business by merging with another organization, you will need to file a final form four months and 15 days after the date of the organization's termination.

Information You Will Need to Disclose

Form 990 filers should check the Termination box in the header area on page 1 of the return and answer yes to the question whether the organization liquidated, terminated, or dissolved (line 31 of Part IV) and, if applicable, to the question whether the organization engaged in a significant disposition of net assets (line 32 of Part IV).

Print

Form 990-EZ filers should check the Termination box in the header area on page 1 of the return and answer yes to the question whether the organization liquidated, terminated, dissolved or substantially contracted (line 36 of Part V).

After you've indicated on the 990 or 990-EZ that you are terminating your organization or transferring assets, you'll need to file a Schedule N: *Liquidation, Termination, Dissolution, or Significant Disposition of Assets*. The information required on Schedule N includes a description of the assets and any transaction fees, the date of distribution, the fair market value of the assets and information about the recipients of the assets.

Relationship Between Your Organization and Transferee Organization
Schedule N also asks specific questions about whether an officer, director, trustee, or key employee of your organization is, or is expected to be, involved in the successor or transferee organization by governing, controlling, or having a financial interest in that organization. If you answer 'yes' to any of the questions, you will need to provide the name of the person involved and an explanation of the circumstances.

Attachments to Your Return
You will need to provide a certified copy of your articles of dissolution or merger, resolutions and plans of liquidation or merger along with your Form 990 or 990-EZ. You may also need to provide any other relevant documentation.

State Filings
Organizations in certain states must notify the state attorney general or other appropriate state office of the organization's intent to dissolve, liquidate, or terminate. A list of state officials can be found on the Charities and Non-profits Web site at www.irs.gov/charities. Enter State Nonprofit Incorporation Forms and Information into the search window.

Private Foundations

Termination of Foundation Under State Law
For the short tax year in which your foundation is fully liquidated, dissolved, or terminated, you must file a final Form 990-PF, *Return of Private Foundation*. You should check the Final Return box in the header area on page 1 of the return, answer yes to the question whether the foundation had a liquidation, termination, or dissolution; and provide the information set forth in General Instruction T of the Form 990-PF instructions. This information includes the following:

- A statement attached to the return explaining the termination,
- A certified copy of any liquidation plan, resolution, etc., and all amendments or supplements that were not previously filed,
- A list of the names and addresses of all recipients of assets, and
- An explanation of the nature and fair market value of assets distributed to each recipient.

If you are terminating your foundation, you will need to file a final form four months and 15 days after the date of the foundation's termination.

You also must consider the special rules that apply to termination of private foundation status.

Termination of Private Foundation Status
Once an organization is classified as a private foundation, it may only terminate that status under the provisions of Internal Revenue Code section 507. Under section 507, there are four ways to terminate private foundation status, two of which involve tax liability:

1. Voluntary termination by notifying the IRS of intent to terminate and paying a termination tax

To voluntarily terminate under section 507(a)(1), the organization must send a statement to the Manager, Exempt Organizations Determinations (Internal Revenue Service, Exempt Organizations Determinations, P.O. Box 2508, Cincinnati, OH 45201) of its intent to terminate its status under section 507(a)(1). The statement must provide, in detail, the computation and amount of private foundation termination tax. Unless the organization requests abatement, it must pay the tax at the time the statement is filed.

2. Involuntary termination for either willful repeated violations or a willful and flagrant violation of the private foundation excise tax provisions and becoming subject to the termination tax

3. Transfer of assets to certain public charities

A private foundation may terminate its status under section 507(b)(1)(A) by distributing all its net assets to one or more organizations with a ruling or determination letter described in section 509(a)(1). However, the organization to which the distribution is made must have been in existence and so described for a continuous period of at least 60 months before the distribution. A private foundation that terminates its status in compliance with section 507(b)(1)(A) is not required to notify the IRS of its intent to terminate, and does not incur any tax under section 507(c).

4. Operating as a public charity for a continuous period of 60 months after giving appropriate notice

An organization may terminate its private foundation status under section 507(b)(1)(B) if it meets the requirements of section 509(a)(1), (2), or (3)) for a continuous 60-month period beginning with the first day of any tax year, and notifies the Service before beginning the 60-month period that it is terminating its private foundation status.

The notice of termination of private foundation status via operation as a public charity should include:

- The name and address of the private foundation,
- Its intention to terminate its private foundation status,
- The Code section under which it seeks classification (section 509(a)(1), (2), or (3)),
- If section 509(a)(1) applies, the specific type of section 170(b)(1)(A) organization for which it seeks classification,
- The date its regular tax year begins, and
- The date the 60-month period begins.

The organization also must establish immediately after the end of the 60-month period that it has met the requirements of section 509(a)(1), (2), or (3).

A foundation may also transfer its assets to another private foundation, commence voluntary termination, and pay no termination tax because it has no assets. In this case, the transferee acquires all of the aggregate tax benefits of the transferor associated with the transferred assets.

References (click to link to IRS.gov page)
Form 990, *Return of Organization Exempt From Income Tax*
Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*
Schedule N: *Liquidation, Termination, Dissolution, or Significant Disposition of Assets*
Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*
Form 990-PF, *Return of Private Foundation*
Form 990 Series, Filing Phase-In
State Non Profit Information
Life Cycle of a Public Charity
Life Cycle of a Private Foundation

# # #

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§20.6 III. SALE OR DISPOSITION OF ASSETS

Subject to the terms of any express charitable trust under which it holds certain assets and which may limit the corporation's rights concerning those assets, a nonprofit corporation may sell or otherwise dispose of all or substantially all its assets. Corp C §§5911, 7911, 9631.

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§20.7 A. Required Approvals

Board of directors. The sale or other disposition of all or substantially all corporate assets requires the board's approval. Corp C §§5911(a)(1), 7911(a)(1), 9631(a)(1). Board approval alone is sufficient if the transaction occurs "in the usual and regular course of its activities." Corp C §§5911(a)(2), 7911(a)(2), 9631(a)(2). Although the statutes do not define that phrase, the courts, interpreting analogous language applicable to business corporations (see Corp C §1001 and its predecessors), have held that a sale that would prevent a corporation from continuing in the business for which it was organized is not in the usual and regular course of its business. *Jeppi v Brockman Holding Co.* (1949) 34 C2d 11, 206 P2d 847.

Members and other specified persons. If the transaction is not in the usual and regular course of the corporation's activities, the sale of all or substantially all corporate assets must be approved by the members, if any, and by any other persons specified in (1) a public benefit or mutual benefit corporation's articles (Corp C §§5911(a)(2), 7911(a)(2)) or (2) a religious corporation's articles or bylaws (Corp C §9631(a)(2)). Approval may be obtained either before or after approval by the board or before or after the transaction. Corp C §§5911(a)(2), 7911(a)(2), 9631(a)(2).

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§20.8 B. Consideration

A nonprofit corporation may sell all or substantially all its assets on "such terms and conditions and for such consideration as the board may deem in the best interests of the corporation." The consideration may be money, property, or securities of any domestic or foreign corporation. Corp C §§5911(c), 7911(c), 9631(c).

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C. Notice to Attorney General

§20.9 1. When Required

The notice requirements are slightly different for the three types of nonprofit corporations:

Public benefit corporations. Generally, the corporation must give written notice to the Attorney General 20 days before it sells or otherwise disposes of all or substantially all its assets, unless the transaction occurs in the usual and regular course of its activities or unless the Attorney General has given the corporation a written waiver of notice of the particular transaction. Corp C §5913.

Mutual benefit corporations. A mutual benefit corporation holding assets subject to charitable trust must give written notice to the Attorney General 20 days before it sells or otherwise disposes of any assets held in charitable trust unless the Attorney General has given the corporation a written waiver of notice of the particular transaction. Corp C §7913; see Corp C §7238.

Religious corporations. The Attorney General has no powers with respect to corporate changes other than dissolution. Corp C §9230(a), (c). Nevertheless, the corporation must give written notice to the Attorney General 20 days before it sells or otherwise disposes of all or substantially all its assets unless the Attorney General has given the corporation a written waiver of notice of the particular transaction. Corp C §9633.

NOTE: If a nonprofit corporation operates or controls a health facility, the notice and approval provisions are much stricter. Corp C §§5914-5925. See §§20.20-20.24.

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§20.10 2. Contents of Notice

The notice to the Attorney General of a proposed sale of assets must contain sufficient written information to enable the Attorney General to review and evaluate the proposed transaction, including the time, date, and place, and a statement indicating whether an approval, ruling, waiver, or other action by the Attorney General is sought. 11 Cal Code Regs §§999.2(e), 999.3(e), 999.4. The Attorney General's instructions request the following:

- A letter signed by an attorney for the corporation or a director of the corporation, describing and stating the material facts (see 11 Cal Code Regs §999.1(c)) of the proposed transaction;
- A copy of the board of directors' resolution or minutes discussing or otherwise authorizing the proposed transaction;
- A copy of the corporation's current financial statement;
- A copy of the corporation's articles of incorporation and bylaws if not already on file with the Registrar of Charitable Trusts;
- A copy of the articles of incorporation of any other corporation that is a party to the proposed transaction; and
- On request of the Attorney General, independent appraisals, or other evidence that the sale price and terms are fair to the corporation (usually in large, complex sales).

See also Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General Approval, available at http://www.ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf.

PRACTICE TIP: If the assets are being transferred to a for-profit entity, counsel should also review the Attorney General's General Review Protocol to learn whether any additional information should be furnished. See http://www.caag.state.ca.us/charities/publications/grp.pdf.

PRACTICE TIP: If no action by the Attorney General is sought, it is advisable to include a statement that these documents are being delivered to the Attorney General to provide the notice required by statute. Corp C §§5913, 7913, 9633; see 11 Cal Code Regs §§999.2(e), 999.3(e), 999.4. These materials should be submitted to the Attorney General's office located nearest to the corporation's principal office. 11 Cal Code Regs §999.1(a).

Proof of notice. The corporation should obtain proof that notice was indeed delivered to the Attorney General at least 20 days before the sale. If an extra copy of the notice or of the letter of transmittal is submitted with a postage paid, self-addressed envelope, the copy or letter will be date-stamped "Received" by the Attorney General and returned to the sender. 11 Cal Code Regs §999.1(b).

WARNING: Written notice is deemed filed when it is received at the Attorney General's office, not when it is deposited in the mail. 11 Cal Code Regs §999.1(a).

PRACTICE TIP: Most nonprofit corporations prefer to give notice of a contemplated sale of assets and obtain the Attorney General's response well before the 20 days required by law. The Attorney General's letter in response to the proposal can serve as proof that the notice requirements were met, or, depending on the contents, it can serve as a written waiver of the requirement.

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D. Certification of Instrument of Transfer

§20.11 1. Use and Effect

Any instrument conveying or otherwise transferring corporate assets may have annexed to it a certificate by the secretary or assistant secretary of the corporation attesting that the transaction was properly noticed and approved. An instrument so certified is prima facie evidence of the existence of facts authorizing the transaction and is conclusive evidence in favor of any good faith purchaser or encumbrancer who parted with value without notice of any trust restriction applicable to the property or any failure to comply with such a restriction. Corp C §§5912, 7912, 9632. See §§20.12-20.17.

The certificate of approval must state the following (Corp C §§5912, 9632):

- That the transaction was validly approved by the board;
- That any notice required to be given to the Attorney General has been given; and
- Either
- That the property described in the instrument is less than "substantially all" of the corporation's assets or that the transfer is in the usual and regular course of the corporation's activities, if such is the case, or
- That, if neither preceding condition applies, membership approval requirements were met (set forth facts).

For mutual benefit corporations, the recital of notice to the Attorney General may be omitted. See Corp C §7912.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ 2. Certificate of Approval of Sale of Assets/§20.12 a. Form: Title; Identification of Parties

2. Certificate of Approval of Sale of Assets

§20.12 a. Form: Title; Identification of Parties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.12-20.17.

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CERTIFICATE OF APPROVAL OF SALE OF ASSETS OF _ _[*NAME OF CORPORATION*]**_ _**

_ _[*Name of officer*]**_ _ certifies that:**

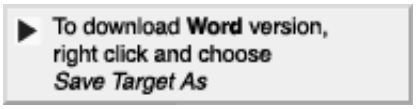
1. _ _[*He/She*]**_ _ is the _ _**[*secretary/assistant secretary*]**_ _ of _ _**[*name of corporation*]**_ _ (Corporation), a California nonprofit _ _**[*public benefit/mutual benefit/religious*]**_ _ corporation.**

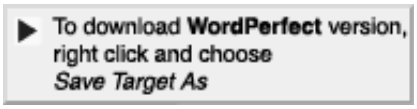
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.13 b. Form: Conveyance Approved

§20.13 b. Form: Conveyance Approved

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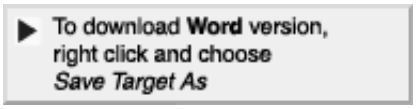
2. The conveyance or transfer of property described in the instrument to which this certificate is attached has been validly approved by the board of directors of the Corporation.

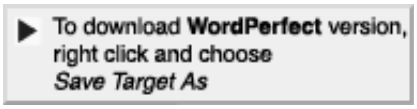
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.14 c. Form: Notice to Attorney General

§20.14 c. Form: Notice to Attorney General

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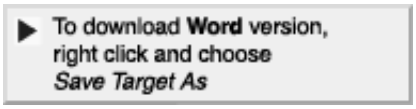
3. Any notice to the Attorney General required by statute has been timely given.

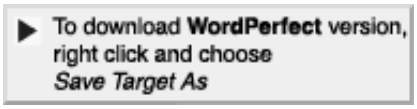
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.15 d. Form: Members' Approvals

§20.15 d. Form: Members' Approvals

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[Add one of the following alternatives]

[Alternative 1: Corporation has no members]

4. The Corporation has no members.

[Alternative 2: Directors are corporation's only members]

4. The directors are the only members of the Corporation.

[Alternative 3: Members' approval not required]

4. Membership approval of this transaction is not required, because the described property constitutes less than "substantially all" of the Corporation's assets.

[Alternative 4: Sale in usual course of business]

4. Membership approval of this transaction is not required, because the transaction is in the usual and regular course of the Corporation's activities.

[Alternative 5: Members' approval obtained]

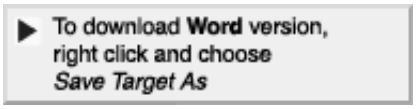
4. The transfer of property described in the attached instrument has been validly approved by the members of the Corporation.

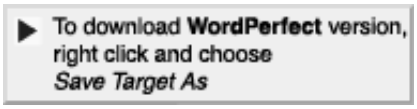
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.16 e. Form: Other Approvals

§20.16 e. Form: Other Approvals

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[Add one of the following alternatives]

[Alternative 1: Other approvals required]

5. The transaction has been approved by the following person(s) whose approval is required by the _ _[*articles/bylaws*]_ _**:** _ _[*Copy name or description from articles or bylaws*]_ _**.**

[Alternative 2: no other approvals required]

5. No other approvals are required.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.17 f. Form: Signature Block

§20.17 f. Form: Signature Block

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Date: _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: See §20.11.

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§20.18 E. Filing With the IRS

As part of its annual IRS Form 990 or IRS Form 990-EZ filing with the IRS, a nonprofit corporation that has made a significant disposition of its net assets must complete Part II of Schedule N. See §12.19. A sale, exchange, disposition, or other transfer of more than 25 percent of the fair market value of the assets will be considered to be a significant disposition, even if the organization received adequate consideration for the transfer. See Instructions to Schedule N and IRS Publication 4779 (reproduced in §20.5A).

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§20.19 F. Abandonment of Sale of Assets

The board of a public benefit or mutual benefit corporation may abandon a sale of assets without further action by the members even if the members have approved the sale. Corp C §§5911(b), 7911(b). The same rule applies to religious corporations unless the board's power is limited by a contrary provision in the articles or bylaws. Corp C §9631(b). In any event, the board's right to abandon a sale of assets is subject to any contractual rights of third parties. Corp C §§5911(b), 7911(b), 9631(b).

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G. Special Rule for Health Facilities: Attorney General's Consent for Certain Transactions

§20.20 1. When Attorney General's Consent Required

Any California nonprofit corporation as defined in Corp C §5046 and any foreign nonprofit corporation (Corp C §§5914(d), 5920(d); 11 Cal Code Regs §999.5(a)(6)) that operates or controls a "health facility" as defined in Health & S C §1250, or operates or controls a facility that provides similar health care services, must provide written notice to the Attorney General and obtain the Attorney General's written consent before it may do either of the following:

- Sell, transfer, lease, exchange, option, convey, or otherwise dispose of a material amount of its assets to a for-profit corporation or entity; or to a mutual benefit corporation or entity; or to another nonprofit corporation or entity. Notice is required even if the transfer or disposition is for adequate consideration. Corp C §§5914(a)(1)(A), 5920(a)(1)(A); 11 Cal Code Regs §999.5(a)(1)(A).
- Transfer control, responsibility, or governance of a material amount of the assets or operations of the nonprofit to a for-profit corporation or entity; or to a mutual benefit corporation or entity; or to another nonprofit corporation or entity. Corp C §§5914(a)(1)(B), 5920(a)(1)(B); 11 Cal Code Regs §999.5(a)(1)(B), (3).

NOTE: The Attorney General considers the transfer to involve a material amount of assets or operations if the transfer directly affects more than 20 percent of the value of the facilities owned by the organization, or if the fair market value of the affected facilities is greater than $3 million. 11 Cal Code Regs §999.5(a)(2).

On whether the notice requirement applies to religious corporations, see the Warning in §20.21.

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§20.21 2. Substitution of Members

The substitution of a new corporate member or members resulting in a transfer or control of, responsibility for, or governance of the nonprofit corporation is deemed a transfer. In addition, the substitution of one or more members of the governing body or any other arrangement, written or oral, that transfers voting control of the governing body is also deemed a transfer. Corp C §§5914(a)(2), 5920(a)(2); 11 Cal Code Regs §999.5(a)(3).

NOTE: The Corporations Code does not define "members of the governing body." Normally, the board of directors would be the governing body. It is unclear from this statute whether a regularly occurring change in the board of directors that results in a change in control now requires that a notice be filed with the Attorney General. Written notice and written consent will not be required if the change is in the usual and regular course of the organization's activities. 11 Cal Code Regs §999.5(a)(4). However, if there is a significant change, it is recommended that such a notice (or a request for waiver of notice) be filed.

WARNING: This requirement arguably applies only to public benefit corporations. The rules discussed in this section are contained in the public benefit corporation law (Corp C §§5110-6910) and are not incorporated by reference in either the mutual benefit corporation law (Corp C §§7110-8910) or the religious corporation law (Corp C §§9110-9690). It is not clear that such a provision can affect mutual benefit or religious corporations, despite the references to those corporations in Corp C §5914. Further, the regulations currently do not apply the requirement to mutual benefit or religious corporations.

NOTE: This requirement does not apply if the nonprofit corporation receiving the assets controls, is controlled by, or is under the common control with the transferring nonprofit corporation. Corp C §5031; 11 Cal Code Regs §999.5(a)(7). In this case, only the regular 20-day notice of transaction is required. See §20.9.

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§20.22 3. Request for Waiver

Unless the contract or transaction is in the usual and regular course of the organization's activity or unless the Attorney General provides a written waiver as to the particular contract or transaction, the written consent of the Attorney General is required before the transaction can take place. Corp C §§5914(c), 5920(c). A request for waiver should be in writing and should comply with 11 Cal Code Regs §§999.1(a) and 999.2(e) (see §20.10); the request will be granted or denied within 30 days after filing with the Attorney General.

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§20.23 4. Filing Requirements for Notice to Attorney General

If the transaction is not in the usual and regular course of the activity and no waiver is granted, then five copies of the notice, plus an electronic version of the same to allow posting to the Attorney General's website, must be filed with the Attorney General. 11 Cal Code Regs §999.5(c)(1), (5). In addition, the corporation must maintain a copy of the notice and any additional information submitted to the Attorney General in the same vicinity as its affected facility for review by the general public, and publicize the location. 11 Cal Code Regs §999.5(c)(4). See 11 Cal Code Regs §999.5(d) for the specific information that must be included with the notice.

NOTE: On written request, the Attorney General will make available (free of charge) the notice and any additional information provided to the Attorney General to members of the public in written form as soon as practicable after receipt except information determined to be confidential. 11 Cal Code Regs §999.5(c)(3)(B), (4). All information provided to the Attorney General will be treated as a public record unless the information is a trade secret or unless the public interest in maintaining the confidentiality of that information clearly outweighs the public interest in disclosure. The corporation has the sole burden of designating and substantiating information as confidential at the time of submission. 11 Cal Code Regs §999.5(c)(3)(A). If the corporation designates any of the information in the notice as confidential, it must submit an additional five copies of the notice to the Attorney General with the confidential information identified and redacted, and the corporation should *not* include the confidential information as part of the electronic version furnished. 11 Cal Code Regs §999.5(c)(3)(C).

Extensions. If necessary, the Attorney General may extend the 60-day deadline for up to an additional 45 days (1) to allow enough time for the consultation, (2) if the transaction is substantially modified after the public hearing, or (3) if the transaction involves a multi-facility health system. Corp C §§5915, 5921; see also 11 Cal Code Regs §999.5(e)(2).

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§20.24 5. Attorney General's Duties on Receipt of Notice

Within 60 days after receipt of notice, the Attorney General must do the following:

- Conduct one or more public hearings on the contract or transaction or on substantive changes to the contract or transaction, with at least one meeting in the county affected by the contract or transaction (Corp C §§5916, 5922);
- Consult with other state agencies (Corp C §§5919(a), 5924(a)); and
- Notify the corporation of its decision.

Extensions. If necessary, the Attorney General may extend the 60-day deadline for up to an additional 45 days (1) to allow enough time for the consultation, (2) if the transaction is substantially modified after the public hearing, or (3) if the transaction involves a multi-facility health system. Corp C §§5915, 5921; see also 11 Cal Code Regs §999.5(e)(2).

NOTE: Notice is not deemed received until substantially all information required is submitted. 11 Cal Code Regs §999.5(e)(1)(A).

In deciding to approve or deny the contract or transaction, the Attorney General must consider all relevant factors, including but not limited to whether (Corp C §§5917, 5923):

- The agreement or transaction will result in inurement (*e.g.,* an unreasonable benefit, such as excessive compensation, stock options, performance bonuses, or corporate loans) to any private person or entity, which is prohibited for an organization exempt under IRC §501(c)(3) (see §3.15);
- The proposed use of proceeds is consistent with the charitable trust in which the assets are held by the nonprofit organization;
- The agreement or transaction involves or constitutes a breach of trust;
- The Attorney General has been given sufficient information to adequately evaluate the agreement or transaction or the effects on the public;
- The agreement or transaction may create a significant effect on the availability or accessibility of health care services to the affected community; and
- The agreement or transaction is in the public interest.

If the transfer is to a for-profit entity or mutual benefit entity, the Attorney General must also consider whether (Corp C §§5917, 5923):

- The terms and conditions of the contract or transaction are fair and reasonable to the nonprofit corporation;
- The agreement or transaction is at fair market value; and
- The parties have manipulated the market value in a manner that causes the value of the assets to decrease.

Reimbursement. The Attorney General is entitled to reimbursement from the nonprofit corporation of all actual, reasonable, and direct costs incurred in this analysis and determination. Corp C §§5919(c), 5924(c). The Attorney General is also entitled to reimbursement from the nonprofit corporation for all reasonable costs incurred in monitoring ongoing compliance with the terms of the sale or transfer of assets. Corp C §§5919(d), 5924(d). When the transfer is to another public benefit corporation or to a religious corporation, the monitoring reimbursement is limited to 2 years. Corp C §5924(d)(3).

NOTE: The Attorney General will not consent to a health facility agreement or transaction pursuant to Corp C §5914 or §5920 if the seller restricts the type of medical services that may be provided at the health facility that is the subject of the agreement or transaction. Corp C §5917.5.

PRACTICE TIP: Counsel should review 11 Cal Code Regs §999.5 before providing the required notice to the Attorney General concerning any proposed transfer of health facility assets. See http://www.caag.state.ca.us/charities/statutes/999a.pdf.

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IV. CONVERSIONS

§20.25 A. General Rules

For conversion purposes, there are five different types of corporations under California law: business, public benefit, mutual benefit, religious, and cooperative. Any of these corporations may convert into any other type of corporation. Corp C §§911, 5813.5, 7813.5, 9621(a), 12504. Although this change of status is technically a type of amendment to the articles of incorporation, it is treated here as a separate topic because of its significance to the corporation and because of its special requirements and unique considerations.

NOTE: A nonprofit may merge with other types of business entities. See §§20.41-20.81. A nonprofit corporation is not permitted to use the conversion procedures in Corp C §§1150-1160 to convert to other business entities. See Corp C §162 (definition of "corporation").

PRACTICE TIP: A nonprofit unincorporated association may convert to a nonprofit corporation simply by filing articles of incorporation and including the appropriate language. Corp C §§5121, 7121, 9124. See chap 6. However, the IRS will consider the corporation to be a separate entity from the association, and will require a separate exemption application to be filed. Rev Rul 67-390, 1967-2 Cum Bull 179. See §§3.60-3.71.

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B. Changing For-Profit Corporation to Nonprofit Corporation

§20.26 1. Amendments to Articles

Required amendments. An amendment changing the status of a business corporation to a nonprofit public benefit, mutual benefit, or religious corporation must revise the corporation's statement of purpose, delete authorization for shares and any other provisions concerning shares, and, if shares have been issued, provide for the cancellation of the shares or conversion of the shares into memberships in the nonprofit corporation. Corp C §911(b). In addition, if shares have been issued, the amendment must be approved by all outstanding shares of all classes, regardless of limitations or restrictions on their voting rights. Corp C §911(c). See also Corp C §§902-903.

PRACTICE TIP: If the provision converting the corporation's status is included in a merger agreement, any provision for cancellation or conversion of shares must be included in the merger agreement rather than in the amendment of the articles. Corp C §911(d). See §20.64.

Mutual water company. If the corporation is a mutual water company, as defined in Pub Util C §2705, and is being converted to a mutual benefit corporation in which each outstanding share will become a membership, the approval of the outstanding shares of each class is required, regardless of limitations or restrictions on the voting rights of those classes. Corp C §911(e).

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§20.27 2. Requirement to Apply for Exempt Status

Conversion of a for-profit corporation to a nonprofit corporation does not automatically make the corporation exempt from paying taxes. The corporation must also file for exempt status with the Franchise Tax Board (FTB) (see §3.71) and, if the organization is to be an IRC §501(c)(3) entity, the IRS. If the organization is an IRC §501(c)(3) entity and has established its exempt status with the IRS, it need not separately establish that status with the FTB, although it must furnish the FTB with a copy of the IRS determination letter or ruling. Rev & T C §23701d(c)(1). No exemption is retroactive before the date the amendment is actually filed because an exemption requires that the corporation be both organized and operated for an exempt purpose.

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§20.28 C. Changing Nonprofit Corporation to Another Type of Corporation

To change a nonprofit corporation into another type of nonprofit, for-profit, or cooperative corporation, the articles must be amended to include all provisions that would have been required, and may include only provisions that would have been permitted, if the corporation had originally been incorporated as the type of corporation into which the nonprofit is changing. Corp C §§5813.5(c), 7813.5(c), 9621(b). If at least one annual report has been filed with the Secretary of State, the name of the initial agent for service of process may be omitted. Corp C §§5813.5(c), 7813.5(c), 9621(b).

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§20.29 D. Required Approvals

General approval requirements. The corporation's board of directors, its members, if any, members of a class, if class membership rights are affected, and any other persons whose approval is required by the articles must approve an amendment changing a corporation's status. Corp C §§5812-5813.5, 7812-7813.5, 9621. In addition, the following approvals are needed:

Public benefit corporations. The Attorney General must approve in advance a change in the status of a public benefit corporation with assets into any form of proprietary corporation (mutual benefit, business, or cooperative corporations). If there are no assets, the corporation must submit a copy of the amended articles to the Attorney General at least 20 days before they are filed. Corp C §5813.5(b). On amending the articles, see §20.26.

NOTE: The Attorney General requires certification that all charitable assets will be transferred to another charity as a condition to consent. See Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General Approval, available at http://www.ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf).

Mutual benefit corporations. The Commissioner of Corporations must determine that a change from a mutual benefit corporation to a public benefit or a religious corporation is fair to the members unless the amendment has been approved by 100 percent of the corporation's voting power or approved by the members in an election by written ballot in which no opposing votes were cast. Corp C §7813.5(b). The transaction must be qualified under California securities laws by applying for qualification by permit under Corp C §25121 and 10 Cal Code Regs §260.113 to request the Corporation Commissioner's determination of fairness. The form may be obtained from the Department of Corporations or online at: http://www.corp.ca.gov/forms/securities.asp. In deciding whether a change is fair to members, the Commissioner may hold hearings at which affected persons have the right to appear. Corp C §25142. The corporation's certificate of amendment should include either a copy of the Commissioner's determination that the change of status is fair to the members or a statement of the circumstances making that determination unnecessary. Corp C §7813.5(b). See §20.36.

Religious corporations. An amendment to the articles changing the status of a religious corporation needs no special approvals other than those generally applicable to amendment of articles of religious corporations. See Corp C §9621(a).

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§20.30 E. Property Held in Charitable Trust

Generally, assets that are considered impressed with a charitable trust must continue to be used for the purpose for which they were initially given. A conversion of a nonprofit public benefit corporation to another type of corporation does not abrogate this duty. One method of ensuring that these assets continue to be used for their initial purpose is to transfer assets equal to the value of the corporation at the time of conversion to a similar nonprofit corporation.

WARNING: The Attorney General considers all assets of public benefit corporations to be assets held in charitable trust and subject to Attorney General supervision. See Abbott & Kornblum, *The Jurisdiction of the Attorney General Over Corporate Fiduciaries Under the New California Nonprofit Corporation Law*, 13 USF L Rev 753 at 779, 783 (1979). The Attorney General requires certification that, as part of the conversion into a "business" corporation, all charitable assets will be transferred to another charity as a condition to consent. See Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580-12599.7). See also Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General Approval, available at http://www.ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf.

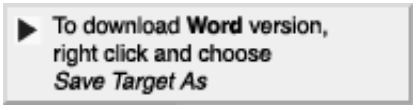
Under common law, the Attorney General has the duty to supervise the use of charitable trust assets. Statutory law on conversion of public benefit corporations continues this duty. Corp C §5813.5(b). Apart from the Attorney General's supervision, an amendment to the articles by itself does not abrogate any requirement or limitation that a charitable trust imposes on the corporation or any of its assets. Corp C §§5820(a), 7820(a), 9620(a). If provisions of the charitable trust reflected in the articles are based on an underlying testamentary or intervivos trust, the trustees (or directors of the corporation as successor trustees) may need to petition the court for approval to modify or terminate the underlying trust. See Prob C §17200(b)(13). See also Prob C §§17200(b)(15) (amendments of trust to qualify decedent's estate for federal charitable deduction), §15409 (modification or termination of trust in changed circumstances), and §§16100-16105 (duties of trustees of private foundations, charitable trusts, and split-interest trusts, especially regarding proceedings to reform or excuse compliance with a trust's governing instrument and notice requirements).

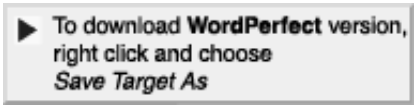
NOTE: A court has no jurisdiction to terminate or modify a charitable trust unless the Attorney General is named as a party. Govt C §12591.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.31 F. Checklist: Contents of Request for Approval From Attorney General

§20.31 F. Checklist: Contents of Request for Approval From Attorney General





A request for the Attorney General's approval or a request for waiver of notice of *any* proposed conversion from public benefit status to *any other* status, profit or nonprofit, should contain the following:

- A letter signed by an attorney or a director of the corporation describing the proposed action and the material facts concerning the proposed action.
- A copy of the resolution of the board of directors authorizing the proposed action, and any board or committee minutes reflecting discussion of the proposed action (minutes of the members' meeting approving the action may also be requested).
- A copy of the corporation's financial statement current to within 90 days before filing the request, if not already on file with the Registrar of Charitable Trusts.
- A copy of the corporation's articles as amended, if not already on file with the Registrar of Charitable Trusts.
- A copy of the articles of incorporation of any other corporation that is a party to the proposed action.
- Any independent appraisals of the value of the public benefit corporation that are available (in a complex transaction this may be required to ensure that the transaction is fair and reasonable to the public benefit corporation).
- A statement of the plan for distributing corporate assets of the corporation to a qualified charitable organization, or for payment by the directors of the public benefit corporation of the value of the corporation to a qualified charitable organization.
- Any other information requested by the Attorney General.

See 11 Cal Code Regs §§999.2(d), 999.3(d), 999.4. See also Attorney General's Guide for Charities, chap 10 (2005); Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General Approval, available at http://ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf.

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§20.32 G. Charitable Trust Requirements of Health Care Service Plans

Health care has been an active arena for conversions from nonprofit to for-profit status. Any transfer of assets involving a public benefit health facility or health facility operated or controlled by a foreign nonprofit imposes special notice and hearing requirements before the Attorney General will approve it. Health care service plans must also meet charitable trust requirements. Health & S C §§1399.72-1399.76. Health care service plans are regulated by the Director of the Department of Managed Care, not the Attorney General. Corp C §10821; Health & S C §1341(a).

Requirements for approval. The requirements that a nonprofit health care service plan must meet before a conversion will be approved by the Director include the following:

- The fair market value of the nonprofit plan is set aside for appropriate charitable purposes.
- The set-aside is dedicated and transferred to one or more existing or new charitable organizations exempt under IRC §501(c)(3); however, the Director may authorize the use of an IRC §501(c)(4) organization if it is necessary to ensure effective management and monetization of equity ownership in the plan.
- Any §501(c)(3) or §501(c)(4) organization receiving a set-aside must meet the following requirements:
- Its directors, officers, and assets, including any plan stock, must be independent of any influence or control by the health care service plan and its directors, officers, subsidiaries, or affiliates.
- The charitable mission and grant-making functions of the charitable organization must be dedicated to serving the health care needs of the people of California.
- Procedures and policies must be in place to prohibit conflicts of interest, including those associated with grant-making activities that may benefit the plan, or the plan's directors, officers, subsidiaries, or affiliates.
- The organization receiving the assets must demonstrate that the officers and directors have sufficient experience and judgment to administer grant-making and other charitable activities to serve the state's health care needs.
- The organization receiving the assets must provide the Director and the Attorney General with an annual report that includes a detailed description of its grant-making and other charitable activities related to its use of the set-aside received from the health care service plan.
- Finally, the plan must satisfy the requirements of Health & S C §§1340-1399.818 for health care service plans, and the plan must be free of actions that could result in a disciplinary action under Health & S C §1386.

These requirements are not limited to public benefit corporations. The Director of the Department of Managed Care, the Attorney General, and the court may impose charitable trust obligations on any or all assets of a mutual benefit corporation, or otherwise treat the mutual benefit in the same manner as a public benefit corporation. Health & S C §1399.75(e).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ H. Certificate of Amendment Changing Status/§20.33 1. Form: Title and Introduction

H. Certificate of Amendment Changing Status

§20.33 1. Form: Title and Introduction

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CERTIFICATE OF AMENDMENT OF ARTICLES OF INCORPORATION OF _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of officers*]_ _ **certify that:**

1. They are the _ _[*president/chair of the board/vice president*]_ _ **and the** _ _[*secretary/assistant secretary/chief financial officer/treasurer/assistant treasurer*]_ _**, of** _ _[*name of corporation*]_ _**, a California** _ _[*public benefit/mutual benefit/religious/business*]_ _ **corporation.**

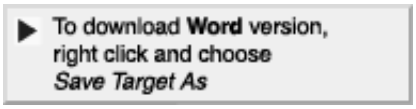
2. Desiring to change the status of the corporation to that of a California _ _[*public benefit/mutual benefit/religious/business*]_ _ **corporation, the directors, by the required vote, have approved the necessary changes to the articles of incorporation, so that the articles as amended read in full as follows:** _ _[*Set forth entire articles as amended.*]_ _

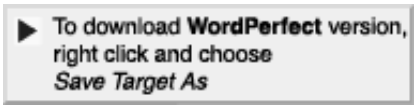
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.34 2. Form: Member or Shareholder Approval

§20.34 2. Form: Member or Shareholder Approval

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[*Add one of the following alternatives*]

[*Alternative 1: No members]*

3. The corporation has no members.

[*Alternative 2: Directors are only members]*

3. The directors are the corporation's only members.

[*Alternative 3: Member approval]*

3. _ _[*These amendments/The articles as amended*]**_ _ have been approved by the required vote of the members.**

[*Alternative 4: Business corporation changing to nonprofit corporation]*

3. _ _[*These amendments/The articles as amended*]**_ _ have been approved by all of the outstanding shares of all classes regardless of limitations or restrictions on their voting rights.**

Comment: See Corp C §911(c).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.35 3. Form: Public Benefit Corporation to Mutual Benefit or Business Corporation

§20.35 3. Form: Public Benefit Corporation to Mutual Benefit or Business Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.33-20.38.

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[*Add one of the following alternatives*]

[*Alternative 1: Corporation has assets]*

4. This change of status to a _ _[*mutual benefit/business*]**_ _ corporation has been approved by the Attorney General, and a copy of the approval is attached to this certificate.**

[*Alternative 2: Corporation has no assets]*

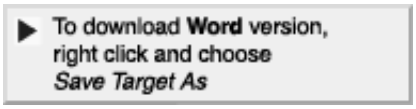
4. The corporation has no assets. A copy of this certificate, changing the corporation's status to that of a _ _[*mutual benefit/business*]**_ _ corporation, has been provided to the Attorney General at least 20 days before the date of filing of this certificate.**

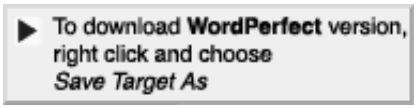
Comment: When a public benefit corporation is converted into a mutual benefit or business corporation, one of the above alternatives must be used. The first alternative is appropriate if the corporation has assets. Otherwise, the second alternative is appropriate. Corp C §5813.5(b). For requirements on notice to or approval by the Attorney General when a public benefit corporation changes to a mutual benefit or a business corporation, see §20.31.

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§20.36 4. Form: Mutual Benefit Corporation to Public Benefit Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.33-20.38.





[*Add one of the following alternatives*]

[*Alternative 1: Commissioner has found change to be fair to members]*

5. The Commissioner of Corporations has determined that this change is fair to the members. A copy of the Commissioner's determination is attached to this certificate.

[*Alternative 2: Commissioner approval not required]*

5. A determination of fairness by the Commissioner of Corporations is not required, because _ _[*state reasons*]**_ _.**

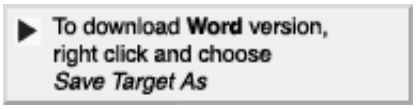
Comment: One of these alternatives should be used when a mutual benefit corporation is converted into a public benefit corporation. If the conversion was approved by 100 percent of the corporation's voting power or approved by the members in an election by written ballot in which no opposing votes were cast, or the corporation has no members, the second alternative is appropriate. In all other situations, the first alternative is appropriate. Corp C §7813.5. For requirements in a determination by the Commissioner of Corporations, see §20.29.

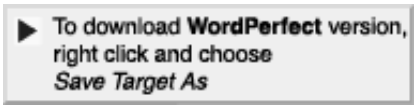
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.37 5. Form: Other Approvals

§20.37 5. Form: Other Approvals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.33-20.38.





6. _ _[*These amendments/The articles as amended*]**_ _ have been approved by the following person(s) whose approval is required by the articles: _ _**[*Copy names or description from articles*]**_ _.**

Comment: This clause must be used if the articles require additional approvals. See §20.29.

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§20.38 6. Form: Declaration and Signatures

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We declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Date: _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _ **President**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Secretary

Comment: A facsimile signature may be submitted to the Secretary of State on documents delivered by mail or by hand; however, the organization must maintain the original signed document for at least 5 years from the date of filing. No direct electronic or facsimile filings can be made until the Secretary of State develops appropriate procedures. Corp C §17.1(e).

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§20.39 7. Filing Requirements

The mechanics of filing a certificate of amendment making a change of status are generally the same as for other amendments to the articles. See §§6.42-6.46. If a nonprofit corporation is converting to a business corporation, the fee for filing a certificate of amendment with the Secretary of State is $70, not the $30 fee for other amendments. Govt C §12186(m). Also, a mutual benefit corporation changing its status to a public benefit corporation must submit an additional copy of the certificate of amendment, which the Secretary of State will forward to the Attorney General's office for filing with the Registrar of Charitable Trusts. Corp C §7813.5(d).

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§20.40 I. Franchise Tax Payment

If a public benefit or religious corporation is changing to a mutual benefit corporation, or if a public benefit, a mutual benefit, or a religious corporation is changing to a business or cooperative corporation, a previous determination of tax exemption by the Franchise Tax Board (FTB) (Rev & T C §23701) is not applicable after the change of status. Corporations that incorporated on or after January 1, 2000, do not need to prepay tax to the Secretary of State. Therefore, the corporation need not prepay the franchise tax when it files the certificate of amendment changing its status. See Corp C §§5813.5(d), 7813.5(e), 9621; Rev & T C §23153(f).

Even when a public benefit changes to a religious corporation, or vice versa, the continuation of the exempt status of the organization may be open to reexamination. Counsel should look at this issue carefully before a change is made, to ascertain what steps are required (*e.g.*, filing copies of the amended articles with the IRS and the FTB).

NOTE: For organizations that have established their exempt status under IRC §501(c)(3), a separate determination by the FTB is not required, although the organization must furnish the FTB with a copy of the IRS determination letter or ruling. See Rev & T C §23701d(c)(1).

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V. MERGERS

A. General Requirements

§20.41 1. Terminology

In the terminology of mergers under the Nonprofit Corporation Law, "survivor" or "surviving corporation" means a corporation into which one or more other corporations are merged. Corp C §5074. A "disappearing corporation" is one that merges into another corporation and does not survive the merger. Corp C §5048. A "constituent corporation" is any corporation, surviving or disappearing, that is a party to a merger. Corp C §5044.

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§20.42 2. Mergers Permitted

The Nonprofit Corporation Law does not specifically prohibit a merger of any type of California nonprofit corporation with any other type of corporation or other business entity and, in fact, appears to permit it. At least theoretically, any of the three types of California nonprofit corporations could merge with any of these three types of California nonprofit corporations, a California consumer cooperative corporation, a California business corporation, a foreign nonprofit corporation, a foreign business corporation, or other business entity (a domestic or foreign limited liability company, limited partnership, general partnership, business trust, unincorporated association), or domestic reciprocal insurer. Corp C §§5063.5, 6010, 8010, 9640(b). These mergers must be authorized by the laws under which each corporation or business entity is organized. Corp C §§6019.1(a), 8019.1(a).

Corporations Code §18360 specifically permits an unincorporated association to merge with a domestic or foreign corporation, domestic or foreign limited partnership, domestic or foreign general partnership, or domestic or foreign limited liability company.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.43 3. Table: Role of Attorney General: Prior Consent or Notice

§20.43 3. Table: Role of Attorney General: Prior Consent or Notice

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Restrictions on mergers are phrased in terms of required prior consent by the Attorney General. Generally, if there is no requirement of prior consent, the Attorney General must be given 20 days' notice of a proposed merger ("notice" being a copy of the proposed agreement of merger). The following table summarizes these requirements.

Attorney General (AG) Consent or Notice Requirements for Mergers			
MERGING CORPORATION	**PUBLIC BENEFIT CORPORATION**	**MUTUAL BENEFIT CORPORATION**	**RELIGIOUS CORPORATION**
1. California Public Benefit Corporation	Prior notice to AG required. Corp C §6010(a)-(b). AG consent required if members receive consideration other than membership in Survivor. Corp C §6010(c).	Consent of AG required. Corp C §§6010(a), 8010.	Prior notice to AG required. Corp C §§6010(b), 9640(a). Consent of AG required if members receive consideration other than membership in Survivor. Corp C §§6010(c), 9640(a).
2. California Mutual Benefit Corporation	AG consent required. Corp C §§6010(a), 8010.	Merger permitted. Corp C §8010. Corporation holding assets in charitable trust may need AG's ruling on validity of merger documents. Corp C §7820(b).	AG consent required. Corp C §§8010, 9640(b).
3. California Religious Corporation	Prior notice to AG required. Corp C §§6010(a)-(b), 9640(a). AG's consent required if members receive consideration other than membership in Survivor. Corp C §§6010(c), 9640(a).	AG consent required. Corp C §§8010, 9640(b).	Prior notice to AG required. AG's prior written consent required if members receive consideration other than membership in Survivor. Corp C §§6010(c), 9640(a).
4. California Consumer Cooperative Corporation	AG consent required. Corp C §§6010(a), 12530.	Merger permitted. Corp C §8010. Corporation holding assets in charitable trust may need AG's ruling on validity of merger documents. Corp C §7820(b).	AG consent required. Corp C §§9640(b), 12530.

5. California Business Corporation or Other Domestic Business Entity	AG consent required. Corp C §§1113(b)(5), 6010(a), 6019.1.	Merger permitted. Corp C §§1113(b)(5), 8010, 8019.1. Corporation holding assets in charitable trust may need ruling by AG on validity of merger documents. Corp C §7820(b).	AG consent required. Corp C §§1113(b)(5), 6019.1, 9640(b).
6. Foreign Nonprofit Corporation	Merger permitted if foreign corporation meets requirements of Corp C §6010(a). Prior notice to AG required. Corp C §6010(b). AG consent required if members receive consideration other than membership in Survivor. Corp C §6010(c).	Merger permitted. Corp C §8010. Corporation holding assets in charitable trust may need ruling by AG on validity of merger documents. Corp C §7820(b).	Merger permitted if foreign corporation meets requirements of Corp C §9640(b). AG's prior written consent required if members receive consideration other than membership in Survivor. Corp C §§6010(c), 9640(a).
7. Foreign Business Corporation or Other Foreign Business Entity	AG consent required. Corp C §6010(a). Authorization by foreign law for foreign business entity also required. Corp C §6019.1(a).	Merger permitted. Corp C §8010. Authorization by foreign law for foreign business entity also required. Corp C §8019.1(a). Corporation holding assets in charitable trust may need ruling by AG on validity of merger documents. Corp C §7820(b).	AG consent required. Corp C §9640(b). Authorization by foreign law for foreign business entity also required. Corp C §6019.1(a).

The purpose of the notice or approval of the Attorney General, or both, is to ensure that the nonprofit's charitable assets continue to be used for the charitable purpose for which they were given. See §20.30. For mergers involving health facilities and health care service plans, see §§20.9, 20.20, 20.32.

Note that under Corp C §5008(b):

> If the Secretary of State determines that an instrument submitted for filing or otherwise submitted does not conform to law and returns it to the person submitting it, the instrument may be resubmitted accompanied by a written opinion of a member of the State Bar of California submitting the instrument, or representing the person submitting it, to the effect that the specific provision of the instrument objected to by the Secretary of State does conform to law and stating the points and authorities upon which the opinion is based. The Secretary of State shall rely, with respect to any disputed point of law (other than the application of [Corp C §§5122, 7122, or 9122]), upon such written opinion in determining whether the instrument conforms to law. The date of filing in such case shall be the date the instrument is received on resubmission.

For the Attorney General's regulations on a request for consent to a merger or notice of a proposed merger, see 11 Cal Code Regs §§999.2(e) (public benefit corporations), §999.3(e) (mutual benefit corporations), and §999.4 (religious corporations). See also Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General

Approval, available at http://www.ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf.

PRACTICE TIP: The Attorney General's regulations on religious corporations deal only with notice of dissolution. 11 Cal Code Regs §999.4. Despite the requirement of Corp C §9640 that the Attorney General consent to a merger, the Attorney General's power over religious corporations is essentially limited to enforcement of the criminal laws and to disposition of the assets on dissolution. Corp C §9230.

Mutual benefit corporations are not usually required to obtain the Attorney General's consent unless charitable assets are involved, as when the merger is with a public benefit or religious corporation. However, if the merger violates the rule requiring equal distributions to class members, the corporation must obtain a determination of fairness by the Commissioner of Corporations unless all members of the affected class consent to the merger's terms and conditions. Corp C §8011.5. For contents of application for a determination of fairness, see 10 Cal Code Regs §260.121(a), made applicable by Corp C §§25121, 25142.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.44 4. Contents of Notice

§20.44 4. Contents of Notice

A notice of merger or application for approval of the merger, as filed with the Attorney General, should contain the following (see Attorney General's Guide for Nonprofit Transactions Requiring Notice or Attorney General Approval, available at http://www.ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf):

- A letter signed by an attorney for the corporation or a director of the corporation, setting forth a description and the material facts of the proposed action;
- A copy of the resolution of the board of directors authorizing the proposed action, and board meeting minutes discussing or otherwise authorizing the proposed action;
- A copy of the corporation's current financial statement;
- A copy of the corporation's articles of incorporation if not already on file with the Registrar of Charitable Trusts;
- A copy of the articles of incorporation of any other corporation that is a party to the proposed action; and
- If requested by the Attorney General, independent appraisal or other evidence that the terms are fair to the corporation (usually in large, complex transactions).

PRACTICE TIP: If the merger involves a foreign corporation, a similar filing with the Attorney General of the foreign state may also be required.

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§20.45 5. Approval by Corporation or Business Entity

Mergers involving nonprofit corporations must be approved by each constituent corporation's board of directors, members, if any, and any other persons entitled to approve amendments to the articles. Corp C §§6011-6012, 8011-8012, 9640(c)-(d). The approval of members or other persons may be obtained either before or after board approval. Corp C §§6012, 8012, 9640(a). The merger must also be approved on behalf of each other party by the persons authorized or required by the law under which it is organized. Corp C §§6019.1(b), 8019.1(b), 9640(a).

If a California business corporation is the disappearing corporation, the merger with the surviving nonprofit corporation must be approved by *all* outstanding shares of all classes of the disappearing corporation. Corp C §1112. This requirement is more rigorous than that for a disappearing nonprofit corporation, in which the merger must be approved by only a *majority* of the members of each class. Corp C §§6012, 8012, 9640(c).

For charts summarizing the procedure for mergers of nonprofit corporations based on the surviving corporation type, see §§20.46-20.48.

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B. Merger Requirements

§20.46 1. Chart: Surviving Public Benefit Corporation

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SURVIVING PUBLIC BENEFIT CORPORATION

Steps	DISAPPEARING PUBLIC BENEFIT CORPORATION	DISAPPEARING MUTUAL BENEFIT CORPORATION	DISAPPEARING RELIGIOUS CORPORATION
1. Approval by Disappearing Corporation's			
a. Board	Required.*	Required.*	Required.*
b. Members (if any)	Required.	Required.	Required.
c. Other persons	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles or bylaws.
2. Approval by Survivor's			
a. Board	Required.*	Required.*	Required.*
b. Members (if any)	Required.	Required.	Required.
c. Other persons	If required by Survivor's articles.	If required by Survivor's articles.	If required by Survivor's articles or bylaws.
3. Determination of fairness by Corporations Commissioner	Not required.	May be required if there are classes, unless class members consent.	Not required.
4. Prior consent by Attorney General (AG)	Not required unless members receive consideration other than membership in Survivor.	Required.	Not required unless members receive consideration other than membership in Survivor.
5. Tax Clearance Certificate from Franchise Tax Board	No longer required. (Secretary of State notifies FTB of merger.)		
6. Notice to AG (20 days before filing)	Required unless AG consent required (see 4 above).	Not required but AG consent is required (see 4 above).	Required unless AG consent required (see 4 above).
7. Filing with Secretary of State	Filed by Survivor.**	Filed by Survivor.**	Filed by Survivor.**

* The board must approve both the terms of the merger and the merger agreement.

** Documents filed by Survivor include Disappearing Corporation's officers' certificate.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.47 2. Chart: Surviving Mutual Benefit Corporation

§20.47 2. Chart: Surviving Mutual Benefit Corporation

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SURVIVING MUTUAL BENEFIT CORPORATION

Steps	DISAPPEARING PUBLIC BENEFIT CORPORATION	DISAPPEARING MUTUAL BENEFIT CORPORATION	DISAPPEARING RELIGIOUS CORPORATION
1. Approval by Disappearing Corporation's			
a. Board	Required.*	Required.*	Required.*
b. Members (if any)	Required.	Required.	Required.
c. Other persons	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles or bylaws.
2. Approval by Survivor's			
a. Board	Required.*		
b. Members (if any)	Required.		
c. Other persons	If required by Survivor's articles.	If required by Survivor's articles.	If required by Survivor's articles or bylaws.
3. Determination of fairness by Corporations Commissioner	May be required if there are classes, unless class members consent.		
4. Prior consent (AG)	Required.	Not required.	Required.
5. Tax Clearance Certificate from Franchise Tax Board	No longer required. (Secretary of State notifies FTB of merger.)		
6. Notice to AG (20 days before filing)	Not required (AG consent required; see 4 above).	Not required.	Not required (AG consent required; see 4 above).
7. Filing with Secretary of State	Filed by Survivor.**	Filed by Survivor.**	Filed by Survivor.**

* The board must approve both the terms of the merger and the merger agreement.

** Documents filed by Survivor include Disappearing Corporation's officers' certificate.

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§20.48 3. Chart: Surviving Religious Corporation

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SURVIVING RELIGIOUS CORPORATION

Steps	DISAPPEARING PUBLIC BENEFIT CORPORATION	DISAPPEARING MUTUAL BENEFIT CORPORATION	DISAPPEARING RELIGIOUS CORPORATION
1. Approval by Disappearing Corporation's			
a. Board	Required.*	Required.*	Required.*
b. Members (if any)	Required.	Required.	Required.
c. Other persons	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles.	If required by Disappearing Corporation's articles or bylaws.
2. Approval by Survivor's			
a. Board	Required.*	Required.*	Required.*
b. Members (if any)	Required.	Required.	Required.
c. Other persons	If their approval is required by Survivor's articles or bylaws.		
3. Determination of fairness by Corporations Commissioner	Not required.	May be required if there are classes, unless class members consent.	Not required.
4. Prior consent (AG)	Not required unless members receive consideration other than membership in Survivor.	Required.	Not required.
5. Tax Clearance Certificate from Franchise Tax Board	No longer required. (Secretary of State notifies FTB of merger.)		
6. Notice to AG (20 days before filing)	Required (unless AG consent required; see 4 above).	Not required (AG consent required; see 4 above).	Not required.
7. Filing with Secretary of State	Filed by Survivor.**	Filed by Survivor.**	Filed by Survivor.**

* The board must approve both the terms of the merger and the merger agreement.

** Documents filed by Survivor include Disappearing Corporation's officers' certificate.

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C. Merger Agreements

§20.49 1. Required Contents

The merger agreement document (not merely the terms of the agreement) must be approved by the board (Corp C §§6011, 8011, 9640(a)) and signed by authorized officers (see Corp C §§6013, 6019.1(e), 8013, 8019.1(f), 9640) of each constituent corporation. The merger agreement document must contain the following information (Corp C §§6011, 6019.1(b), 8011, 8019.1(b), 9640(d)):

- The terms and conditions of the merger;
- Any amendments to the articles or bylaws of the surviving corporation required by the merger;
- The name, place of incorporation, and status of each party, and the identity of the surviving party;
- The manner, if any, of converting memberships in the constituent corporation into shares, memberships, or other securities in the surviving party; or the securities, cash, rights, or other property that members are to receive in exchange for their memberships or securities; or, for mutual benefit corporations, the information that memberships are to be canceled without consideration;

WARNING: Members in public benefit and religious corporations may not receive any cash, rights, securities, or other property in exchange for their memberships interests. To do so would violate the prohibition against private inurement, as well as violating the charitable trust in which the nonprofit assets are held. See §3.15.

- Any other provision desired; and
- Any other details or provisions required by the laws under which any party to the merger is organized.

For a simple agreement of merger, see §§20.50-20.53; for a more detailed agreement of merger, see §§20.54-20.72; and for a certificate of approval, see §§20.73-20.79.

NOTE: Neither agreement is designed to address the special issues contained in the merger of a domestic or foreign for-profit corporation or other business entity with a nonprofit. These are specialized agreements and, for public benefit and religious organizations, will likely require extensive negotiations with the Attorney General before they will be approved.

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§20.50 2. Simple Merger Agreement

The following agreement of merger in §§20.51-20.53 is designed to cover a very simple merger transaction. In this transaction, the current articles and bylaws of the surviving corporation will remain in effect and the directors of the surviving corporation will continue to serve after the effective date of the merger. This form provides a guideline for the minimum terms a merger agreement should contain. For a more detailed merger agreement, see §§20.54-20.72.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.51 a. Form: Introduction and Parties

§20.51 a. Form: Introduction and Parties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.51-20.53.

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AGREEMENT OF MERGER

This Agreement of Merger (Agreement) dated _ _[*date*]_ _, is between _ _[*name of surviving corporation*]_ _ (Surviving Corporation), and _ _[*name of disappearing corporation*]_ _ (Disappearing Corporation).

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§20.52 b. Form: Merger Terms

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.51-20.53.

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1. Disappearing Corporation shall be merged into Surviving Corporation.

2. The memberships of Disappearing Corporation shall be converted into memberships of Surviving Corporation.

3. Disappearing Corporation shall from time to time, when requested by Surviving Corporation, execute and deliver such documents and take such actions as are necessary or desirable to evidence or carry out the intent of this Agreement.

4. The effect of the merger and the effective date of the merger are as prescribed by law.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.53 c. Form: Attestation and Signatures

§20.53 c. Form: Attestation and Signatures

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Date: _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

IN WITNESS WHEREOF, the parties have executed this Agreement.

_ _[*NAME OF SURVIVING CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

_ _[*NAME OF DISAPPEARING CORPORATION*]_ _**,**
a California nonprofit corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The merger agreement must be signed on behalf of each constituent corporation by (1) the chair of the board, the president, or a vice president; and (2) the secretary or assistant secretary. Corp C §§6013, 8013, 9640(a). See Comment to §20.38.

A certificate of approval for each constituent corporation (see §§20.73-20.79) must be attached to the agreement.

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§20.54 3. More Detailed Agreement of Merger

The following sample agreement of merger (see §§20.55-20.72) is designed to cover a somewhat more complex merger transaction, but is not intended to be exhaustive of all provisions that might be desirable.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.55 a. Form: Introduction

§20.55 a. Form: Introduction

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AGREEMENT OF MERGER

This agreement of merger (Agreement), dated _ _[*date*]**_ _ (Effective Date), is between _ _**[*name of surviving corporation*]**_ _ (Surviving Corporation) and _ _**[*name of disappearing corporation*]**_ _ (Disappearing Corporation).**

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§20.56 b. Form: Parties' Intent

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.

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Parties' Intent. **The parties intend by this Agreement to set forth the terms and conditions of a merger, subject to approvals as required by law and by the articles and bylaws of the parties.**

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c. Participating Corporations

§20.57 (1) Form: Surviving Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.

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Surviving Corporation. **Surviving Corporation is a California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation with the following _ _[*class/classes*]_ _ of memberships and _ _[*number/numbers*]_ _ of members:**

_ _[*Name of class*]_ _ _ _[*Number of members*]_ _

_ _[*Name of class*]_ _ _ _[*Number of members*]_ _

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.58 (2) Form: Disappearing Corporation

§20.58 (2) Form: Disappearing Corporation

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Disappearing Corporation. **Disappearing Corporation is a** _ _[*state of incorporation and type of corporation, e.g., California nonprofit/mutual benefit*]_ _ **corporation with the following** _ _[*class/classes*]_ _ **of** _ _[*memberships/shares*]_ _ **and** _ _[*number/numbers*]_ _ **of** _ _[*members/outstanding shares*]_ _**.**

_ _[*Name of class*]_ _	_ _[*Number of members or outstanding shares*]_ _
_ _[*Name of class*]_ _	_ _[*Number of members or outstanding shares*]_ _

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§20.59 d. Form: Effective Date

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Effective Date. **When all applicable laws have been complied with and all necessary authorizations, approvals, or consents have been received, a copy of this agreement, together with an officer's certificate of each constituent corporation, shall be submitted by Surviving Corporation to the California Secretary of State for filing. This merger shall become effective on the _ _[***date of filing/later of the following: (1) the date of filing or (2)* **_ _[***date***]_ _]_ _. The date on which the merger becomes effective is referred to in this Agreement as the "Effective Date."**

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.60 e. Form: Approvals and Consents

§20.60 e. Form: Approvals and Consents

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Approvals and Consents. **This merger is subject to receipt of the approval of any person or persons required by law or by the articles or bylaws of Surviving Corporation or of Disappearing Corporation or needed to gain or maintain Surviving Corporation's tax-exempt status. If such approval or approvals are not obtained, this Agreement is to be terminated, as provided in paragraph _ _**[*number; see §20.66*]**_ _.**

Comment: Depending on the type of merger, advance approval by the Internal Revenue Service and the Franchise Tax Board may be necessary to ensure that the surviving corporation will have tax-exempt status after the merger. On tax exemption generally, see chap 3.

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§20.61 f. Form: Statement of Merger

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Statement of Merger. **It is agreed by the parties that on the Effective Date, as determined under Paragraph _ _[***number; see §20.59***]_ _ of this Agreement, Disappearing Corporation shall be merged into Surviving Corporation, the corporate existence of Surviving Corporation shall continue, and the separate corporate existence of Disappearing Corporation shall cease. The corporate identity, existence, purposes, powers, rights, and immunities of Disappearing Corporation shall be merged into and vested in Surviving Corporation and _ _[***, except as otherwise provided in this Agreement,***]_ _ the corporate identity, existence, name, purposes, powers, rights, and immunities of Surviving Corporation shall continue unaffected and unimpaired by the merger.**

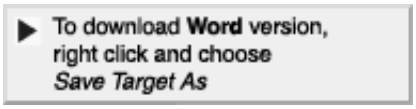
Surviving Corporation shall be subject to all Disappearing Corporation's debts, liabilities, and trust obligations in the same manner as if Surviving Corporation had itself incurred them, and all rights of creditors and all liens and trust obligations on or arising from the property of each constituent corporation shall be preserved unimpaired, as long as such liens and trust obligations on the property of Disappearing Corporation, if any, shall be limited to the property affected by such liens and obligations immediately before the Effective Date.

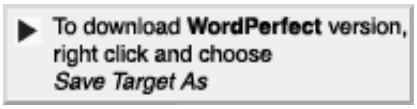
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.62 g. Form: Articles and Bylaws

§20.62 g. Form: Articles and Bylaws

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[Add one of the following alternatives]

[Alternative 1: Amendments to surviving corporation's articles and bylaws]

Articles and Bylaws. **Surviving Corporation's articles of incorporation shall be amended as of the Effective Date** _ _[*to read as follows/in the following respects*]_ _**:** _ _[*Set forth articles in full, as amended, or set forth text of amendments, properly identified to the existing articles*]_ _**. Surviving Corporation's bylaws shall be amended as of the Effective Date** _ _[*to read as follows/in the following respects*]_ _**:** _ _[*Set forth bylaws in full, as amended, or set forth text of amendments, properly identified to the existing bylaws*]_ _**.**

[*Alternative 2: No changes in surviving corporation's articles or bylaws*]

Articles and Bylaws. **Surviving Corporation's articles of incorporation in effect immediately preceding the Effective Date shall be and remain its articles of incorporation until amended or repealed as provided by law.**

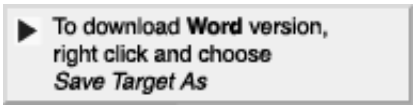
Surviving Corporation's bylaws in effect immediately preceding the Effective Date shall be and remain its bylaws until amended or repealed as provided by law.

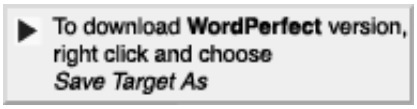
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.63 h. Form: Directors and Officers

§20.63 h. Form: Directors and Officers

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Directors and Officers. **Surviving Corporation's directors and officers from and after the Effective Date until changed in accordance with law and Surviving Corporation's articles and bylaws, shall be:** _ _[*Set forth names and/or positions of directors and officers—e.g., the following individuals who currently serve on Surviving Corporation's board and the following individuals who serve on Dissolving Corporation's board* _ _[*specify*]_ _]_ _**.**

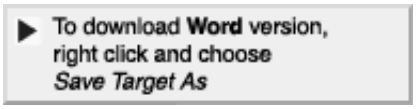
Comment: There is no requirement that the surviving corporation's directors and officers after the effective date be named in the merger agreement, but it is good practice to list them if there are to be any changes. If there will be no changes, this paragraph may be omitted.

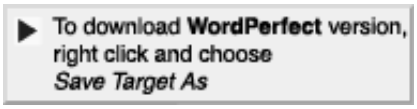
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.64 i. Form: Effect of Merger on Memberships

§20.64 i. Form: Effect of Merger on Memberships

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Effect on Surviving Corporation. **Memberships in Surviving Corporation outstanding on the Effective Date shall not be changed or converted as a result of the merger but shall remain outstanding as memberships in Surviving Corporation.**

Effect on Disappearing Corporation. **On the Effective Date, each _ _[*membership/share*]_ _ of Disappearing Corporation shall be converted into _ _[*specify number*]_ _ _ _[*membership/memberships*]_ _ in Surviving Corporation. No fractional memberships in Surviving Corporation shall be issued in this transaction.**

[If appropriate, add]

Surrender and Exchange of Certificates. **After the Effective Date, each holder of an outstanding _ _[*membership certificate evidencing membership in/share certificate evidencing ownership of shares of*]_ _ Disappearing Corporation shall surrender the same, duly endorsed as Surviving Corporation may require, to Surviving Corporation for cancellation, in exchange for which each holder shall receive _ _[*a membership in Surviving Corporation/a certificate evidencing membership in Surviving Corporation/(state other)*]_ _ to which the holder is entitled as provided in this Agreement.**

[If appropriate for disappearing mutual benefit corporation, add]

Cash for Fractional Holdings. **Holders of _ _[*memberships/shares*]_ _ in Disappearing Corporation who would otherwise be entitled to receive a fraction of a membership in Surviving Corporation shall in lieu of that fraction be paid an amount in cash equal to the value of their fractional holding _ _[*based on the _ _[market*]_ _ *value of memberships on the Effective Date/as determined by Surviving Corporation's board of directors in office immediately after the Effective Date*]_ _.**

[If appropriate, add]

Board of Director's Authority. **The board of directors is authorized and directed to adopt any and all measures necessary to carry out the exchange of _ _[*memberships/memberships and shares*]_ _.**

Comment: Most nonprofit corporations do not use membership certificates.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.65 j. Form: Interim Provisions

§20.65 j. Form: Interim Provisions

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Activities Prohibited During Merger. **Between the date of this Agreement and the Effective Date or date of termination, neither Surviving Corporation nor Disappearing Corporation shall, without the prior written consent of the other, (1) engage in any activity or transaction other than in the ordinary course of its affairs, except as contemplated by this Agreement, or (2) issue, purchase, _ _[*sell,*]_ _ or redeem any of its _ _[*memberships/shares/memberships or shares*]_ _.**

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.66 k. Form: Termination or Abandonment

§20.66 k. Form: Termination or Abandonment

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Termination or Abandonment. **This Agreement may be terminated and the merger abandoned at any time before the Effective Date (1) by the mutual consent of the respective boards of directors of Disappearing Corporation and Surviving Corporation; or (2) if in the opinion of the board of directors of either Disappearing Corporation or Surviving Corporation, evidenced by a certified copy of resolutions of that board filed with the other party to this Agreement, the merger is impractical or undesirable because of any of the following facts or circumstances:** _ _[*Insert any discretionary rights of termination, such as occurrence of a material and adverse change in the other party's activities, holdings, or financial position, opinion of counsel that the merger would not be a tax-free reorganization, inability to obtain necessary approvals, etc.*]_ _**. If termination occurs as provided in this paragraph, neither Disappearing Corporation nor Surviving Corporation or their respective boards of directors or** _ _[*members/shareholders*]_ _ **shall be liable to the other or its board of directors or** _ _[*members/shareholders*]_ _**.**

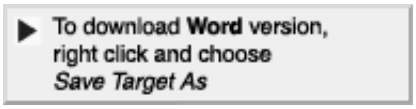
Comment: A board decision to abandon a merger does not require the approval of the members or other persons entitled to approve the merger. Corp C §§6016, 8016, 9640(a).

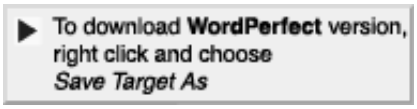
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.67 I. Form: Amendments to Agreement

§20.67 I. Form: Amendments to Agreement

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.





Amendments to Agreement. **This Agreement may be amended by the boards of directors of the constituent corporations, except that any amendment that would change any principal term of the Agreement must be approved by the members or other persons in the same manner as the original Agreement.**

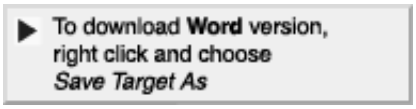
Comment: See Corp C §§6015, 8015, 9640(a).

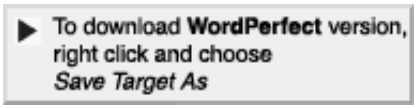
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.68 m. Form: Governing Law

§20.68 m. Form: Governing Law

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Governing Law. **This Agreement, and any dispute arising from the relationship between the parties to this Agreement, shall be governed by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of another jurisdiction's laws.**

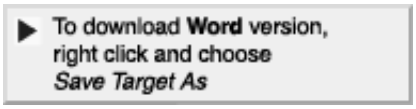
Comment: This provision may be important if one or more of the dissolving corporations are foreign corporations. If the merger is with a foreign corporation, the agreement of merger must contain the provisions required by both California law and the law of the state of the foreign corporation.

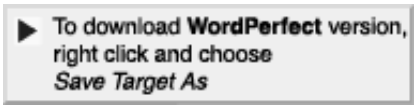
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.69 n. Form: Entire Agreement

§20.69 n. Form: Entire Agreement

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.





Entire Agreement. **This Agreement constitutes the entire agreement of the parties, superseding any prior written or oral agreements between them on the same subject.**

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§20.70 o. Form: Counterparts

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.

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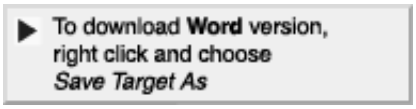
Counterparts. **This Agreement may be executed in any number of counterparts and each such counterpart shall be deemed to be an original instrument, but all of them together shall constitute only one Agreement.**

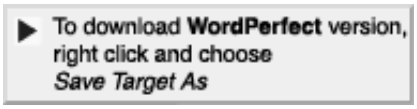
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.71 p. Form: Further Assurances

§20.71 p. Form: Further Assurances

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.55-20.72.





Further Assurances. **On request by Surviving Corporation, Disappearing Corporation shall from time to time execute and deliver any documents and instruments and take any actions desirable or necessary to vest in Surviving Corporation the title to and possession of all rights, properties, assets, trusts, and business of Disappearing Corporation or otherwise to carry out the full intent and purpose of this Agreement.**

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.72 q. Form: Attestation and Signatures

§20.72 q. Form: Attestation and Signatures

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IN WITNESS WHEREOF, Disappearing Corporation and Surviving Corporation have executed this Agreement on the day and year first above written.

_ _[*NAME OF SURVIVING CORPORATION*]_ _,

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

_ _[*NAME OF DISAPPEARING CORPORATION*]_ _,

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The merger agreement must be signed on behalf of each constituent corporation by (1) the chair of the board, the president, or a vice president; and (2) the secretary or assistant secretary. Corp C §§6013, 8013, 9640(a). See Comment to §20.38.

A certificate of approval for each constituent corporation (see §§20.73-20.79) must be attached to the agreement.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ 4. Certificate of Approval of Agreement of Merger/§20.73 a. Form: Title; Identification of Parties

4. Certificate of Approval of Agreement of Merger

§20.73 a. Form: Title; Identification of Parties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.73-20.79.

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CERTIFICATE OF APPROVAL OF AGREEMENT OF MERGER OF _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of officers*]_ _ **certify that:**

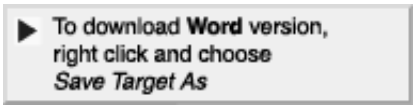
1. They are the _ _[*president/chair of the board/vice president*]_ _ **and the** _ _[*secretary/assistant secretary*]_ _**, respectively, of** _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious/business*]_ _ **corporation.**

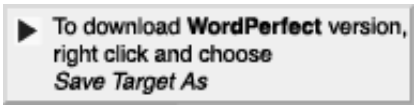
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.74 b. Form: Board Approval of Merger

§20.74 b. Form: Board Approval of Merger

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.73-20.79.





2. The Agreement of Merger in the form attached has been approved by the board of directors of this corporation.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.75 c. Form: Member Approval of Merger

§20.75 c. Form: Member Approval of Merger

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[Add one of the following alternatives]

[Alternative 1: Corporation has no members]

3. The corporation has no members.

[Alternative 2: Approval by members]

3. The principal terms of the Agreement of Merger in the form attached were approved by the required vote of the members of this corporation. There is only one class of members and the total number of members entitled to vote on the merger is _ _[*number*]_ _.

Comment: This form may be modified to reflect particular classes of stock.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.76 d. Form: Additional Required Approvals

§20.76 d. Form: Additional Required Approvals

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[Add one of the following alternatives]

[Alternative 1: No additional approval required]

4. No additional approval of the Agreement of Merger is required.

[Alternative 2: Additional approval required]

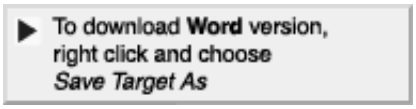
4. The principal terms of the Agreement of Merger in the form attached were approved by _ _[*insert name(s)*]**_ _, whose approval of mergers is required by this corporation's _ _**[*articles of incorporation/bylaws*]**_ _.**

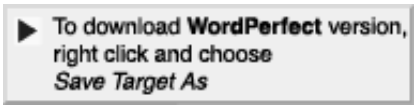
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.77 e. Form: Attorney General Notice or Consent

§20.77 e. Form: Attorney General Notice or Consent

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.73-20.79.



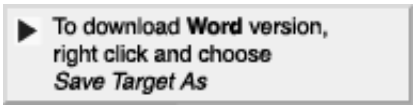


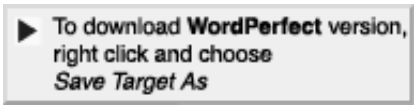
5. The Attorney General of California _ _[*has given prior written consent to/has been given prior written notice of/is not required to be given notice of*]**_ _ this merger.**

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§20.78 f. Form: Approval of Commissioner of Corporations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.73-20.79.





6. The California Commissioner of Corporations has determined that this merger is fair to the members; a copy of this determination is attached to this certificate.

Comment: The Commissioner of Corporations must determine the fairness of any unequal distribution to class members of a mutual benefit corporation unless all members of the affected class consent to the merger's terms and conditions. See the final paragraph of §20.43. See Corp C §8011.5.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.79 g. Form: Declaration and Signatures

§20.79 g. Form: Declaration and Signatures

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We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Date: _ _ _ _ _ _ **By:** __[*Signature*]__

Name: _ _[*Typed name*]_ _
_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ **By:** __[*Signature*]__

Name: _ _[*Typed name*]_ _
_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

Its: _ _[*Title*]_ _

Comment: See Comment to §20.38. Each constituent corporation must prepare a certificate of approval of the agreement of merger that the surviving corporation will submit for filing to the Secretary of State. Corp C §§6014, 8014, 9640(a). In lieu of an officers' certificate, a certificate of merger on a form prescribed by the Secretary of State must be filed for each constituent other business entity. Corp C §§6019.1(f), 8019.1(g), 9640(a).

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§20.80 5. Filing Requirements

The constituent corporations prepare certificates of approval of agreement of merger (see §§20.73-20.79). The surviving corporation attaches these to a copy of the agreement of merger and submits the package to the Secretary of State for filing, together with any amendments to the surviving corporation's articles required by the merger. A surviving domestic or foreign corporation or other business entity is deemed to have assumed the California tax liability of each disappearing domestic or foreign corporation or other business entity. Therefore, if the surviving entity is a domestic entity or a foreign entity qualified to do business in California, the Secretary of State will file the merger agreement and will notify the Franchise Tax Board of the merger. Corp C §§6020.5(b), 8020.5(b), 9640(a). See discussion of this process in §20.114.

The filing fee with the Secretary of State is $100 for each merger transaction involving corporations, regardless of the number of constituent corporations, and $150 for each merger transaction with another type of business entity. Govt C §12186(k)-(*l*). Procedural requirements are generally the same as in filing a certificate of amendment; see §§6.42-6.46.

PRACTICE TIP: If the merger is with a foreign corporation, the merger agreement must be filed with the California Secretary of State and the corresponding entity in the other state.

If the surviving party is a foreign corporation or foreign other business entity, the merger shall be effective for the domestic disappearing corporation as of the effective date in the foreign jurisdiction on the requisite filing in California. However, if the date of filing in California is more than 6 months after the effective date in the foreign jurisdiction, or if the powers of the domestic disappearing corporation would be suspended at the effective date in the foreign jurisdiction, the merger is effective on the date of the California filing. Corp C §§6018, 6019.1(h)(3)-(4), 8018(d)-(e), 8019.1(i)(3)-(4).

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§20.81 6. Effect of Merger

Surviving party. In a merger, the separate existence of each disappearing party ceases. The surviving party succeeds to all rights and property and is subject to all debts, liabilities, and trust obligations of the disappearing parties. Corp C §§6020(a), 8020(a), 9640(a). Further, the surviving party succeeds to any bequest, devise, gift, grant, or promise in a will or other instrument of donation, subscription, or conveyance that was made to a disappearing party and that takes effect or remains payable after the merger. Corp C §§6022, 8022, 9640(a). The surviving party is also deemed to have assumed the California tax liability, if any, of each disappearing domestic or foreign corporation or other business entity, and is required to file any tax and informational returns otherwise required of the disappearing entity and to pay any tax liability due. Corp C §§6020.5(a), 8020.5(a), 9640(a).

Creditors' rights. All creditors' rights and all liens and trusts on the constituent parties' property are preserved unimpaired as if the surviving party had incurred them itself; however, liens and trusts on the property of a disappearing party are limited to the property subject to the lien immediately before the time the merger is effective. Corp C §§6020(b), 8020(b), 9640(a).

Recordation. The surviving party's record ownership of the disappearing party's real property can be evidenced by filing a certified copy of the merger agreement (or a certificate in the form prescribed by the Secretary of State) with the county recorder in the county where the property is located. Corp C §§6021, 8021, 9640(a).

PRACTICE TIP: Because of the possibility that a nonprofit might merge with a for-profit entity, which would likely cause a loss of tax-exempt status, anyone desiring a charitable contribution deduction for any future bequest, devise, gift, or similar contribution should make such bequest, devise, gift, or similar contribution contingent on the entity then being tax-exempt.

Foreign survivor. If the surviving corporation is a foreign entity, it will continue to exist under the laws of the state of its incorporation. Corp C §§6018(a), 6019.1, 8018(a), 8019.1, 9640(a). If the foreign corporation intends to operate in California, it should qualify with the Secretary of State to do business as a foreign corporation and establish its exempt status with the Franchise Tax Board (FTB). If the organization has established its exempt status under IRC §501(c)(3), the organization must furnish the FTB with a copy of the IRS determination letter or ruling. Rev & T C §23701d(c)(1).

NOTE: Although the surviving party succeeds to all rights of the disappearing entity, some licenses (*e.g.,* to operate a preschool) are contingent on there being no change in the location, the governing board, etc. Because a merger is likely to result in some changes that may necessitate a new license being obtained, counsel should review each license that either party has in order to determine whether any refilings are necessary and should be made before the merger is finalized.

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§20.82 7. Filing of Final Informational Returns by Disappearing Corporation

If the disappearing corporation is required to file IRS Form 990 or IRS Form 990-EZ, then a final Form 990 or 990-EZ must also be filed with the IRS. The corporation must complete Part I of Schedule N as part of this filing. Schedule N is used to provide information relating to the going out of existence or disposition of more than 25 percent of an organization's assets through contraction, sale, exchange, or other disposition. (Part II is used to report a significant disposition of net assets.) Information about the assets transferred and the transferee must be included (with a merger, the assets generally go to the similarly exempt organization with which it is merging). Among other information required, whether any officer, director, or key employee will continue with the surviving corporation must be specifically noted.

PRACTICE TIP: A certified copy of the agreement of merger and the resolutions supporting the merger must be attached, along with any other relevant documentation. Consult the instructions for more details. The forms are available on the IRS website at http://www.irs.gov/formspubs. See also IRS Publication 4779, reproduced in §20.5A.

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§20.83 VI. PLANNING DISSOLUTIONS

If dissolution is necessary, the board of directors must plan the dissolution. Depending on the reason for considering dissolution in the first place, a do-nothing course may result in the corporation's drifting into insolvency or wasting its assets, exposing its directors to liability. See Corp C §§5231, 5233, 5240, 7231, 7238, 9241, 9250. The Attorney General may intervene in the affairs of a public benefit corporation or of one that holds assets subject to a charitable trust (see §20.30), or an involuntary dissolution may result, in either case, with the directors' loss of control over the ultimate disposition of the corporation's net assets. If the corporation is a private foundation that is required to distribute a percentage of its assets each year and it does nothing, the penalties may be even more significant.

Even if the corporation pays its debts and settles its liabilities, permitting it to linger as a no-asset shell can result in fines or suspension because of failure to file tax returns, state reports, and the like. See, *e.g.,* Corp C §§6810, 8810; Govt C §§12580-12599.7; Rev & T C §19141.

Disposition of assets. Once the decision to wind up and dissolve has been reached, the board of directors should consider the disposition of the corporation's assets after its liabilities are paid. Members of mutual benefit corporations are usually entitled to share pro rata in the corporation's assets. The assets of a public benefit or religious corporation can be sold for fair value, with the proceeds distributed to another public benefit or religious corporation, or donated directly to another public benefit or religious corporation, and the articles of incorporation can be amended to designate new recipients of the corporation's assets, subject to the powers of the Attorney General. Corp C §5820. If the proponents of the corporation desire to control the disposition of assets (again subject to the powers of the Attorney General), plans for doing so should be made and implemented before the corporation is dissolved.

For a discussion of procedures available when a corporation cannot take necessary actions to dissolve, see §§20.137-20.148.

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VII. VOLUNTARY DISSOLUTIONS

§20.84 A. Checklist: Procedures

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Voluntary dissolution of a nonprofit corporation requires the following basic procedural steps:

- The board of directors, members, or both, as appropriate, adopt resolutions electing to wind up and dissolve (see §§20.86-20.99).
- The corporation files a certificate of election to wind up and dissolve with the Secretary of State (see §20.100).

PRACTICE TIP: A certificate of election to wind up and dissolve is no longer necessary if the vote is by all members of a corporation with members or by all directors of a corporation without members, and if a statement to that effect is added to the certificate of dissolution. Corp C §§6611(c), 8611(c).

- The corporation notifies the Attorney General and, if it is a public benefit corporation, a religious corporation, or a mutual benefit corporation that holds assets in charitable trust, it requests a waiver of objections to any proposed distribution of assets (see §§20.106-20.113).
- The corporation sends notice of the dissolution and winding up to members and creditors as necessary (see §§20.117, 20.120).
- The corporation or its directors wind up operations, pay or adequately provide for payment of liabilities, and distribute assets (see §§20.118-20.122).
- The corporation files a certificate of dissolution with the Secretary of State (see §§20.124-20.131).
- If the corporation holds assets in charitable trust (as do all public benefit, religious, and some mutual benefit corporations), the corporation notifies the Registrar of Charitable Trusts (see §20.30).
- If the corporation is required to file informational returns (IRS Form 990 or IRS Form 990-EZ and FTB Form 199), it files a final return which must include Schedule N (see §20.136).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.85 B. Table: Dissolution Procedure Summary

§20.85 B. Table: Dissolution Procedure Summary

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Dissolution Procedural Chart

Steps	DISSOLVING PUBLIC BENEFIT CORPORATION	DISSOLVING MUTUAL BENEFIT CORPORATION	DISSOLVING RELIGIOUS CORPORATION
1. Approval by Corporation's			
a. Board	Required.	Required.	Required.
b. Members (if any)	Required.	Required.	Required.
c. Other persons	Not required (but see §20.78).		
2. File Certificate of Election to Wind Up and Dissolve	Normally required, unless dissolution approved by 100% of members or, if no members, by 100% of directors.		
3. Notify Attorney General	Required.	Required if assets held in charitable trust.	Required.
4. Request Waiver of Objections From Attorney General	Required unless court order consenting to distribution is obtained.	Required if assets held in charitable trust unless court order consenting to distribution is obtained.	Required unless court order consenting to distribution is obtained.
5. Tax Clearance Certificate From Franchise Tax Board	No longer required. (Secretary of State notifies FTB of Dissolution.) *	No longer required. (Secretary of State notifies FTB of Dissolution.) *	No longer required. (Secretary of State notifies FTB of Dissolution.) *
6. Notify Members	Required to members who did not vote for dissolution.		
7. Notify Creditors	Required.	Required.	Required.
8. Wind up Operations — Distribute Assets	Required.	Required.	Required.
9. File Certificate of Dissolution	Normally required.	Normally required.	Normally required.
10. Notify Registrar of Charitable Trusts	Required.	Required if assets held in charitable trust.	Not required unless requested by Attorney General.
11. File Final Informational Returns	Required.	Required.	Required* unless exempt from filing IRS Form 990, 990-EZ, or 990-PF, and FTB Form 199.

*NOTE: The Certificate of Dissolution must now state that a final tax return has been or will be filed. Corp C §8615(a)(5). See §§20.92, 20.114

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§20.86 C. Commencing Dissolution

A nonprofit corporation elects to dissolve by the approval of a majority of the members (Corp C §§5033, 6610(a)(1), 8610(a)(1), 9680(b)(1)(A)) or by approval of the board and approval of the members (Corp C §§5032, 5034, 6610(a)(2), 8610(a)(2), 9680(b)(1)(B)). Although approval of third parties may be required to amend the articles of a corporation, there is no requirement that those third parties consent to dissolution. However, they may be able to force an involuntary dissolution (see §§20.138-20.148) and they may have contractual rights (reflected in the corporation's articles or bylaws) to approve such actions.

Board approval. Only the approval of the board is needed to wind up and dissolve a corporation if the corporation (see Corp C §§6610(b), 6616, 8610(b), 8616, 9680(b)(2)):

- Is the subject of an order for relief in bankruptcy;
- Has disposed of all its assets and has not conducted any activity for the preceding 5 years;
- Has no members; or
- Is required to dissolve under the terms of its articles of incorporation.

If a corporation is required to dissolve under Corp C §6616 or §8616 because the term of corporation existence has expired, there actually is no "election" to do so. Arguably, these sections eliminate the need for resolutions under Corp C §6610 or §8610 and the need to file a certificate of election to wind up and dissolve under Corp C §6611 or §8611. See §20.100. Until the matter is clarified, however, it is good practice to adopt the resolutions and file the certificate of election.

Quorum. By the time dissolution of a corporation becomes necessary or appropriate, it is often impossible to find a sufficient number of directors to make up the quorum necessary for approval. If the corporation would be permitted to dissolve by approval of the board, but the number of directors then in office is less than a quorum, an action by the board to elect to dissolve may be taken by unanimous consent of all remaining directors, by a vote of a majority of the remaining directors, or by approval of the sole remaining director. Corp C §6610(c), 8610(c), 9680(b)(3).

NOTE: The Secretary of State will not file dissolution documents on behalf of a suspended corporation. Rev & T C §§23301, 23775.

An owners' association for holding real property interests may not dissolve without 100-percent approval of its members. Corp C §8724(a).

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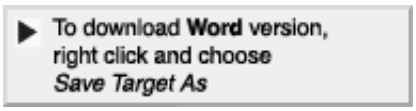
Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ 1. Initial Resolutions/ a. Board of Director's Resolution to Wind Up and Dissolve/§20.87 (1) Form: Intention to Wind Up and Dissolve Corporation

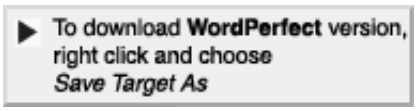
1. Initial Resolutions

a. Board of Director's Resolution to Wind Up and Dissolve

§20.87 (1) Form: Intention to Wind Up and Dissolve Corporation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.





***Intention to Dissolve*. The board of directors has determined that it is in the best interests of this corporation _ _[*and its members*]_ _ that this corporation be wound up and dissolved.**

Comment: As appropriate, forms in §§20.87-20.98 should be combined in one physical document.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.88 (2) Form: Corporation Without Members

§20.88 (2) Form: Corporation Without Members

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.

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***No Members*. This corporation has no members and Corporations Code §_ _[*6610/8610/9680*]_ _ permits such a nonprofit corporation to elect to voluntarily wind up and dissolve by approval of its board of directors.**

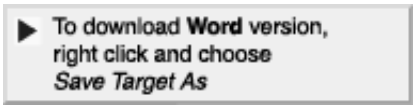
Comment: This form should be used if the corporation has no members. If the corporation has members, see §20.90.

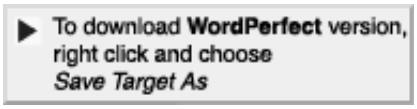
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.89 (3) Form: Resolution to Wind Up and Dissolve

§20.89 (3) Form: Resolution to Wind Up and Dissolve

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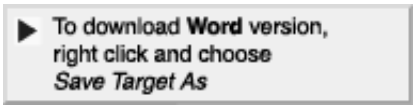
IT IS THEREFORE RESOLVED THAT the officers and directors of this corporation are authorized and directed to take appropriate measures to wind up and dissolve this corporation.

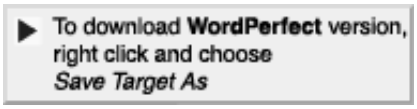
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.90 (4) Form: Members' Consent

§20.90 (4) Form: Members' Consent

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.





IT IS FURTHER RESOLVED THAT the officers and directors of this corporation are authorized and directed to obtain the vote or written consent of the members of this corporation necessary for adoption of the plan of complete liquidation described in these resolutions and for the election to wind up and dissolve the corporation, and to take such other measures as are necessary or appropriate to wind up and dissolve this corporation.

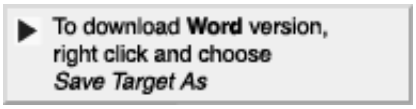
Comment: This form should be used only if the corporation has members. If it does not have members, see §20.88.

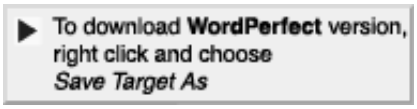
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.91 (5) Form: Resolution for Certificate of Election to Wind Up and Dissolve

§20.91 (5) Form: Resolution for Certificate of Election to Wind Up and Dissolve

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.





IT IS FURTHER RESOLVED THAT _ _[*, on obtaining the consent of the members,*]_ _ the president and secretary of this corporation or a majority of the directors currently in office are authorized and directed to execute and verify a Certificate of Election to Wind Up and Dissolve in accordance with Corporations Code §_ _[*6611/8611/9680*]_ _, to file the Certificate with the California Secretary of State, and to file a copy of that Certificate with the California Attorney General.

Comment: This provision should be used if there is approval from less than 100 percent of members or, if no members, from less than 100 percent of directors.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.92 (6) Form: Resolution Authorizing Filing of Final Tax Return

§20.92 (6) Form: Resolution Authorizing Filing of Final Tax Return

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IT IS FURTHER RESOLVED THAT the officers of this corporation are authorized and directed to file a final return as provided in Revenue and Taxation Code §23332 with the California Franchise Tax Board.

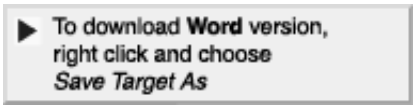
Comment: A tax clearance certificate is no longer required on dissolution of the corporation. Instead, the certificate of dissolution must state that a final tax return has been or will be filed with the Franchise Tax Board. Corp C §8615(a)(5).

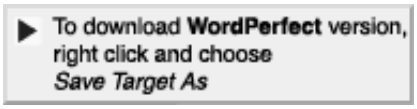
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.93 (7) Form: Resolution Permitting Other Necessary Actions

§20.93 (7) Form: Resolution Permitting Other Necessary Actions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.





IT IS FURTHER RESOLVED THAT, on commencement of proceedings to wind up the corporation, the officers of this corporation are authorized and directed to prepare and file such other documents and take such other action as may be necessary or advisable in connection with the winding up and dissolution of the corporation.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.94 (8) Form: Introduction to Plan of Liquidation and Distribution of Assets

§20.94 (8) Form: Introduction to Plan of Liquidation and Distribution of Assets

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PLAN OF LIQUIDATION/DISTRIBUTION OF ASSETS

The corporation currently holds the cash and other assets listed in Exhibit A to this resolution, and the corporation is able to pay or provide for all its known debts and liabilities.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.95 (9) Form: Resolution to Provide for Debts

§20.95 (9) Form: Resolution to Provide for Debts

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IT IS THEREFORE RESOLVED THAT all known debts and liabilities of the corporation be provided for or paid.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.96 (10) Form: Resolution to Set Aside Reserve

§20.96 (10) Form: Resolution to Set Aside Reserve

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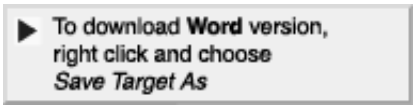
IT IS FURTHER RESOLVED THAT this corporation shall set aside in reserve the amount of _ _[*dollar amount*]**_ _ in cash for the payment of estimated expenses, taxes, unascertained or contingent liabilities, and expenses and costs of winding up, distribution of assets, and dissolution.**

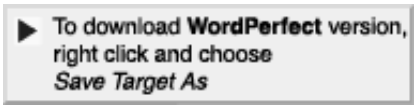
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.97 (11) Form: Resolution to Distribute Assets

§20.97 (11) Form: Resolution to Distribute Assets

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.87-20.98.





IT IS FURTHER RESOLVED THAT after (1) paying or adequately providing for all its known debts and liabilities, (2) setting aside the amount of the reserve fund referred to above, and (3) complying with Corporations Code §_ _[*6716/8717/9680*]_ _, _ _[*i.e., securing a decree of the superior court in proceedings to which the Attorney General is a party, or securing the Attorney General's written waiver of objections to the disposition,*]_ _ the corporate assets described in Exhibit A remaining on hand shall be distributed, in conformity with this corporation's articles of incorporation, to _ _[*name*]_ _.

Comment: The optional language above should be used if the corporation is a public benefit or religious corporation or if it is a mutual benefit corporation with property deemed subject to a charitable trust. If the corporation is exempt under IRC §501(c)(3), then any organizations receiving corporate assets must also be exempt under §501(c)(3).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.98 (12) Form: Resolution Authorizing Necessary Instructions

§20.98 (12) Form: Resolution Authorizing Necessary Instruments

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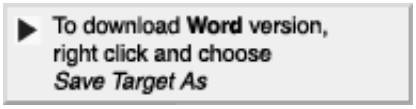
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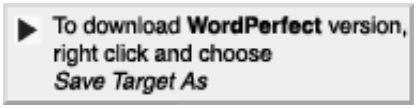
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IT IS FURTHER RESOLVED THAT the president and secretary of this corporation are authorized, empowered, and directed to execute and deliver in the name of and on behalf of the corporation such deeds, assignments, or other instruments of transfer as may be deemed necessary or proper and the officers and directors of this corporation are authorized, empowered, and directed to do any and all acts and things necessary to carry out, perform, implement, and consummate the above-described distribution and to wind up the corporate affairs and dissolve this corporation, including, but not limited to, filing a Certificate of Dissolution in accordance with Corporations Code §_ _[*6615/8615/9680*]_ _.

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§20.99 b. Form: Resolution by Members Approving Dissolution





The board of directors of this corporation, by resolutions adopted on _ _[*date*]_ _, copies of which are attached to this resolution as Exhibit A, have approved the voluntary dissolution of this corporation and the winding up of its affairs pursuant to a plan of complete liquidation.

NOW, THEREFORE, IT IS RESOLVED THAT the actions taken by the board of directors, as set forth in the resolutions attached to this resolution as Exhibit A, including the plan of complete liquidation set forth in those resolutions, are approved and adopted.

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2. Certificate of Election to Wind Up and Dissolve

§20.100 a. Filing Requirements

Secretary of State filings. After electing to wind up and dissolve (see §§20.86-20.99), the corporation must ordinarily file a certificate of election to wind up and dissolve with the Corporate Filing Division of the Secretary of State in the Sacramento headquarters office. Corp C §§6611(a), 8611(a), 9680(a). However, although a corporation can always file this certificate, the filing is not required if the vote is by 100 percent of the members of a corporation with members or by 100 percent of the directors of a corporation without members, and a statement to that effect is added to the certificate of dissolution. Corp C §§6611(c), 8611(c), 9680(a). The Secretary of State has an optional form, Form ELEC NP, that may be used for this purpose. See §20.101. Alternatively, the corporation may file its own, attorney-drafted form, a sample of which is set forth in §§20.102-20.103.

NOTE: Dissolution documents are not accepted at branch offices.

Attorney General filings. Public benefit and religious corporations, as well as mutual benefit corporations that hold assets in charitable trust or have a charitable dissolution clause, must also file a copy of the election with the Attorney General. Corp C §§6611(a), 8611(a), 9680(a). For a form of letter to the Attorney General, see §§20.106-20.113.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.101 b. Form: Certificate of Election to Wind Up and Dissolve (Optional Secretary of State Form ELEC NP)

§20.101 b. Form: Certificate of Election to Wind Up and Dissolve (Optional Secretary of State Form ELEC NP)



ELEC NP

State of California
Secretary of State

Domestic Nonprofit Corporation
Certificate of Election To Wind Up and Dissolve

NOTE: To complete the dissolution process, the corporation must also file a Certificate of Dissolution (Form DISS NP).

There is no fee for filing a Certificate of Election To Wind Up and Dissolve.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

Corporate Name (Enter the name of the domestic nonprofit corporation exactly as it is of record with the California Secretary of State.)

1. Name of corporation

Required Statement (The following statement is required by statute and should not be altered.)

2. The corporation has elected to wind up and dissolve.

Election (Check the applicable statement. Note: Only one box may be checked.)

3. ☐ The election was made by the vote of _____ (number of members) members of the corporation, constituting a majority of all the members.

☐ The election was made by the board of directors together with the vote of a majority of the members voting on the election to dissolve and in accordance with California Corporations Code section 5034 or 12224.

☐ The corporation has no members; the election was made by the board of directors of the corporation.

Signatory Authority (Check the applicable statement. Note: Only one box may be checked.)

4. ☐ The undersigned constitutes the sole director or a majority of the directors now in office of the above-named corporation.

☐ The undersigned constitute the chair of the board, president or vice president **and** the secretary, chief financial officer, treasurer, assistant secretary or assistant treasurer of the above-named corporation.

☐ The undersigned constitute(s) the member(s) authorized to execute this certificate by approval of a majority of all members.

Verification and Execution (If additional signature space is necessary, the dated signature(s) with verification(s) may be made on an attachment to this certificate. Any attachments to this certificate are incorporated herein by this reference.)

5. I declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of my own knowledge.

_____
Date

_____ _____
Signature of Director, Officer or Member | Type or Print Name of Director, Officer or Member

_____ _____
Signature of Director, Officer or Member | Type or Print Name of Director, Officer or Member

_____ _____
Signature of Director or Member | Type or Print Name of Director or Member

Print

Instructions for Completing the Certificate of Election To Wind Up and Dissolve (Form ELEC NP)

Where to File: For easier completion, this form is available on the Secretary of State's website at www.sos.ca.gov/business/be/forms.htm and can be viewed, filled in and printed from your computer. The completed form can be mailed to Secretary of State, Document Filing Support Unit, 1500 11th Street, 3rd Floor, Sacramento, CA 95814 or delivered in person (drop off) to the Sacramento office. If you are not completing this form online, please type or legibly print in black or blue ink. This form is filed only in the Sacramento office.

It is recommended for proof of submittal that if the Certificate of Election to Wind Up and Dissolve is mailed to the Secretary of State, the document be sent by Certified Mail with Return Receipt Requested. To facilitate the processing of documents mailed to the Secretary of State, a self-addressed envelope and a letter referencing the corporate name and number as well as the sender's name, return address and telephone number should be included with the submittal.

Legal Authority: Statutory filing provisions are found in California Corporations Code sections 6611, 8611, 9680 and 12631. All statutory references are to the California Corporations Code, unless otherwise stated.

- The Certificate of Election to Wind Up and Dissolve **is required** when the election to dissolve was approved by less than 100 percent of the members, or if the corporation has no members, by less than 100 percent of the directors. To complete the dissolution process the corporation must also file a Certificate of Dissolution pursuant to Section 6615, 8615, 9680 or 12635. Note: The corporation will not be completely dissolved until the Certificate of Dissolution is filed.

- The Certificate of Election to Wind Up and Dissolve **is not required** when the election to dissolve was approved by 100 percent of the members, or if the corporation has no members, by 100 percent of the directors, and if a statement to that effect is included in the Certificate of Dissolution.

- It is recommended that legal counsel be consulted prior to submitting dissolution documents to ensure that all issues are appropriately addressed.

Fees: There is no fee for filing a Certificate of Election to Wind Up and Dissolve. However, a $15.00 special handling fee is applicable for processing documents delivered in person (drop off) to the Sacramento office. The special handling fee will be retained whether the document is filed or rejected. The preclearance and/or expedited filing of a document *within a guaranteed time frame* can be requested for an additional fee in lieu of the special handling fee. Please refer to the Secretary of State's website at www.sos.ca.gov/business/be/service-options.htm for detailed information regarding preclearance and expedited filing services. The special handling fee or preclearance and expedited filing services are not applicable to documents submitted by mail. Check(s) should be made payable to the Secretary of State.

Copies: The Secretary of State will certify two copies of the filed document without charge, provided that the complete copies with any required attachments are submitted to the Secretary of State with the document to be filed. Any additional copies submitted will be certified upon request and payment of the $8.00 per copy certification fee.

Complete the Certificate of Election to Wind Up and Dissolve as follows:

Item 1. Enter the name of the domestic nonprofit corporation exactly as it is of record with the California Secretary of State.

Item 2. This statement is required by statute and should not be altered.

Item 3. Check the box next to the applicable statement. Only one box may be checked. If the first box is checked, specify the number of members voting for the election to dissolve in the space provided.

Item 4. Check the box next to the applicable statement. Only one box may be checked.

Item 5. If the first box of Item 4 was checked, the certificate must be dated, signed and verified under penalty of perjury by a majority of the directors of the corporation now in office or by the sole director, if there is only one.

If the second box of Item 4 was checked, the certificate must be dated, signed and verified under penalty of perjury by two of the corporate officers authorized by Section 5062 or 12241 (i.e., the chair of the board, the president or any vice president **and** by the secretary, the chief financial officer, the treasurer or any assistant secretary or assistant treasurer).

If the third box of Item 4 was checked, the certificate must be dated, signed and verified under penalty of perjury by the member(s) authorized to execute this certificate by approval of a majority of all members.

If additional signature space is necessary, the dated signature(s) with verification(s) may be made on an attachment to the certificate. All attachments should be 8½" x 11", one-sided and legible.

Comment: This optional form is available at the Secretary of State's website at

http://www.sos.ca.gov/business/corp/pdf/dissolutions/corp_npdiss.pdf, where it may be completed online and printed.

Under Corp C §17.1, a facsimile signature may be submitted to the Secretary of State on documents delivered by mail or by hand; however, the organization must maintain the original signed document for at least 5 years from the date of filing. No direct electronic or facsimile filings can be made until the Secretary of State develops appropriate procedures. Corp C §17.1(e).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ c. Certificate of Election to Wind Up and Dissolve (Attorney-Drafted Form)/§20.102 (1) Form: Title, Parties, and Election

c. Certificate of Election to Wind Up and Dissolve (Attorney-Drafted Form)

§20.102 (1) Form: Title, Parties, and Election

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CERTIFICATE OF ELECTION TO WIND UP AND DISSOLVE _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of officers*]_ _ **certify that:**

1. They are the President and Secretary, respectively, of _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious*]_ _ **corporation.**

2. The corporation has elected to wind up and dissolve.

[*Add one of the following alternatives*]

[*Alternative 1: No members; election by Board*]

3. The corporation has no members and the election was made by the Board of Directors of the corporation.

[*Alternative 2: Election by majority of members and Board*]

3. The election was made by the Board of Directors together with the vote of a majority of the members of the corporation voting on the election to dissolve.

[*Alternative 3: Election by majority of members*]

3. The election was made by the vote of _ _[*number*]_ _ **members of the corporation, constituting a majority of all members.**

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.103 (2) Form: Declaration and Signatures

§20.103 (2) Form: Declaration and Signatures

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We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Date: _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _**, President**

__[*Signature*]__
_ _[*Typed name*]_ _**, Secretary**

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3. Notice to Attorney General

§20.104 a. Attorney General's Role

Enforcement and supervision duties. The Attorney General has common law and statutory enforcement and supervisory powers over charitable corporations and trustees, including corporate directors, that hold property for charitable purposes. See, *e.g.,* Govt C §§12580-12599.7; *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 40 CR 244; *People v Cogswell* (1896) 113 C 129, 136, 45 P 270. Thus, with some exceptions, any public benefit, mutual benefit, or religious corporation that holds property as a trustee for charitable purposes is subject to the Attorney General's general supervision with regard to dissolution and distribution of those assets. Corp C §§6716(c), 8716(c), 9680(c). See also Corp C §§5250, 6216, 7240 on general supervision apart from dissolution.

Purpose and use of assets after distribution. The Attorney General must be notified of the commencement of voluntary dissolution of a public benefit corporation (Corp C §§6611(a), 6613(c)), a religious corporation (Corp C §9680(a)), or a mutual benefit corporation that holds assets in charitable trust (Corp C §§8611(a), 8613(c)). Apart from recovery of improper distributions (Corp C §§6719, 8719, 9680(a)) or actions against recipients of assets that were improperly distributed (Corp C §§6721, 8721, 9680(a)), a prime concern of the Attorney General is the purpose of and use to which the assets will be put after distribution. This concern particularly applies to the assets of a public benefit corporation. For example, assets subject to restrictions under the articles of incorporation, the bylaws, or a trust (Corp C §6716) must be distributed for a use that is consistent with the restrictions. See, *e.g., Estate of Zahn* (1971) 16 CA3d 106, 93 CR 810.

Mutual benefit corporations. The jurisdiction of the Attorney General and the courts is more limited for mutual benefit corporations, and the issue may arise whether assets are indeed devoted to charitable purposes. See *Lynch v Spilman* (1967) 67 C2d 251, 62 CR 12. As a result, before a mutual benefit corporation holding assets in charitable trust may dispose of those assets, the corporation must obtain either a court decree or the Attorney General's written waiver of objections to disposition. Corp C §8716.

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§20.105 b. Letter to Attorney General

The dissolving corporation must give the Attorney General notice of the commencement of dissolution proceedings and a copy of the certificate of election to wind up and dissolve (see §20.100) by a public benefit corporation (Corp C §§6611(a), 6613(c)), a religious corporation (Corp C §9680(a)), or a mutual benefit corporation that holds assets in charitable trust (Corp C §§8611(a), 8613(c)), if one is filed. Without a court decree, the Attorney General's waiver of objections is needed to distribute certain assets of public benefit and religious corporations, and assets held in charitable trust by mutual benefit corporations. Corp C §§6716(c), 8716(c), 9680(e). Instructions for preparing a request for waiver are contained in 11 Cal Code Regs §§999.1-999.8, and simplified instructions are provided in the Attorney General's General Guide for Dissolving a California Nonprofit Corporation (Form CT-603), available at http://www.ag.ca.gov/charities/publications/dissolving.pdf. However, the Attorney General will often want to see copies of the exempt determination letters for each recipient, the minutes authorizing the distribution, and other specific verifications and certificates not listed in the general guide. For a sample format of the letter to be sent, see §§20.106-20.113.

PRACTICE TIP: Because this letter must be attached to the certificate of dissolution, the corporation is forced to comply with the requirement, and the time for obtaining approval has increased. Counsel should file the request for waiver with the Attorney General as soon as possible.

For public benefit and religious corporations, the Attorney General's waiver of objections or a written confirmation by the Attorney General that the corporation has no assets must be attached to the certificate of dissolution that must be filed with the Secretary of State. Corp C §§6515(c), 9680(a). See §20.124.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.106 (1) Form: Address and Salutation

§20.106 (1) Form: Address and Salutation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.

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Office of Attorney General
_ _[*address of nearest Attorney General's office*]_ _

Re: Dissolution and Disposition of Assets of _ _[*name of nonprofit corporation*]_ _

Waiver of Notice

Dear Sirs or Madams:

Comment: The letter should be addressed to the Attorney General's office nearest to the principal office of the corporation on whose behalf the notice is being given. See 11 Cal Code Regs §999.2. The current mailing address may be verified by calling (916) 445-2021.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.107 (2) Form: Request for Waiver of Objections

§20.107 (2) Form: Request for Waiver of Objections

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.

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In accordance with Corporations Code §_ _[*6716(c)/8716(c)/9680(e)(3)*]_ _, this letter is to request a written waiver of objections to the disposition of the remaining assets in connection with the dissolution of the above-named California nonprofit _ _[*public benefit/mutual benefit/religious*]_ _ corporation.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.108 (3) Form: Documents Enclosed

§20.108 (3) Form: Documents Enclosed

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Copies of the articles of incorporation and the bylaws _ _[*, and all their amendments,*]_ _ of _ _[*name of nonprofit*]_ _ are enclosed, along with copies of its exemption letters from both the Internal Revenue Service and the Franchise Tax Board.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.109 (4) Form: Nature of Corporate Assets

§20.109 (4) Form: Nature of Corporate Assets

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.

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The present assets of _ _[*name of corporation*]_ _ are the cash and property described in the enclosed balance sheet. Also enclosed are _ _[*financial statements/the corporation's completed IRS Form _ _[990/990-PF/990-EZ*]_ _]_ _ for the three most recent accounting periods.

Comment: Financial statements should include a receipts and disbursement statement and a balance sheet for each accounting period.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.110 (5) Form: Assets Are Not Proceeds of Restricted Funds

§20.110 (5) Form: Assets Are Not Proceeds of Restricted Funds

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.

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Officers of _ _[*name of corporation*]_ _ have informed us that none of its assets are (or were purchased with) proceeds of restricted funds or gifts, nor do they consist of the proceeds of fundraising campaigns through which special representations about the use of such proceeds were made to donors.

Comment: If any assets are restricted, the plan of distribution should address how the restriction will continue to be met.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.111 (6) Form: Distribution of Assets

§20.111 (6) Form: Distribution of Assets

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.

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Enclosed is

[*Add if election to wind up and dissolve is filed*]

a copy of _ _[*name of corporation*]_ _'s election to wind up and dissolve, together with

[*Continue*]

a certified copy of the resolutions of the board of directors _ _[*and members*]_ _ of _ _[*name of corporation*]_ _ authorizing the plan of dissolution

[*Add if election to wind up and dissolve is not filed*]

_ _[*by 100 percent of the _ _[members/directors]_ _ of the corporation*]_ _.

[*Continue*]

These resolutions include a plan of complete liquidation and the proposed disposition of the remaining assets of _ _[*name of corporation*]_ _. The proposed distribution is as follows:

1. _ _[*Describe assets*]_ _ to _ _[*specify*]_ _, a California nonprofit _ _[*public benefit/religious*]_ _ corporation, located at _ _[*address*]_ _, _ _[*telephone number*]_ _.

2. _ _[*Describe assets*]_ _ to _ _[*specify*]_ _, a California nonprofit _ _[*public benefit/religious*]_ _ corporation, located at _ _[*address*]_ _, _ _[*telephone number*]_ _.

3. The remaining assets to _ _[*specify*]_ _, a California nonprofit _ _[*public benefit/religious*]_ _ corporation, located at _ _[*address*]_ _, _ _[*telephone number*]_ _.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.112 (7) Form: Distributees' Status

§20.112 (7) Form: Distributees' Status

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All these corporations are organized and operated for _ _[*specify, e.g., religious, charitable, scientific, or educational purposes*]**_ _, selected by the Board of Directors in office at the time of dissolution, as required in Article _ _**[*number*]**_ _ of _ _**[*name of corporation*]**_ _'s Articles of Incorporation. Copies of their articles and bylaws, or trust instrument, and exemption determination letters are also attached to this letter.**

Comment: Attaching copies of the articles and bylaws, or trust instrument, and exemption determination letters is especially helpful if the organization is one with which the Attorney General may not be familiar.

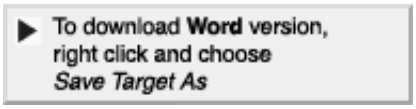
Dissolving corporations should ensure that any proposed distributee that is required to report to the Attorney General is current in its reporting obligations before receiving a distribution.

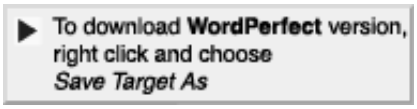
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.113 (8) Form: Closing and Signatures

§20.113 (8) Form: Closing and Signatures

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.106-20.113.





If you need further information or have any questions, please call us at your earliest convenience. Thank you for your assistance in this matter.

_ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The letter should be signed by an attorney for the corporation or by a director of the corporation.

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§20.114 4. Tax Return Filing Obligation

A tax clearance certificate is no longer required on dissolution of the corporation. Instead the Certificate of Dissolution must state that the final tax return has been or will be filed with the Franchise Tax Board "as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code." Corp C §§6615(a)(4), 8615(a)(5). See §20.130.

NOTE: Churches and other religious corporations are generally exempt from filing informational returns with the Franchise Tax Board. It is unclear whether the language of Corp C §6615(a)(4) imposes a new requirement on religious organizations to file, when the Revenue and Tax Code imposes no such obligation. There is currently no specific exemption from Corp C §6615 set forth for religious corporations. Corp C §9680(a).

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§20.115 D. Revoking Election

Although it is rarely done, a voluntary election to wind up and dissolve may be revoked at any time before a Certificate of Dissolution is filed (Corp C §§6612, 8612, 9680(a)). The revocation process is identical to the election process. For example, if the election was made by the approval of a majority of all members (Corp C §6610(a)(1)), then the revocation must be adopted by the approval of a majority of all members (Corp C §6612(a)(1)).

PRACTICE TIP: Although Corp C §§6612 and 8612 use the word "vote," little distinction, if any, exists between "vote" and "approval." Approval merely means voting in any form by class, by ballot, or at a meeting. See Corp C §§5033, 6610-6611, 8610-8611. See also Corp C §5077. Moreover, Corp C §8612 has not been amended to parallel Corp C §8611, which contemplates an election to dissolve by:

- The approval of a majority of all members,
- The approval of the board and the approval of the members, or
- The board, depending on the circumstances authorized under Corp C §8610.

Therefore, Corp C §8612 does not speak to a revocation of a certificate approved by the board *and* by the members. It is recommended that §8612 be read as though it were so worded, in this regard, identically to Corp C §6612 (with "vote" to be read as "approval"). Thus, if the election to dissolve was made by both the members and the board of a mutual benefit corporation, the revocation should also be made by both the members and the board even though this is not expressly authorized by Corp C §8612.

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E. Procedure During Winding Up and Dissolution

§20.116 1. Board's Powers and Duties

Winding up and dissolution. The winding up and dissolution process commences when the resolutions described in §§20.87-20.99 are adopted. See Corp C §§6613(a), 8613(a). Except as specifically noted, Corp C §9680(a) makes most of the statutes for voluntary dissolution of public benefit corporations applicable to religious corporations. The corporation's board of directors continues, and the directors (or the persons appointed by the court, see §20.145) have full power to wind up and settle the corporation's affairs (see Corp C §§6710, 8710, 9680(d)). However, after dissolution has begun, the corporation may conduct only the activities necessary for winding up and dissolution. See Corp C §§6613(b)-(c), 8613(b)-(c), 9680(a). This restriction does not prohibit an orderly winding down of functions, *e.g.,* phasing out hospital services or concluding an academic period (see Corp C §§6613(c), 8613(c)), but new activities should not be undertaken.

Board may sell assets. The directors' comprehensive powers and duties during dissolution and winding up are the same as the board's predissolution powers, except that the board may also "sell at public or private sale, exchange, convey or otherwise dispose of all or any part of the assets of the corporation for an amount deemed reasonable by the board" without the member approval that would otherwise be required in membership corporations by Corp C §§5911, 7911, and 9631. Corp C §§6710(g), 8710(g), 9680(d)(7). In selling the corporation's assets, the board of a public benefit or religious corporation nevertheless remains subject to Corp C §5142 or §9142. These sections generally permit officers, directors, the Attorney General, or persons with an interest in the trust assets to bring an action for breach of the trust (with public benefits this section refers to "charitable" trusts; no such designation is in Corp C §9142). In disposing of assets during liquidation, the board must comply with the standards of conduct in Corp C §§5230-5237 or §§9240-9245. See §§9.103-9.105.

NOTE: The power to sell assets without member approval is subject to the Attorney General's power to ensure that assets restricted to charitable purposes will be so used. See §20.30.

Vacancies. Vacancies on the board of directors during dissolution may be filled in the usual manner. See Corp C §§6711, 8711. If a director's identity or right to hold office is in doubt, or if a director is dead, fails or refuses to act, or cannot be located, a petition may be filed for a court order verifying the directors' identities or, if there are no directors, appointing directors to wind up the corporation's affairs. See Corp C §§6712, 8712, 9680(a).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.117 2. Form: Notice to Members and Creditors

§20.117 2. Form: Notice to Members and Creditors

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_ _[*NAME AND ADDRESS OF CORPORATION*]_ _

NOTICE OF COMMENCEMENT OF PROCEEDINGS TO VOLUNTARILY WIND UP AND DISSOLVE

To all _ _[*members,*]_ _ **Creditors and Claimants of** _ _[*name of corporation*]_ _**, a California** _ _[*public benefit/mutual benefit/religious*]_ _ **Corporation:**

This notice is to inform you that on _ _[*date*]_ _**,** _ _[*name of corporation*]_ _ **began proceedings to voluntarily wind up and dissolve by action of its** _ _[*members/board of directors/board of directors and members*]_ _**.**

Date: _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _**, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _ **Secretary**

Comment: Written notice of winding up and dissolving must be given to all members who voted against dissolution. See Corp C §§6613(c), 8613(c). For an alternative form of notice to creditors, see §20.121.

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3. Payment of Liabilities and Distribution of Assets

a. Payment of Liabilities

§20.118 (1) General Requirement

Debts are paid or provided for. Before corporate assets can be distributed, the board of directors must either pay or provide for the payment of all corporate debts or liabilities. Corp C §§6713-6714, 8713-8714, 9680(a). For exceptions to this requirement, see §20.119. A financially responsible person, as determined by the board of directors, exercising good faith and reasonable care may make a good faith guaranty of the debt in order to provide for payment of liabilities, as opposed to making direct payment. Corp C §§6714(a), 8714(a). The corporation may deposit the amount of the debt or liability with the State Controller in trust for the benefit of the parties entitled to payment. This process is made available when a creditor is unknown or refuses to accept payment or when the creditor's whereabouts cannot be ascertained after diligent inquiry. It is also available if a claim is contingent or contested. Corp C §§6718, 8720.

Nonexclusive methods. Although the procedures in Corp C §§6714 and 8714 are not the exclusive methods of making adequate provision for payment of debts (Corp C §§6714(b), 8714(b)), whatever provision is made for payment of corporate debts must satisfy the spirit of the Code and allow the signing directors or officers to execute the Certificate of Dissolution.

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§20.119 (2) Exceptions to Requirement

Statutory exception. The rule that corporate debts must be paid or adequately provided for before assets can be distributed is subject to exceptions. Payment or provision for payment is not required before distribution of assets that are not subject to attachment, execution, or sale for the corporation's debts and liabilities, and that either (1) are held by the corporation on a valid condition requiring return, transfer, or conveyance, if the condition occurs because of the dissolution, or (2) must be distributed according to the terms of any trust under which they are held. The corporation must dispose of all other assets in conformity with the corporation's articles or bylaws. Corp C §§6713, 8713, 9680(a). In the absence of a court order to do so, the corporation may need to obtain the Attorney General's waiver of objections to distribute certain assets. Corp C §§6716(c), 8716(c); see §20.122.

Obtaining court order. Despite this statutory exception to the rule on payment of debt, a court order should be obtained unless the condition relied on is crystal clear and unless counsel is fully satisfied that the assets are immune from attachment, execution, or sale for the corporation's debts. Assets held by a nonprofit corporation as a trustee of an express trust should meet the threshold test of immunity from attachment; a discussion of creditors' rights and remedies is beyond the scope of this chapter. For treatment of this subject, see Debt Collection Practice in California (2d ed Cal CEB 1999).

Joint and several liability. Directors who approve a transfer of a corporation's assets without a court order and without providing for payment of liabilities are themselves jointly and severally liable to the corporation to the extent of the fair market value of any assets improperly transferred plus interest, together with all reasonably incurred costs of appraisal or other valuation. Corp C §§5237, 7236, 9245. The corporation may recover the amount of any improper distribution. For a mutual benefit corporation, however, if the action is brought for the creditors' benefit, the directors' liability is limited to the amount owed to *nonconsenting* creditors at the time of the violation. Corp C §§5237(d), 7236(d), 9245(c).

NOTE: Any director of a public benefit or a mutual benefit corporation who is present at the meeting at which an improper distribution is approved and who abstains from voting is considered to have approved the action. See Corp C §§5237(b), 7236(b).

The Attorney General or any creditor may bring an action in the corporation's name to recover any amounts improperly distributed. Corp C §§6719, 8721, 9680(g). It is unclear whether a distribution is "improper" when debts and liabilities were not paid or provided for or whether a distribution is "proper" when Corp C §§6713 and 8713 are relied on. Arguably, there is no purpose in recapturing assets to which a creditor could enforce no claim—the circumstance addressed by §§6713 and 8713. However, if avoiding litigation is considered a worthwhile goal, a court-aided dissolution is recommended whenever debts and liabilities exceed asset values.

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(3) Notice to Creditors

§20.120 (a) Creditors' Responsibilities

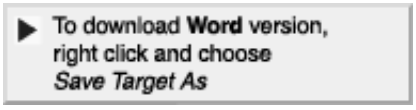
Every reasonable effort should be made to identify and pay creditors of the corporation. See Corp C §§6811, 8812. However, it can sometimes be difficult to ascertain the exact amount due. In addition, the corporation may have legitimate defenses to a claim.

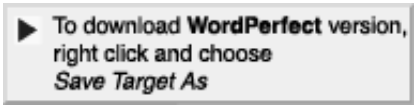
Nonprofit corporations have a claim procedure by which they can dispose of known claims against the corporation. See Corp C §§6618, 8618, 9680(a). Although this method does not resolve issues when the claims or claimants are unknown, when the claim is a contingent liability, or when the claim is based on an event occurring after dissolution (Corp C §§6618(d), 8618(d), 9680(a)), it does allow known claims to be barred if the creditor, after receiving notice, does not pursue the claim within a certain time. To bar known claims, the notice must comply with Corp C §§6618(b) and 8618(b). See §20.121. A creditor that has received proper notice must deliver the claim within the statutory deadline and, if it is rejected, begin proceedings to enforce the claim within 90 days after receipt of a rejection notice. If the creditor fails in either respect, the claim is forever barred. Corp C §6618(c), 8618(c).

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§20.121 (b) Form: Notice to Creditors





_ _[*Name of creditor*]_ _
_ _[*Address*]_ _
_ _[*Date*]_ _

NOTICE OF COMMENCEMENT OF PROCEEDINGS TO VOLUNTARILY WIND UP AND DISSOLVE

To all Creditors and Claimants of _ _[*name of corporation*]_ _, a California _ _[*Public Benefit/Mutual Benefit/Religious*]_ _ Corporation:

This notice is to inform you that on _ _[*date*]_ _, _ _[*name of corporation*]_ _ began proceedings to voluntarily wind up its affairs and dissolve the corporation by action of its _ _[*members/board of directors/board of directors and members*]_ _.

According to our records, you may have a claim against the corporation. All communications concerning any claim should be mailed to the address shown below.

If you wish to assert a claim, you must do as follows:

1. Provide the following information to substantiate your claim:

[*Set forth information required, e.g.*]

a. Your name and address;

b. Amount of claim;

c. Basis for the claim;

d. Other relevant information that will help confirm the amount due.

2. Send this information to: _ _[*mailing address*]_ _

3. The claim must be received on or before _ _[*specify date—at least 120 days after the effective date of this notice*]_ _.

NOTE: IF THE CORPORATION DOES NOT RECEIVE THE CLAIM ON OR BEFORE _ _[*date*]_ _, THE CLAIM WILL BE BARRED IN ITS ENTIRETY.

If you have any questions, please contact _ _[*name and address*]_ _.

By order of the board of directors.

Date: _ _ _ _ _ **_ _[*NAME OF CORPORATION*]_ _, a California nonprofit corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Secretary

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§20.122 b. Distribution of Assets

Distribution of remaining assets. After the board of directors has determined that all known debts and liabilities have been paid or adequately provided for, and subject to the exceptions in Corp C §8724 (assets of an owners association cannot be distributed without 100-percent member approval) and the exceptions discussed in §20.119, all remaining corporate assets must be distributed. Corp C §§6713, 8713. Assets held by a corporation subject to a condition requiring return, transfer, or conveyance, when the condition has occurred or when the condition will occur because of the dissolution, must be distributed in accordance with that condition. Corp C §§6715, 8715. Assets subject to distribution under a trust must be distributed according to its provisions; all other assets are distributed according to the articles or bylaws. Corp C §§6716(a), 8716(a), 9680(e).

Approval requirements. Disposition of the assets of a public benefit or religious corporation, or assets held subject to a charitable trust by a mutual benefit corporation, must either be approved by the Attorney General or made under a superior court decree in a proceeding to which the Attorney General is a party. Corp C §§6716(b), 8716(b), 9680(c). See Corp C §§6716(c), 8716(c), and sample request form in §§20.106-20.113. The corporation has no vested right to designate the recipients. See, *e.g., In re Veterans' Indus., Inc.* (1970) 8 CA3d 902, 88 CR 303.

PRACTICE TIP: As a practical matter, unless the corporation proposes to distribute assets for a purpose not contemplated by or fairly within the language of its articles, the Attorney General will waive objections to the disposition. However, if the Attorney General disagrees with the distribution plan, the matter must be resolved in court. In reaching a decision, the court will be guided by the doctrine of cy pres and will take the Attorney General's arguments into consideration.

Mutual benefit corporations. If a mutual benefit corporation's articles or bylaws do not provide for disposition of assets, they must be distributed pro rata among the members according to their respective rights. Corp C §8717. It is possible, however, for a mutual benefit corporation to adopt a liquidation plan that is not in accordance with the members' liquidation rights if both the board and each class of members approve the plan. Corp C §8719.

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§20.123 4. Court-Aided Dissolution

A petition for the superior court to assume jurisdiction of a voluntary winding up may be filed by any of the following (see Corp C §§6614, 8614, 9680(c)):

- The corporation;
- The authorized number of the members (5 percent of the voting power, unless there are 1000 or more members; see Corp C §5036; §10.37);
- The Attorney General, in the case of a corporation holding assets in charitable trust; or
- Three or more of the corporation's creditors.

Public benefit corporations. The court will grant the petition if it appears necessary to protect any parties in interest or if it appears necessary to protect the purposes served by the corporation. Corp C §6614.

Mutual benefit corporations. The court will grant the petition if it appears necessary to protect creditors, members, other parties in interest, or corporate assets held in charitable trust. Corp C §8614.

Religious corporations. The court will grant the petition if it appears necessary to protect the assets of the corporation. Corp C §9680(c).

Because the directors risk personal liability for improper distribution of assets, a court-aided dissolution is recommended if debts and liabilities exceed the value of the assets and if it is impossible to reach a settlement with all outstanding creditors. Bankruptcy and insolvency proceedings are other possible solutions in this situation.

If the court grants a petition and assumes jurisdiction of a voluntary dissolution, Corp C §§6512-6519 or §§8512-8519, relating to involuntary dissolution, become applicable to court proceedings. Corp C §§6614, 8614, 9680(c). See §§20.137-20.148.

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5. Certificate of Dissolution

§20.124 a. Procedure

After the winding up and voluntary dissolution is completed, a majority of the directors or a majority of the directors then in office (see Corp C §§6610(c)-(d), 8610(c)-(d), 9680(b)(3)-(4)) must sign a Certificate of Dissolution (see §§20.125-20.134), which must be filed with the Secretary of State. Corp C §§6615, 8615, 9680. Public benefit and religious corporations must attach a document issued by the Attorney General, consisting of a written waiver of objections or written confirmation that the corporation has no assets, to the Certificate of Dissolution. Corp C §§6615(b), 9680(a). See §20.105. Without one of these documents, the Secretary of State may not file the Certificate of Dissolution. Corp C §§6615(c), 9680(a).

NOTE: A Franchise Tax Board tax clearance certificate is no longer required. Rather, the Certificate of Dissolution must state that a final franchise tax return has been or will be filed. Corp C §§6615(a)(4), 8615(a)(5), 9680(a). See §20.114. See also Rev & T C §23332.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.125 b. Form: Certificate of Dissolution (Optional Secretary of State Form DISS NP)

§20.125 b. Form: Certificate of Dissolution (Optional Secretary of State Form DISS NP)



DISS NP

State of California
Secretary of State

Domestic Nonprofit Corporation Certificate of Dissolution

There is no fee for filing a Certificate of Dissolution.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

Corporate Name (Enter the name of the domestic nonprofit corporation exactly as it is of record with the California Secretary of State.)

1. Name of corporation

Required Statements (The following statements are required by statute and should not be altered.)

2. a) A final franchise tax return, as described by Section 23332 of the California Revenue and Taxation Code, has been or will be filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.
   b) The corporation has been completely wound up.
   c) The corporation is dissolved.

Debts and Liabilities (Check the applicable statement. Note: Only one box may be checked.)

3. ☐ The corporation's known debts and liabilities have been actually paid.

☐ The corporation's known debts and liabilities have been paid as far as its assets permitted.

☐ The corporation's known debts and liabilities have been adequately provided for by their assumption and the name and address of the assumer is _____.

☐ The corporation's known debts and liabilities have been adequately provided for as far as its assets permitted.
(Specify in an attachment to this certificate (incorporated herein by this reference) the provision made and the address of the corporation, person or governmental agency that has assumed or guaranteed the payment, or the name and address of the depositary with which deposit has been made or other information necessary to enable creditors or others to whom payment is to be made to appear and claim payment.)

☐ The corporation never incurred any known debts or liabilities.

Assets (Mutual Benefit or Consumer Cooperative Corporations ONLY: Check the applicable statement. Note: Only one box may be checked. If the corporation is a public benefit or religious corporation, leave Item 4 blank and attach to this Certificate of Dissolution a letter from the Attorney General waiving objections to the distribution of the corporation's assets pursuant to California Corporations Code section 6716(c) or confirming the corporation has no assets (see instructions).)

4. ☐ The known assets have been distributed to the persons entitled thereto. ☐ The corporation never acquired any known assets.

Election (Check the "YES" or "NO" box as applicable. Note: If the "NO" box is checked, a Certificate of Election to Wind Up and Dissolve pursuant to California Corporations Code section 1901, 6611, 8611, 9680 or 12631 must be filed prior to or together with this Certificate of Dissolution.)

5. The election to dissolve was made by the vote of all the members of the corporation or the corporation has no members and the election was made by the vote of all the directors of the corporation. ☐ YES ☐ NO

Verification and Execution (If additional signature space is necessary, the dated signature(s) with verification(s) may be made on an attachment to this certificate. Any attachments to this certificate are incorporated herein by this reference.)

6. The undersigned constitute(s) the sole director or a majority of the directors now in office. I declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of my own knowledge.

_____
Date

_____ _____
Signature of Director Type or Print Name of Director

_____ _____
Signature of Director Type or Print Name of Director

_____ _____
Signature of Director Type or Print Name of Director

Print

Instructions for Completing the Certificate of Dissolution (Form DISS NP)

Where to File: For easier completion, this form is available on the Secretary of State's website at www.sos.ca.gov/business/be/forms.htm and can be viewed, filled in and printed from your computer. The completed form can be mailed to Secretary of State, Document Filing Support Unit, 1500 11th Street, 3rd Floor, Sacramento, CA 95814 or delivered in person (drop off) to the Sacramento office. If you are not completing this form online, please type or legibly print in black or blue ink. This form is filed only in the Sacramento office.

It is recommended for proof of submittal that if the Certificate of Dissolution is mailed to the Secretary of State, the document be sent by Certified Mail with Return Receipt Requested. To facilitate the processing of documents mailed to the Secretary of State, a self-addressed envelope and a letter referencing the corporate name and number as well as the sender's name, return address and telephone number should be included with the submittal.

Legal Authority: Statutory filing provisions are found in California Corporations Code sections 6615, 8615, 9680 and 12635. All statutory references are to the California Corporations Code, unless otherwise stated.

- The Certificate of Dissolution must be filed after or together with a Certificate of Election to Wind Up and Dissolve pursuant to Section 6611, 8611, 9680 or 12631. However, if the election to dissolve was made by the vote of all the members or, if the corporation has no members, by the vote of all the directors, only the Certificate of Dissolution is required to be filed.
- Upon filing the Certificate of Dissolution the corporation will be dissolved and its powers, rights and privileges will cease.
- It is recommended that legal counsel be consulted prior to submitting dissolution documents to ensure that all issues are appropriately addressed.

Additional Requirement (public benefit and religious corporations): If the dissolving corporation is a public benefit or religious corporation, the Certificate of Dissolution must be accompanied by a letter from the Attorney General that either waives objections to the distribution of the corporation's assets pursuant to California Corporations Code section 6716(c) or confirms that the corporation has no assets. (Sections 6615 and 9680.) Information regarding the required letter can be obtained by calling the Office of the Attorney General - Registrar of Charitable Trusts at (916) 445-2021 or can be downloaded from the Attorney General's website under Charitable Trusts at www.caag.state.ca.us/charities. A written request for the required letter can be mailed to the Office of the Attorney General - Registrar of Charitable Trusts at P.O. Box 903447, Sacramento, California 94203-4470.

Fees: There is no fee for filing a Certificate of Dissolution. However, a $15.00 special handling fee is applicable for processing documents delivered in person (drop off) to the Sacramento office. The special handling fee will be retained whether the document is filed or rejected. The preclearance and/or expedited filing of a document *within a guaranteed time frame* can be requested for an additional fee in lieu of the special handling fee. Please refer to the Secretary of State's website at www.sos.ca.gov/business/be/service-options.htm for detailed information regarding preclearance and expedited filing services. The special handling fee or preclearance and expedited filing services are not applicable to documents submitted by mail. Check(s) should be made payable to the Secretary of State.

Copies: The Secretary of State will certify two copies of the filed document(s) without charge, provided that the complete copies with any required attachments are submitted to the Secretary of State with the document(s) to be filed. Any additional copies submitted will be certified upon request and payment of the $8.00 per copy certification fee.

Complete the Certificate of Dissolution as follows:

Item 1. Enter the name of the domestic nonprofit corporation exactly as it is of record with the California Secretary of State.

Item 2. These statements are required by statute and should not be altered. For information regarding final tax returns, contact the Exempt Organization Unit of the Franchise Tax Board at (916) 845-4171 or visit their website at www.ftb.ca.gov.

Item 3. Check the box next to the applicable statement. Only one box may be checked. If the third box is checked, specify the name and address of the assumer in the space provided. If the fourth box is checked, specify in an attachment to this certificate, the provision made and the address of the corporation, person or governmental agency that has assumed or guaranteed the payment, or the name and address of the depositary with which deposit has been made or other information necessary to enable creditors or others to whom payment is to be made to appear and claim payment.

Item 4. Mutual Benefit or Consumer Cooperative Corporations ONLY: Check the box next to the applicable statement. Only one box may be checked.

Item 5. Check the appropriate box. Only one box may be checked. NOTE: If the election to dissolve was not made by the vote of all the members, or if the corporation has no members, by the vote of all the directors, a Certificate of Election to Wind Up and Dissolve (Form ELEC NP) must be filed prior to or together with the Certificate of Dissolution.

Item 6. The certificate must be dated, signed and verified under penalty of perjury by a majority of the directors of the corporation now in office or by the sole director, if there is only one.

If additional signature space is necessary, the dated signature(s) with verification(s) may be made on an attachment to the certificate. All attachments should be 8½" x 11", one-sided and legible.

Comment: This optional form is available at the Secretary of State's website at

http://www.sos.ca.gov/business/corp/pdf/dissolutions/corp_npdiss.pdf, where it may be completed online and printed.

For an attorney-drafted form of certificate of dissolution, see §§20.126-20.134.

The certificate of dissolution must be signed and verified by a majority of the directors (Corp C §§6615(a), 8615(a), 9680(a)) or by a majority then in office (Corp C §§6610(c)-(d), 8610(c)-(d), 9680(b)(3)-(4)). It must be delivered by mail or in person to the Secretary of State's Sacramento office at the address listed on the form.

Under Corp C §17.1, a facsimile signature may be submitted to the Secretary of State on documents delivered by mail or by hand; however, the organization must maintain the original signed document for at least 5 years from the date of filing. No direct electronic or facsimile filings can be made until the Secretary of State develops appropriate procedures. Corp C §17.1(e).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/ c. Certificate of Dissolution (Attorney-Drafted Form)/§20.126 (1) Form: Title; Identification of Parties

c. Certificate of Dissolution (Attorney-Drafted Form)

§20.126 (1) Form: Title; Identification of Parties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.

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CERTIFICATE OF DISSOLUTION OF _ _[*NAME OF CORPORATION*]_ _

_ _[*Names of directors*]_ _ **certify that:**

1. They constitute a majority of the current directors of _ _[*name of corporation*]_ _**, a California nonprofit** _ _[*public benefit/mutual benefit/religious*]_ _ **corporation.**

Comment: The Secretary of State has an optional form of certificate of dissolution available on its website and set forth in §20.125.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.127 (2) Form: Corporate Affairs Wound Up

§20.127 (2) Form: Corporate Affairs Wound Up

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.

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2. The corporation has been completely wound up.

Comment: This language is required. See Corp C §§6615(a)(1), 8615(a)(1), 9680(a).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.128 (3) Form: Debts and Liabilities

§20.128 (3) Form: Debts and Liabilities

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.

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[*Add one of the following alternatives*]

[*Alternative 1: Debts and liabilities paid*]

3. The corporation's known debts and liabilities have been actually paid.

[*Alternative 2: Debts and liabilities paid to extent assets permit*]

3. The corporation's known debts and liabilities have been paid as far as its assets permitted.

[*Alternative 3: Debts and liabilities have been assumed*]

3. The corporation's known debts and liabilities have been adequately provided for through their assumption by _ _[*name and street address*]**_ _.**

[*Alternative 4: Debts and liabilities adequately provided for to extent assets permit*]

3. The corporation's known debts and liabilities have been adequately provided for as far as its assets permitted. _ _[*Specify provision made, name and address of person that has assumed or guaranteed payment, or name and address of depository, or other information necessary to enable creditors to claim payment of debt or liability.*]**_ _**

[*Alternative 5: No debts or liabilities*]

3. The corporation has incurred no known debts or liabilities.

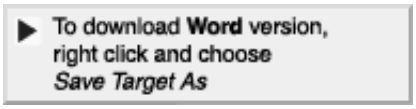
Comment: One of these clauses is required. See Corp C §§6615(a)(2), 8615(a)(2), 9680(a).

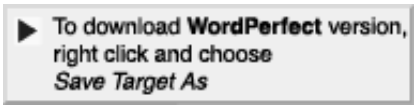
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.129 (4) Form: Election to Dissolve

§20.129 (4) Form: Election to Dissolve

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.





[*Add one of the following alternatives*]

[*Alternative 1: Election to dissolve (with members)*]

4. The election to dissolve was made by the vote of all the members of the corporation.

[*Alternative 2: Election to dissolve (no members)*]

4. The corporation has no members. The election to dissolve was made by the vote of all the directors of the corporation.

Comment: The applicable statement should be included if no certificate of election was filed. See §§20.100-20.103.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.130 (5) Form: Final Franchise Tax Return

§20.130 (5) Form: Final Franchise Tax Return

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.

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5. A final franchise tax return, as described in Revenue and Taxation Code §23332, has been or will be filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.

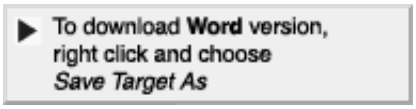
Comment: The certificate of dissolution must state the specific language set forth in the form above concerning the filing of a final tax return. See Corp C §§6615(a)(4), 8615(a)(5), 9680(a). See also Rev & T C §23332. However, it is not clear how this requirement will affect religious organizations that are exempt from filing franchise tax returns.

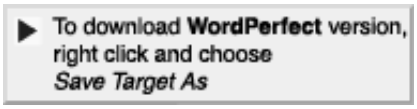
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.131 (6) Form: Distribution of Assets; Public Benefit or Religious Corporations

§20.131 (6) Form: Distribution of Assets; Public Benefit or Religious Corporations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.





[*Add one of the following alternatives*]

[*Alternative 1: Waiver of objections*]

6. A written waiver of objections to the distribution of the corporation's assets issued by the Attorney General pursuant to Corporations Code §6716(c) is attached to this certificate.

[*Alternative 2: Confirmation of no assets*]

6. A written confirmation that the corporation has no assets issued by the Attorney General is attached to this certificate.

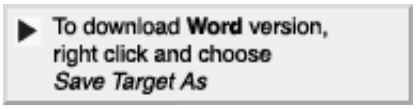
Comment: Public benefit or religious corporations should use one of these alternatives. Corp C §§6716(b)-(c), 9680(c). See §20.122.

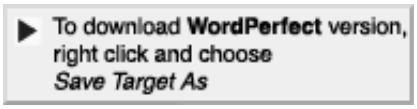
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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.132 (7) Form: Distribution of Assets; Mutual Benefit Corporations

§20.132 (7) Form: Distribution of Assets; Mutual Benefit Corporations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.





[*Alternative 1: Assets distributed*]

6. The known assets have been distributed to the persons entitled to the assets.

[*Alternative 2: Corporation has no assets*]

6. The corporation acquired no known assets.

Comment: Mutual benefit corporations should use one of these alternatives. Corp C §8716(b). See §20.122.

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.133 (8) Form: Statement of Dissolution

§20.133 (8) Form: Statement of Dissolution

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7. The corporation is dissolved.

Comment: This language is required. See Corp C §§6615(a)(3), 8615(a)(3), 9680(a).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.134 (9) Form: Declaration and Signatures

§20.134 (9) Form: Declaration and Signatures

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§20.126-20.134.

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We declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Date: _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a California nonprofit corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _**, President**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _**, Secretary**

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§20.135 6. Court Order in Lieu of Filing Certificate of Dissolution

The board may petition the superior court for an order declaring the corporation wound up and dissolved. Corp C §§6617, 8617, 9680(a). Although this procedure is rarely used, it should be considered if the claims of the corporations' creditors cannot be resolved. See Corp C §§6517-6519, 6618, 8517-8519, 8618.

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§20.136 7. Filing of Final Informational Returns

Federal filings. Although exempt organizations are not required to file IRS Form 966 (Corporate Dissolution or Liquidation), they will have to include information about the dissolution on their final informational returns if they file IRS Form 990 or IRS Form 990-EZ, and may have to include this information if they file IRS Form 990-PF. As part of filing Form 990 or Form 990-EZ, the corporation must complete Part I of Schedule N. A certified copy of the certificate of dissolution and the resolution supporting the dissolution must be attached, along with any other relevant documentation. Assets being transferred (which may be aggregated into categories) must be listed, along with the value and the recipient.

NOTE: For mutual benefit corporations that transfer assets to individual members, the names of individual members need not be listed, but may be aggregated.

Transaction expenses should also be listed. Among other information required, whether any officer, director, or key employee will continue with a successor or transferee organization must be specifically noted. Consult the instructions on the form for more details.

State filings. A final Franchise Tax Board return (FTB Form 199) must also be filed, either before or after the certificate of dissolution is filed. Rev & T C §23332.

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§20.137 VIII. INVOLUNTARY DISSOLUTIONS

Public benefit and mutual benefit corporations generally may be subjected to involuntary dissolution. Corp C §§6510-6519, 8510-8519. But see Corp C §8510(d) (certain corporations subject to Public Utilities Act, Insurance Code, and Credit Union Law are exempt from the procedure). Although a religious corporation cannot be subjected to involuntary dissolution (see Corp C §9680(g)), the superior court may grant a petition filed by certain interested persons to assume jurisdiction over a dissolution that was voluntarily begun. Corp C §9680(g). If the court assumes jurisdiction, it will apply most of the rules and procedures that apply to involuntary proceedings. See §§20.140-20.145.

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A. Grounds for Involuntary Dissolution

§20.138 1. General Grounds

Public and mutual benefit corporations. The grounds for involuntary dissolution of a public benefit or mutual benefit corporation are the following (Corp C §§6510(b), 8510(b)):

- Corporate activity has been abandoned for more than 1 year;
- The board of directors has an even number of directors who are equally divided and cannot agree as to corporate management (such that the corporation's activities can no longer be conducted to advantage or there is danger that corporate property will be impaired or lost, or its activities impaired) and the members are unable to elect a board consisting of an uneven number of directors;
- There is internal dissension, and groups of members are so deadlocked that corporate activities can no longer be conducted with advantage;
- The members have failed to elect directors to replace those whose terms have expired, during the shorter period of (1) 4 years, (2) two consecutive meetings, or (3) two written ballots;
- The controlling persons are guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority;
- The officers or directors have misapplied or wasted the corporation's property;
- Liquidation is reasonably necessary because the corporation is failing and has continuously failed to carry out its purposes (unless it is a mutual benefit corporation with 35 or fewer members);
- The corporation's charter has expired without extension; or
- The corporation is required to dissolve under Corp C §5132(a)(2)(A) or §7132(a)(4)(A) because its charter has been surrendered to, taken away by, or revoked by the founding organization that granted it.

Religious corporations. The ground for assuming jurisdiction of a religious corporation's voluntary dissolution is that the court finds it necessary to protect the corporate assets. Corp C §9680(c).

NOTE: Corporations Code §9132(a)(2)(A) allows religious corporations to require in their articles that the corporation dissolve when its charter is surrendered to, taken away by, or revoked by the founding organization granting it. Apparently, the legislature assumed that the directors would do so voluntarily. See Corp C §9680(b)(2)(D).

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§20.139 2. Additional Grounds for Dissolution Action by Attorney General

In addition to the general grounds for dissolution (see §20.138), the Attorney General may bring an action for dissolution against any nonprofit public benefit or mutual benefit corporation, on his or her own information or on the complaint of a private person, if the corporation has done any of the following (Corp C §§6511(a), 8511(a)):

- Seriously violated the statutes regulating corporations or, if a public benefit corporation, the statutes regulating charitable organizations;
- Fraudulently abused or usurped corporate privileges or powers;
- Violated any law so as to provide a basis for forfeiture of corporate existence; or
- Failed for 5 years to pay any taxes imposed by the corporate tax law (Rev & T C §§23001-25141).

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Source: Business Law/Advising California Nonprofit Corporations/20 Corporate Changes/§20.140 B. Who May File Complaint or Convert Proceedings

§20.140 B. Who May File Complaint or Convert Proceedings

Public and mutual benefit corporations. A complaint for involuntary dissolution may be filed against a public benefit corporation or a mutual benefit corporation by the following (Corp C §§6510(a), 8510(a)):

- At least half of the directors in office;
- A person or persons holding or authorized in writing by persons holding one third or more of the voting power (excluding memberships held by persons who have personally participated in fraud, mismanagement, or abuse of authority);
- Any member if the reason for dissolution is that the corporate existence has expired without extension;
- Anyone authorized to do so by the articles of incorporation;
- The Attorney General (except that the Attorney General has jurisdiction of a mutual benefit corporation only when assets are held in a charitable trust); and
- The founding organization under whose authority the corporation was created if the provisions for dissolution in Corp C §5132(a)(2)(A) or §7132(a)(4)(A) are included in the articles of incorporation.

Religious corporations. After a religious corporation has voluntarily elected to dissolve, a petition requesting the court to assume jurisdiction over the dissolution may be brought by the corporation itself (presumably by action of the board and the members); the authorized number of members, or of directors if no members (see Corp C §5036; §10.37); three or more creditors; or the Attorney General. Corp C §9680(c).

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§20.141 C. Parties to Action

Attorney General. The Attorney General is an indispensable party to an action for involuntary dissolution of a public benefit corporation. Corp C §6510(d). In an involuntary dissolution of a mutual benefit corporation holding assets in a charitable trust, the Attorney General must be served with a copy of the complaint and may intervene in the proceedings. Corp C §8510(e).

Creditors and members. At any time before trial, any creditor may intervene, as may the authorized number of members (Corp C §5036) of a public benefit corporation or any single member of a mutual benefit corporation. Corp C §§6510(c), 8510(c).

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§20.142 D. Curative Steps Before Suit

Before bringing an action for dissolution under Corp C §6511 or §8511 (see §20.137), the Attorney General must give the corporation at least 30 days' notice if the corporation can cure the violation or default by corporate action. The Attorney General may maintain the dissolution suit only if the corporation fails or is unable to take corrective action within that 30-day period or thereafter fails to duly and properly take the corrective action. Corp C §§6511(b), 8511(b).

NOTE: A corporation can probably cure such things as delinquent taxes or filings, but it is highly unlikely that fraudulent or abusive practices can be cured.

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E. Procedural Matters

§20.143 1. Jurisdiction of Court

Court jurisdiction in a proceeding for winding up and dissolution includes the following:

- Requiring proofs of claims and demands against the corporation and barring the claims of creditors who fail to make and present the required claims and proof. Corp C §§6516(a), 8516(a).
- Determining or compromising, or both, all claims, including determining the amount of money or assets required to be retained to pay or provide for the payment of claims. Corp C §§6516(b), 8516(b).
- Presenting, filing, hearing, allowing or disallowing, and settling the accounts of the directors or of any persons appointed to conduct the winding up, and discharging them from their duties and liabilities. Corp C §§6516(c), 8516(d).
- Filling vacancies on the board that directors or members cannot fill. Corp C §§6516(e), 8516(f).
- Removing a director under specified conditions and appointing a director to fill the vacancy created by that removal. Corp C §§6516(f), 8516(g).
- Staying court actions against the corporation and requiring claimants to prove claims in the same manner as other creditors. Corp C §§6516(g), 8516(h).
- Making various other determinations and orders. Corp C §§6516(d), (h)-(*l*), 8516(c), (e), (i)-(m).

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§20.144 2. Notice to Creditors and Settlement of Claims

Notice period. In a manner analogous to probate and bankruptcy proceedings, a creditor's claim may be barred if the creditor fails to make and present proofs of claim within the time set by the court. General creditors have a period set by the court within which to assert a claim. The notice period must be at least 4 and no more than 6 months after the first notice to creditors is published; however, the period may be limited to 3 months if it appears by affidavit that there are no claims. Corp C §§6517(a), 8517(a). The notice must be published at least once a week for 3 consecutive weeks, and copies must be mailed to persons listed as creditors or claimants on the corporation's books. Corp C §§6517(b), 8517(b). Unlike the procedure to dispose of claims in a voluntary dissolution (see §§20.118-20.121), this procedure also allows for disposition of unknown or unidentified claims, as well as unmatured, contingent, and disputed claims. Corp C §§6517(b), (d), 8517(b), (d).

NOTE: If a claimant shows that he or she did not receive the notice because of absence from the state or some other cause, the court may allow a claim to be filed or presented at any time before the distribution of assets is completed. Corp C §§6517(a), 8517(a).

Secured creditors can be barred only to the extent their claim for a deficiency exceeds the amount realized on their security. Corp C §§6517(c), 8517(c).

Payment to court. The amount of unmatured, contingent, and disputed claims that are not disallowed is paid into court for subsequent distribution to claimants or to the corporation for distribution under its liquidation plan. Corp C §§6517(d), 8517(d).

Rejected claims. If a claim is rejected, any suit on the rejected claim must be brought within 30 days after the claimant receives written notice of rejection. Corp C §§6517(e), 8517(e).

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§20.145 3. Appointment of Receiver

Public benefit corporations. If the court has reasonable grounds to believe that it is necessary to protect the interests of the corporation or the public, or the charitable purpose of the corporation, the court may appoint a receiver to take charge of the corporation's affairs and property pending the hearing and determination of a petition for dissolution. Corp C §6513.

Mutual benefit corporations. If the court has reasonable grounds to believe that it is necessary to protect the interests of the corporation or its members, the court may appoint a receiver to take charge of the corporation's affairs and property pending the hearing and determination of a petition for dissolution. Corp C §8513.

Procedure. Appointment is made on application and after hearing and is subject to the general limitations on and requirements for receivers. CCP §§566-567.

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§20.146 4. Decree of Dissolution and Other Orders

After the hearing, the court may order a winding up and dissolution or may make other orders and issue other decrees and injunctions. Corp C §§6514, 8514.

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§20.147 5. Winding Up

Winding up the corporation's affairs begins when the court enters the order for winding up. Corp C §§6515(a), 8515(a). The board of directors may then conduct the winding up, subject to the court's supervision, unless the court appoints other persons, on good cause shown, to do so. The board (or other appointed persons) may generally exercise all normal powers without other specific court orders. Corp C §§6515(b), 8515(b). The corporation, however, must discontinue its activities except as necessary for winding up. The directors must mail written notice of the winding up to all members and all known creditors. Corp C §§6515(c), 8515(c).

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§20.148 6. Order of Dissolution

Court order of dissolution. When all accounts of directors and others appointed to wind up and dissolve the corporation are settled and the court finds that the corporation's affairs are in a condition for it to be dissolved, the court may issue an order declaring the corporation wound up and dissolved. Corp C §§6518, 8518. It appears that a final franchise tax return (see Rev & T C §23332) must be filed before the order can be issued. Corp C §§6518(a)(1), 8518(a)(1).

Filing with Secretary of State. A copy of the judgment, order, or decree, certified by the court clerk, must be filed with the Secretary of State. A tax clearance certificate is no longer necessary; the Secretary of State will notify the Franchise Tax Board of the dissolution. Corp C §§6519, 8519.

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§20.149 IX. POSTDISSOLUTION ACTIVITIES

The existence of a nonprofit corporation continues for certain limited purposes even after final dissolution. If necessary, the corporation may continue winding up its affairs. The corporation will usually need to file final tax returns (see §20.136), and it may need to handle other administrative or housekeeping matters. In addition, the corporation may continue either as plaintiff or defendant in any litigation begun before dissolution, and it may bring any new actions necessary for final winding up. Corp C §§6720, 8722, 9680(a).

Despite final dissolution, persons who are entitled to bring actions against a dissolved corporation may sue to recover property from any recipients of improperly distributed assets. Further, the Attorney General may intervene in such actions. Corp C §§6721, 8723, 9680(a).

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21

Financial Accounting for Not-for-Profit Organizations

Nancy E. Shelmon

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§21.1 I. SCOPE OF CHAPTER

This chapter discusses the financial accounting requirements for not-for-profit organizations (NPOs). It covers accounting principles applicable to all NPOs (see §§21.2-21.4) and the parties responsible for their implementation (see §§21.5-21.14). The chapter also discusses extensively the use of internal controls in financial accounting (see §§21.15-21.26) and compliance with the rules applicable to financial statements, reporting, and disclosures (see §§21.27-21.57). It includes a discussion of accounting rules applicable to cash and noncash contributions and pledges (see §§21.58-21.64), as well as to investments and endowments (see §§21.65-21.78). It also addresses a broad range of NPO accounting issues (see §§21.79-21.87), and provides accounting guidance for specific types of NPOs (see §§21.88-21.93). Finally, the chapter also includes a brief discussion of trends in financial accounting (see §21.94), as well as tables and diagrams for distinguishing contributions from exchanges, relationships with other NPOs, and factors for determining whether a donor has made a bona fide pledge. See §§21.95-21.98.

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II. ACCOUNTING GUIDANCE

§21.2 A. Terminology

The ultimate objective of a not-for-profit organization (NPO) is to meet some socially desirable need or goal of the community or its members. Several key characteristics distinguish NPOs from a for-profit or business enterprises:

- Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return;
- Operating purposes other than to provide goods or services at a profit; and
- The absence of ownership interests like those of business enterprises.

Not-for-profit organizations are generally subject to the same accounting rules as for-profit entities. However, accounting principles specifically applicable or inapplicable to NPOs present unique accounting challenges. Not-for-profit accounting relies on numerous sources of guidance:

- The Financial Accounting Standards Board (FASB) has issued Statements of Financial Accounting Standards (SFAS), as well as Staff Positions, Interpretations, and Technical Bulletins that are referred to as FASB Staff Positions, FASB Interpretations, and FASB Technical Bulletins, respectively. See §21.3.
- The American Institute of Certified Public Accountants (AICPA) has issued Statements of Auditing Standards (SAS) and Statements of Position (AICPA SOP) that provide additional financial guidance to NPOs. In addition, AICPA publishes the Codification of Statements on Auditing Standards (2008). (Auditing standard codifications are cited in this chapter as "AU.")
- The Governmental Accounting Standards Board (GASB), a private, not-for-profit organization formed in 1984 to set accounting and financial reporting standards for state and local governments, has established standards for state and local governmental accounting and financial reporting. These standards are designed to provide useful information for users of financial reports, and to guide and educate the public, including issuers, auditors, and users of those financial reports.

NOTE: Accounting standards such as the International Financial Reporting Standards (IFRS) and pronouncements issued by the Governmental Accounting Standards Board (GASB) are outside the scope of this chapter. For further guidance or additional discussion of topics in this chapter, refer to Gross, McCarthy & Shelmon, Financial and Accounting Guide for Not-for-Profit Organizations (7th ed 2005).

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.3 B. The Hierarchy of Generally Accepted Accounting Principles (GAAP)

§21.3 B. The Hierarchy of Generally Accepted Accounting Principles (GAAP)

Auditing Standard Codification §411 (AU §411) (on "the meaning of 'present fairly in conformity with generally accepted accounting principles'") establishes the hierarchy of generally accepted accounting principles (GAAP). For financial statements of NPOs other than governmental entities, the hierarchy is summarized as follows:

Category (a). This category consists of officially established accounting principles, comprising Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS) and interpretations, Accounting Principles Board (APB) opinions, and Accounting Research Bulletins (ARBs).

Category (b). This category consists of FASB Technical Bulletins, as well as American Institute of Certified Public Accountants (AICPA) Industry Audit and Accounting Guides, and AICPA Standard Operating Procedures (SOPs) that have been cleared by FASB.

Category (c). This category consists of AICPA, Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared by FASB, and consensus positions of the FASB Emerging Issues Task Force (EITF).

Category (d). This category consists of AICPA accounting interpretations and implementation guides (Qs and As) published by FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

On the FASB Accounting Standards Codification (FASB ASC) of these sources, see §§21.3A-21.3B.

Specific accounting guidance promulgated by FASB that is unique to nonprofit organizations includes:

- SFAS No. 116 (accounting for contributions received and contributions made);
- SFAS No. 117 (financial statements of not-for-profit organizations);
- SFAS No. 124 (accounting for certain investments held by not-for-profit organizations);
- SFAS No. 133 (accounting for derivative instruments and hedging activities);
- SFAS No. 136 (transfers of assets to not-for-profit organization or charitable trust that raises or holds contributions for others);
- SFAS No. 153 (exchanges of nonmonetary assets—an amendment of APB Opinion No. 29);
- SFAS No. 157 (fair value measurements);
- FASB Staff Position on SFAS 115-1 and SFAS 124-1 (the meaning of "other-than-temporary impairment" and its application to certain investments);
- FASB Staff Position 117-1 (endowments of not-for-profit organizations: net asset classification of funds subject to enacted version of Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510; see §21.71), and enhanced disclosures for all endowment funds); and
- FASB Interpretation No. 30 (accounting for involuntary conversions of nonmonetary assets to monetary assets—an interpretation of Accounting Principles Board (APB) Opinion No. 29).

In general, except as noted above and as noted within the language of any specific pronouncement for accounting, NPOs are subject to the same accounting standards as all organizations.

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§21.3A C. FASB Accounting Standards Codification

The FASB Accounting Standards Codification (FASB ASC) integrates all accounting standards currently within levels (A) through (D) of the GAAP hierarchy (see §21.3) into one central, topically organized, electronically searchable site. The GAAP hierarchy has been flattened, and all information within the codification is considered level A (authoritative) GAAP.

Effective July 1, 2009, the FASB ASC became the single source of authoritative United States GAAP for periods ending after September 15, 2009. Other accounting standards are superseded; information not included in the codification is nonauthoritative. See SFAS No. 168.

The codification is a major restructuring of accounting standards that will affect the day-to-day work of nearly every financial professional who prepares, reviews, or audits financial statements of private-sector organizations. Because a significant portion of the GAAP hierarchy consisted of pre-codification FASB and AICPA standards that are no longer authoritative, the governmental sector will also feel the impact of the codification.

Private-sector GAAP was a proliferation of thousands of standards established by a variety of standard setters, which resulted in a lack of consistent and logical structure. An explosive increase in recent years of financial reporting guidance compounded the difficulties that preparers and auditors encountered in applying and interpreting GAAP.

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§21.3B D. Accessing the Codification

The FASB ASC represents a major change in how accounting literature can be researched and accessed. The codification's website (http://asc.fasb.org) provides general information about how to use the online research system. An online tutorial is available. A basic view of the codification can be accessed online free of charge on the website. A subscription service offers a more sophisticated version with high level search and retrieval functions.

The FASB ASC is arranged within topics, subtopics, sections, and subsections. Topics reside in these main areas:

- Presentation (financial statement presentation matters, e.g., statement of activities, balance sheet);
- Financial statement accounts (assets, liabilities);
- Equity, revenue and expenses (specific financial statement accounts, e.g., revenue recognition, contributions, receivables);
- Broad transactions (transaction-oriented topics, e.g., business combinations, derivatives);
- Industries (accounting unique to an industry, *e.g.,* not-for-profit organizations, healthcare organizations).

EXAMPLE: To find information on the GAAP requirements for the statement of activities of a not-for-profit organization, a search could start with either the "Presentation" or "Industries" topic. Moving down through the topics and subtopics, either of the following paths would retrieve that guidance:

- Presentation: 225—Income Statement; 958—Not-for-Profit Organizations, or
- Industry: 958—Not-for-Profit Organizations; 205—Presentation of Financial Statements

FASB encourages organizations plan to use plain English in their footnotes for broad topic references rather than referring to specific codification standards, which can be a much longer number than the FASB Standard it replaced.

NOTE: For simplicity, this chapter continues to refer to the original SFAS statements. However, the AICPA audit guide, Not-for-Profit Entities—AICPA Audit and Accounting Guide (March 2009), has been updated with FASB ASC references.

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§21.4 E. Fund Accounting

Historically, many NPOs used fund accounting for both internal recordkeeping and external financial reporting purposes. Fund accounting is a system of recording restricted resources (whether by donors, granting agencies, governing boards, or other individuals or by law). To keep records of these limitations for internal purposes, some NPOs maintain separate "funds" for specific purpose or restriction. Though fund accounting is no longer required by generally accepted accounting principles, many NPOs continue to use fund accounting for internal recordkeeping purposes.

Statements of Financial Accounting Standards (SFAS) No. 117 establishes a standard financial reporting model for all NPOs based on net assets, classified solely on the basis of donor-imposed restrictions. SFAS No. 117 requires an NPO's external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.

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§21.5 III. TRIAD OF RESPONSIBILITY FOR FINANCIAL ACCOUNTING AND REPORTING

Within any organization, the various parties and individuals responsible for the financial accounting and financial reporting for the organization include management (see §§21.6-21.9), the board of directors (see §§21.10-21.13), and the external auditors (see §21.14).

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§21.6 A. Management

Members of an NPO's management, particularly individuals within the financial management organization (*e.g.,* chief financial officer, treasurer, controller, assistant controller, and accountants) have the direct day-to-day responsibility for the organization's financial accounting and reporting. Management is ordinarily responsible for establishing a system of internal controls to safeguard the organization's assets and ensure that liabilities are paid. See §21.7.

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§21.7 1. Internal Controls

Internal controls are the system of checks and balances that help ensure that the organization's assets are safeguarded and accounted for and that its liabilities are appropriately incurred and paid. A good set of internal controls will also help prevent and detect employee theft and unauthorized use of the organization's assets (commonly referred to as "fraud" or "embezzlement"). Specific components of a good set of internal controls include evidence of supervisory reviews and dual signatures on large payments. For further discussion, see §§21.16-21.26.

An organization's system of key internal controls should be reviewed periodically by the board or the audit committee. This review will provide comfort to the various stakeholders that the internal controls are still properly functioning, or will highlight weaknesses that management should address through a modification of operating procedures.

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§21.8 2. Internal Reporting

An organization's management relies on internally prepared information to make business decisions that affect the entire organization. Because the organization's internal financial reports are key to the decision-making process, it is important that they be complete and accurate.

The business office is commonly responsible for preparing a variety of financial reports for the chief financial officer, the chief executive officer, and others. This information may include month-end financial results for both the month just ended, as well as year-to-date results. Comparisons to the prior year are useful in determining whether an organization is growing and if current year goals are being achieved. Financial results are also commonly produced for specific groups, or departments, within an organization and ordinarily include a comparison to their budget for the year.

PRACTICE TIP: The business office, through its internal controls, must pay attention to the details and current rules for reporting particular transactions, as well as to current regulations as set forth by various government entities.

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§21.9 3. External Reporting

Just as internal management relies on financial reports, so do external parties to the organization. Reports supplied to external parties may impact whether the organization is granted a loan, receives a donation, or continues to receive government funding.

As outside third parties are relying on information prepared by the organization, a higher standard is placed on externally reported information. In this situation, it is not just the organization's assets that are being used; rather, a third party is making a decision regarding its assets based on the information provided by the organization. Because of this reliance by the public, management has the burden to ensure that the information reported is complete and accurate.

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§21.10 B. Board of Directors

The board of directors (also referred to as the board of trustees or governors) is usually made up of individuals from outside the organization. The board serves as the steering committee of the organization and a sounding board for the chief executive officer. In NPOs, the board often includes some of the organization's largest donors.

The board has the ultimate responsibility of overseeing the organization's system of internal controls and approving key business decisions. However, the board may delegate responsibility for certain financial aspect to committees comprised of certain board members. Often organizations will appoint board members with specific skills or expertise to assist the organization in those areas to avoid having to hire persons with those skills.

NOTE: In some states, NPO board members may be held personally liable for errors or omissions occurring during their board term. For discussion of statutory liability protections for board members and officers in California, see §§9.151-9.155; on the indemnification of directors, officers, and agents, see §§9.156-9.162.

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§21.11 1. Audit Committee

Independent review. An audit committee provides an NPO with a group of individuals to review financial information before it is distributed to third parties. An audit committee should be comprised of individuals who are independent of management and other finance-related board committees. For example, audit committee members should not receive any payments from the NPO other than any reimbursement of travel costs that may be typical for that specific organization and to which all board members are entitled. Further, audit committee members should have an understanding of financial reporting (especially for NPOs) and internal controls.

PRACTICE TIP: Best practice also has the audit committee being separate from the investment committee. Additionally, with the ever-changing accounting rules and regulations, it typically takes a different skill set to serve on the audit committee versus the investment committee.

NOTE: After the enactment of the Sarbanes-Oxley Act of 2002 (SOX) (Pub L 107-204, 116 Stat 745) (15 USC §§7201-7266) for public companies, some states require NPOs to have a separate audit committee. California requires every charitable corporation and unincorporated association that receives or accrues gross revenues of at least $2 million in any fiscal year to have a separate audit committee. This is also true for corporate trustees required to file reports with the Attorney General. In determining whether the entity had $2 million in gross revenues, the following revenue is excluded: grants from, and contracts for services with, governmental entities that require an accounting. Govt C §12586(e)(2). Govt C §12586(e). It is certainly a best practice for NPOs to have an audit committee, even when not required. On the SOX, see Counseling California Corporations, chap 2 (3d ed Cal CEB 2008).

Review. The audit committee should meet periodically to review the financial results of the year, any new accounting or regulatory rules, and any reports on the organization's internal controls. It should also be familiar with any reports that are publicly available, such as the annual audit and tax information filings.

AICPA toolkit. The American Institute of Certified Public Accountants (AICPA) has developed an excellent tool for audit committee members entitled "The AICPA Audit Committee Toolkit: Not-for-Profit Organizations." This toolkit may be downloaded at no charge from http://www.aicpa.org/Audcommctr/toolkitsnpo/homepage.htm. The toolkit contains the following checklists or tools: administrative tools; audit committee charter matrix; financial expertise overview; sample request for proposal (RFP) for CPA services; independent and related issues overview; summary of peer review requirements for CPA firms; evaluation of the auditor's engagement letter; and guidelines for hiring the chief audit executive and external experts. It also includes audit process tools, such as an overview of basic information for the audit committee about internal control and fraud; a whistleblower tracking report; guidelines for conducting an audit committee executive session; an issues report from management; and a summary of what to expect in discussions with the independent auditors. Also included in the toolkit are sample performance evaluations and other tools for evaluating the independent auditors and the internal audit team; guidelines for conducting an audit committee self-evaluation; a summary of Single Audits Circular No. A-133: Audits of States, Local Governments, and Non-Profit Organizations; guidance on unique transactions and financial relationships; plus an overview of resources for audit committees. The toolkit is in the process of being updated and new tools are expected to be added.

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§21.12 2. Investment Committee

The investment committee is a group of knowledgeable board members who assist management in investing the organization's excess funds and planning for long-term growth. It is not uncommon to have money managers on the investment committee, and they may also be involved in managing some of the organization's funds. These members may provide at least a discount on management fees and should recuse themselves from the selection of investments in which they are involved.

NOTE: It is considered best practice to keep the investment committee separate from the audit committee. See §21.11.

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§21.13 3. Internal Audit

The board may engage internal auditors to assist in discharging its responsibility for overseeing the organization's internal controls. Internal auditors are individuals with experience in auditing organizations; however, unlike external auditors (see §21.14), internal auditors may not be independent of the organization if they report to management and not solely to the audit committee.

Internal auditors should directly report to the audit committee, but they may also have an indirect reporting relationship to the chief financial officer or the chief executive officer. Whatever the arrangement, the internal auditor's primary reporting responsibility is to the board of directors (through the audit committee).

Internal auditors, in conjunction with the audit committee, will develop an audit plan for the year and then conduct the audits. Their audits are normally a test of internal controls and adherence to the organization's policies and procedures. The resulting reports are then submitted to the audit committee.

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§21.14 C. External Auditors

Independence from management. External auditors are outside third parties that are independent of the organization. Being independent means that external auditors cannot act in a managerial capacity for or make decisions on behalf of the organization. They may present recommendations to the board or to management, but final decisions will be made by the organization.

External auditors must adhere to the applicable independence standards set forth by the American Institute of Certified Public Accountants (AICPA), individual states, and federal rules. The applicable standards may vary, depending on the nature of the organization (*e.g.,* public or federally funded). These standards may also limit the types of services that external auditors may provide the organization. For example, external auditors would not perform bookkeeping services because they would be auditing their own work.

It is critical that external auditors maintain their independence as they are opining on the organization's financial statements (and footnotes). The footnotes include a combination of required disclosure, such as the significant accounting policies followed by the organization, as well as supplemental information, such as further detail on restrictions or the maturity of pledges receivable. Footnotes supplement the financial statements and should be read in conjunction with them. Third parties will be relying on these financial statements and assuming that the external auditor's opinion indicates that the financial statements can be trusted.

NOTE: Due to the increased focus on independence of external auditors, independence should be upheld in both fact and appearance.

Role of audit committee. The engagement of an organization's external auditors should be made by the audit committee to ensure independence from management. Additionally, the external auditors' direct reporting relationship is to the audit committee and secondarily to management.

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§21.15 IV. FINANCIAL ACCOUNTING AND REPORTING STARTS WITH INTERNAL CONTROLS

In 1992, the National Commission on Fraudulent Financial Reporting (a private-sector initiative sponsored by several accounting organizations, commonly known as the Treadway Commission) took a look at internal controls. The result was a report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This report, commonly called the COSO report, has become the standard for defining internal controls, and provides a gauge against which businesses can evaluate their internal controls.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.16 A. Definition of Internal Controls

§21.16 A. Definition of Internal Controls

The report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO report) broadly defines internal controls as a process, effected by an organization's board, management, and other personnel, designed to reasonably ensure three outcomes:

(1) Operations are effectively and efficiently operated;

(2) Financial reporting is reliable; and

(3) Applicable laws and regulations have been followed.

The first category relates to an organization's ability to establish and work toward certain goals, whether financial or operational, and protect the organization's assets. The second category relates to the financial information, statements, or reports that an organization prepares for internal or external consumption and asks whether the information is complete and accurate. The last category addresses the various laws and regulations under which the organization operates and reports, including federal and state laws and generally accepted accounting principles. These three categories are interrelated and overlap, but they address different needs.

NOTE: Management, including the board, is responsible for establishing and enforcing internal controls.

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§21.17 B. Internal Control Components

Internal controls consist of five interrelated and interdependent components:

(1) Control environment (see §21.18);

(2) Risk assessment (see §21.19);

(3) Control activities (see §21.20);

(4) Information and communication (see §21.21); and

(5) Monitoring (see §21.22).

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§21.18 1. Control Environment

The control environment, set by the "tone at the top," generally consists of the attitude within the NPO toward a system of checks and balances and management's tolerance of employees knowingly circumventing them. Factors include the level of involvement of the board, management's operating mechanisms, as well as the integrity and values of the workforce. The control environment is the cornerstone of the other internal control components as its sets the ethical standard for the organization.

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§21.19 2. Risk Assessment

All NPOs face risks from both internal and external sources. An organization should step back and attempt to understand these various risks and determine which risks are key risks and how the organization is assessing and addressing those risks. These risks could jeopardize the organization's ability to achieve its desired goals and objectives. Once the risks are identified, a course of action can be mapped out to address the risks, while ensuring that the organization continues to move forward toward its goals and objectives.

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§21.20 3. Control Activities

Control activities are the checks and balances that an NPO establishes to meet its goals and objectives. Individuals within the organization will take the prescribed actions to address the various risks to those goals and objectives. Every individual in an organization has a role in the control activities, some more than others, including reviews, approvals, and authorizations.

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§21.21 4. Information and Communication

Management must secure complete and accurate information to make business decisions for the organization. Management should establish an information system to use this information to control business operations.

Communication works both up and down the lines of command in an organization. Employees report to their supervisors and provide information to management. Management must also clearly communicate the NPO's goals and objectives to the employees; the information allows employees to know why they are performing a particular task and how it will benefit the organization. Communication also flows to outside third parties, such as suppliers, bondholders, donors, funding agencies, and regulators.

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§21.22 5. Monitoring

Not-for-profit organizations must monitor their system of internal controls to ensure that the system continues to meet the NPO's needs. This monitoring occurs during the course of operations (including reviews of reconciliations and annual external audits) as well as by independent evaluation. But in all cases, these instances of monitoring provide an assessment of the effectiveness of an organization's system of internal controls.

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§21.23 C. Statement of Auditing Standard No. 112

Statement of Auditing Standard (SAS) No. 112 (communicating internal control-related matters identified in audit) establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. This SAS applies whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and changes the definition of certain key categories of internal control deficiencies. External auditors use these internal control categories in their reports on internal controls and in their year end reports to audit committees.

The categories as defined in SAS No. 112 are:

(1) Deficiency in control, design, or operation. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively. Control deficiencies may involve one or more of the five interrelated components of internal control. SAS No. 112, ¶5.

(2) Significant deficiency and material weakness. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. SAS No. 112, ¶6.

(3) More than inconsequential. The phrase "more than inconsequential" as used in the definition of significant deficiency describes the magnitude of potential misstatement that could occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential. SAS No. 112, ¶7.

In determining whether a potential misstatement would be more than inconsequential, the auditor should consider qualitative and quantitative factors. Inconsequential in this context is not the same concept as the threshold amount the auditor establishes in an audit of financial statements below which known and likely misstatements need not be accumulated. For example, for the purposes of evaluating control deficiencies, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered inconsequential in quantitative terms. However, the same misstatement may be considered more than inconsequential as a result of qualitative factors. SAS No. 112, ¶8.

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§21.24 D. Statement of Auditing Standard No. 114

Statement of Auditing Standards No. 114 (auditor's communication with those charged with governance) establishes standards and provides guidance concerning the auditor's communication with those charged with governance in relation to an audit of financial statements. It requires that the communications occur regardless of whether an NPO has an audit committee. This SAS is effective for periods beginning after December 15, 2006 (*i.e.,* for year-end periods beginning December 31, 2007, and forward).

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.25 E. Internal Control Characteristics Unique to NPOs

§21.25 E. Internal Control Characteristics Unique to NPOs

There are certain internal control characteristics unique to not-for-profit entities, including:

- Restricted contributions are identified, evaluated, and accepted;
- Promises to give are valued and recorded;
- Contributed goods and services, utilities, facilities, and use of long-lived assets are valued and recorded;
- Compliance with donor restrictions and board designations is monitored;
- Reporting requirements imposed by donors, contractors, and regulators are met;
- Conformity with accounting presentation and disclosure principles, including those related to functional and natural expense reporting and allocation of joint costs, is achieved; and
- New programs are identified and accounted for.

PRACTICE TIP: Obtaining knowledge of the client's organization and operations should include performing the procedures in Auditing Standards Codification §334 (AU §334) (related parties) (see American Institute of Certified Public Accountants (AICPA) Professional Standards, vol. 1 (2008)), to determine the existence of related-party relationships and transactions with such parties and to examine those transactions. The definition of related parties includes an organization's management, members of management's immediate family, and affiliated entities. Statement of Financial Accounting Standards (SFAS) No. 57 (related party disclosures). Accordingly, transactions with brother-sister organizations and certain national and local affiliates, as well as entities whose officers or directors are members of the NPO's governing board, may have to be disclosed under SFAS No. 57.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.26 F. Internal Controls in Anti-Fraud Programs

§21.26 F. Internal Controls in Anti-Fraud Programs

The internal controls provide certain checks and balances that should be designed to either prevent or detect fraud. These internal controls may include:

- Providing monthly financial reports to management;
- Performing monthly bank reconciliations;
- Reconciling financial sub-systems to the general ledger;
- Management review (and documenting evidence) of employees' work;
- Preparing budget to actual analysis, including explanations for unexpected items;
- Preparing trend analysis;
- Preparing ratio analysis;
- Monitoring debt covenants;
- Documenting internal control procedures and testing the documentation for accuracy and completeness;
- Considering the establishment of an internal audit function;
- Requiring dual custody of incoming payments;
- Maintaining emergency cash counts; and
- Obtaining conflict of interest statements from board members and certain members of management.

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V. REPORTING AND DISCLOSURES IN FINANCIAL STATEMENTS

§21.27 A. Combination Versus Consolidation

One issue unique to NPOs is how to present financial statements when there are affiliated entities. The American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 94-3 (reporting of related entities by not-for-profit organizations) provides guidance in this area. For recent changes to this SOP, see §21.27A-21.27B.

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§21.27A 1. FASB Staff Position 94-3-1 Amendments

FASB Staff Position 94-3-1 (omnibus changes to consolidation and equity method guidance for not-for-profit organizations), made several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position (SOP) 94-3 and the AICPA Accounting Guide to Health Care Organizations. Among other changes, it:

- Eliminates the temporary control exception to consolidation for certain relationships between not-for-profit organizations, amends the definition of majority voting interest in the board of another entity, and conforms the categorization of sole corporate membership in SOP 94-3 to that in the health care guide;
- Confirms the continued applicability to not-for-profit organizations of the guidance on consolidation of special-purpose entities in several EITF issues; and
- Requires that not-for-profit organizations apply the guidance on the equity method of accounting in several specified pronouncements to their investments in for-profit partnerships, limited liability companies (LLCs), and similar entities unless those investments are reported at fair value.

FASB Staff Position 94-3-1 eliminates the exception to consolidation for related but separate not-for-profit organizations if control is likely to be temporary. Consolidation of one not-for-profit organization by another is required, permitted, or prohibited, depending on whether there is control, an economic interest, or both, and depending on the nature of the control, regardless of whether that control is likely to be temporary. For a summary of the provisions of SOP 94-3-1, see §21.27A.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.27B 2. Chart: Summary of Amendments to SOP 94-3 and AICPA Health Care Guide

§21.27B 2. Chart: Summary of Amendments to SOP 94-3 and AICPA Health Care Guide

SOP 94-3

RELATIONSHIP TYPE	PARAGRAPH	EXISTING GUIDANCE	AMENDED GUIDANCE
Controlling financial interest through ownership of a majority voting interest	10	Consolidation is required unless control does not rest directly or indirectly with the majority owner (no temporary control exception).	No change, except sole corporate membership interests are now included here.
Control through majority voting interest in the board of another entity (by means other than ownership), coupled with an economic interest	11	Consolidation is required unless control is likely to be temporary, in which case consolidation is prohibited. (Currently includes sole corporate membership interests, which the health care Guide deems a controlling financial interest.)	Consolidation is required (no temporary control exception). (This FSP also clarifies the definition of majority voting interest.)
Control through other means, coupled with an economic interest	12	Consolidation is permitted unless control is likely to be temporary, in which case consolidation is prohibited. Disclosures are required if not consolidated.	Consolidation is permitted. Disclosures are required if not consolidated (no temporary control exception).

Health Care Guide

RELATIONSHIP TYPE	PARAGRAPH	EXISTING GUIDANCE	AMENDED GUIDANCE
Controlling financial interest through ownership of a majority voting interest or sole corporate membership	11.10	Consolidation is required unless control does not rest directly or indirectly with the majority owner or sole corporate member (no temporary control exception).	No change.
Control through majority voting interest in board of another entity (by means other than ownership or sole corporate membership), coupled with an economic interest	11.11	Consolidation is required unless control is likely to be temporary, in which case consolidation is prohibited.	Consolidation is required (no temporary control exception). (This FSP also clarifies the definition of majority voting interest.)
Control through other means, coupled with an economic interest	11.12	Consolidation is permitted unless control is likely to be temporary, in which case consolidation is prohibited. Disclosures are required if not consolidated.	Consolidation is permitted. Disclosures are required if not consolidated (no temporary control exception).

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§21.27C 3. SFAS No. 164: Mergers and Acquisitions

Statement of Accounting Standards (SFAS) No. 164 (not-for-profit entities: mergers and acquisitions, including an amendment of SFAS No. 142) provides guidance on accounting for mergers and acquisitions of not-for-profit organizations. The amendment to SFAS 142 (goodwill and other intangible assets) made that statement fully applicable to not-for-profit organizations.

SFAS No. 164 applies to mergers occurring on or after December 15, 2009, and to acquisitions occurring in annual periods beginning on or after December 15, 2009. The SFAS No. 142 amendments are effective for annual reporting periods beginning on or after December 15, 2009.

SFAS No. 164 provides that most not-for-profit mergers and acquisitions are accounted for under the acquisition method. However, when all of the combining organizations cede control to a new economic entity (as opposed to one organization obtaining control over other organizations), the assets and liabilities of the combining organizations are brought into the new entity at their carryover basis.

When merger occurs. A merger occurs when the governing bodies of all the combining entities cede control of their respective organizations to a new entity with a newly-formed governing body. The combining entities in a merger cannot obtain control of (or continue to control) the other entities, or dominate the merger transaction. A merger is accounted for using carryover basis, *i.e.*, the new entity carries forward the value of the assets and liabilities of the combined entities.

Combinations that are not mergers. Combinations that are not mergers are acquisitions. Identification of the acquirer will require consideration of all facts and circumstances surrounding a combination, in particular, the ability of one organization to dominate the process of selecting a voting majority of the combined organization's governing board. SFAS No. 164 details various indicators organizations should consider when identifying an acquirer. The Board purposely provided guidance in the form of principles, rather than prescriptive criteria.

Measuring value of acquired entities. Once the acquirer is identified, the value of the acquired entities must be measured. This requires considering the fair value of the identifiable assets acquired, the liabilities assumed, and the consideration, if any, transferred.

If the fair value of identifiable assets acquired is greater than the fair value of liabilities assumed and consideration transferred, the acquirer recognizes contribution income. The contribution increases permanently restricted, temporarily restricted, and/or unrestricted net assets depending on the existence and types of donor-imposed restrictions that must be assumed.

If the fair value of liabilities assumed and consideration transferred exceeds the fair value of identifiable assets acquired, the accounting varies depending on whether the acquiree's operations are expected to be predominantly supported by contributions and investment return or, alternatively, by revenue earned in exchange transactions.

If the acquiree will be predominantly contribution-supported, the excess is immediately expensed, as if the acquirer had made a contribution in taking on the acquired entity. This amount is reported as a separate line item in the statement of activities.

If the acquiree's operations are expected to be predominantly supported by revenue earned in exchange transactions, the acquired net deficit represents goodwill.

As they relate to goodwill and intangible assets**,** at the date of acquisition, the assets acquired and liabilities assumed (including goodwill, if any) should be assigned to reporting units as described in SFAS No. 142.

Amortization of goodwill. The amendments prohibit amortization of goodwill and certain intangible assets that have indefinite useful lives. Intangible assets that have finite useful lives continue to be amortized over their useful lives. An acquirer predominantly supported by contributions and investment returns may write off any previously recognized goodwill; all other acquirers must perform SFAS No. 142's transitional impairment evaluation on any preexisting goodwill.

Reporting minority interests. SFAS No. 164 provides reporting model guidance for a not-for-profit's minority interest (referred to as "noncontrolling interests") in subsidiaries. Noncontrolling interests should be reported on the

balance sheet as a separate component of the appropriate net asset class.

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§21.28 B. Financial Statement Requirements Under SFAS No. 117

Statement of Financial Accounting Standards (SFAS) No. 117 establishes standards for "general-purpose" external financial statements prepared and issued by NPOs. Its stated purposes include providing relevant information to donors, members, creditors, and service-providers; improving the understandability of financial statements; and establishing standards for comparison. See SFAS No. 117, ¶¶1-4. Under this Statement, all NPOs must provide the following (see SFAS No. 117, ¶¶6-8):

- A statement of financial position (see §§21.29-21.31);
- A statement of activities (see §§21.32-21.35); and
- A statement of cash flows (see §§21.36-21.39).

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§21.29 1. Statement of Financial Position

The purpose of a statement of financial position (referred to as the balance sheet by for-profit entities) is to present a snapshot of an organization's total amount of assets, liabilities, and net assets at a particular point in time and to focus on the organization as a whole. This information is used by the board and outside parties to determine the organization's ability to continue as a going concern (*i.e.,* being able to continue providing services), its financial flexibility (*i.e.,* any need to obtain outside financing), and its liquidity (*i.e.,* ability to meet its current obligations). See SFAS No. 117, ¶¶9-10.

SFAS No. 117 also requires the reporting of other specific balances and defines three net asset categories (see §21.30).

NOTE: For voluntary health and welfare organizations (see §21.92), the statement of financial position requires a statement of functional expenses. See SFAS No. 117, ¶¶63-64. For further discussion, see §21.47.

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§21.30 a. Sequence of Assets and Liabilities

To provide the user of the statement of financial position a better idea as to the organization's liquidity, the statement provides three options in reporting assets and liabilities (see Statement of Financial Accounting Standards (SFAS) No. 117, ¶¶11-12):

(1) Sequencing assets based on their proximity of conversion to cash (*i.e.,* how easy would it be for the organization to sell the asset) and sequencing liabilities according to their maturity (*i.e.,* liabilities coming due first are reported first) and the resulting use of that cash.

(2) Specifically classifying assets and liabilities as current and noncurrent in accordance with FASB Accounting Research Bulletin No. 43, ch 3A, "Working Capital—Current Assets and Current Liabilities."

(3) Disclosing pertinent information about the maturity or liquidity of the assets and liabilities in the footnotes to the financial statements.

NOTE: The last option is rarely used in practice.

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§21.31 b. Net Assets

Statement of Financial Accounting Standards (SFAS) No. 117 also requires that the net assets of the organization be classified into three categories: unrestricted, temporarily restricted, and permanently restricted. See SFAS No. 117, ¶¶11-16. These categories are defined below.

"Unrestricted net assets" means the part of net assets of an NPO that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

"Temporarily restricted net assets" means the part of the net assets of an NPO resulting from (1) contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations; (2) other asset enhancements and diminishments subject to the same kinds of stipulations; and (3) reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

"Permanently restricted net assets" means the part of the net assets of an NPO resulting from (1) contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization; (2) other asset enhancements and diminishments subject to the same kinds of stipulations; and (3) reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

NOTE: It is also common for NPOs to have funds that the board or management have set aside for a specific purpose. These types of funds are called "designated net assets." The Financial Accounting Standards Board (FASB) only allows for an outside third party (*i.e.,* the donor) to "restrict" an asset, whereas internally limited or directed assets are "designated." A good rule to follow is, "Donors restrict, boards (and management) designate."

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§21.32 2. Statement of Activities

A statement of activities (referred to as the income statement by for-profit entities) provides information about the effects of transactions and other occurrences on the amount and nature of an NPO's net assets and how the NPO's assets are used for its programs and purpose. See Statement of Financial Accounting Standards (SFAS) No. 117, ¶¶17-18. The statement looks at the entity as a whole and must include any changes in permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. See SFAS No. 117, ¶¶18-19.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.33 a. Results of Operations

§21.33 a. Results of Operations

With the exception of healthcare organizations, NPOs are not required to define and present results of operations (versus nonoperating results). However, NPOs may elect to define (in the footnotes) an operating measure, report results from operations, and classify all other activity as nonoperating.

PRACTICE TIP: If the NPO adopts a definition of operations, management (with the auditor's concurrence) should ensure that it accurately captures the purpose and mission of the organization and that it is applied consistently for all fiscal periods included in the financial statements.

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§21.34 b. Program Services and Supporting Activities

Within the expense section of the statement of activities, an NPO will want to ensure that the amounts reported for program services and supporting activities are clearly identified and reported by their functional classification. See Statement of Financial Accounting Standards (SFAS) No. 117, ¶¶26-28. Third parties regularly focus on these amounts to measure an organization's efficiency in carrying out its mission.

The expense categories should be specific enough to define the main types of expenses (*e.g.,* program, administrative, program support), without having so many categories as to make it hard to read the statement of activities. These categories can be designed by referring to the financial statements of peer organizations, which will allow management to prepare comparisons to other organizations for benchmarking purposes.

NOTE: Voluntary health and welfare organizations (see §21.92) must also provide information about expenses according to their natural classification in a separate financial statement. Other NPOs are similarly encouraged to do so. See SFAS No. 117, ¶26.

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§21.35 c. Release From Restrictions

Generally, temporarily restricted revenue is recorded within the temporarily restricted category on the statement of activities. Alternatively, temporarily restricted revenue collected and expended within the same fiscal period may be recorded as unrestricted net assets. However, all of the expenses are recorded within unrestricted net assets, resulting in an inconsistency between where the receipt of the funds and the expenditures are reported.

For the expenditure of temporarily restricted funds, the statement of activities will reflect a "release from restrictions": a decrease will be reported in the temporarily restricted net assets, and a corresponding increase will be reported in the unrestricted net assets for the amount equal to the temporarily restricted net assets funds expended in that fiscal period. Although the net impact of this report line is zero, it allows for the reclassification of net assets to the category from which the funds were used.

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§21.36 3. Statement of Cash Flows

A statement of cash flows provides information regarding the "ins and outs" of an organization's cash. In other words, the statement provides the sources of cash as well as the uses of cash. The receipts and payments of cash are organized into three categories: operating, investing, and financing (see §§21.37-21.39). See Statement of Financial Accounting Standards (SFAS) No. 95, ¶¶4-6. The reporting requirements also have organizations disclosing noncash investing and financing activities (*e.g.,* obtaining a vehicle by taking out a note payable). See SFAS No. 95, ¶24; see also ¶¶26-31 (form and content requirements).

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§21.37 a. Operating Activities

This section of the statement of cash flows provides information about the NPO's "operating activities," that is, activities related to the core mission of the organization that do not involve debt (other than normal accounts payable and accrued liabilities) or investing activities. They are activities that do not constitute investing or financing activities (see §§21.38-21.39) and typically involve the provision of goods or services in exchange for cash. See Statement of Financial Accounting Standards (SFAS) No. 95, ¶¶21-24.

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§21.38 b. Investing Activities

This section of the statement of cash flows provides information as to the activity occurring with the NPO's investments, fixed assets, and any other assets held or used to produce the NPO's goods or services. See SFAS No. 95, ¶¶21-24. While the statement of financial position (see §§21.28-21.31) presents the balance of the investments and fixed assets at a point in time, the investing activities section provides information on the total amount of investments sold and purchased during the period, as well as the amount of fixed assets purchased. A high level of investment purchases and sales in a period (as compared to the balance on the statement of financial position) would indicate that the investment portfolio turned over numerous times during the fiscal period.

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§21.39 c. Financing Activities

The financing activities section of the statement of cash flows provides the reader with information regarding the cash obtained by incurring debt and payments on outstanding debt. Additionally, donated cash that is restricted for long-term purposes (see §21.41) is also included as financing activities. See Statement of Financial Accounting Standards (SFAS) No. 95, ¶¶18-20.

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§21.40 4. Reporting Methodologies

The statement of cash flows can be presented by using either the direct or indirect method. See SFAS No. 95, ¶¶26-31.

Direct method. The direct method reports gross cash receipts and gross cash payments in major classes for operating activities (*e.g.,* total cash paid to employees, total cash paid to vendors) to arrive at the subtotal "cash provided by (used in) operating activities." It then requires that this subtotal be reconciled to the change in net assets from the statement of activities.

Indirect method. The indirect method starts with the change in net assets from the statement of activities and reconciles to the "cash provided by (used in) operating activities" subtotal.

NOTE: The indirect method is simpler, and the more common approach for NPOs.

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5. Issues Unique to NPOs

§21.41 a. Contributions of Permanently Restricted Cash

Many NPOs benefit from donors generously contributing cash that is to be invested in perpetuity so that the organization can use the income these investments generate (*i.e.,* endowments) or use the cash to purchase long-lived assets. These contributions are included in the total change in net assets on the statement of activities, and this amount is the starting point for the indirect method or the amount being reconciled to in the direct method (see §21.40). In either situation, as these types of cash contributions are not part of an organization's operations, the amount received must be backed out of the total change in net assets and then included as a cash inflow in the financing section of the statement of cash flows (see §21.36).

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§21.42 b. Contributions of Securities

Contributions of securities are noncash transactions, that is, the organization is not receiving a noncash asset rather than cash. The total amount of these contributions is reported either at the bottom of the statement of cash flows, or in the footnotes as noncash transactions. The former is the most common approach.

If the organization routinely sells contributed securities on receipt, then the cash obtained through the sale of these securities would be reported in the investment activities section as part of the "sale of investments."

NOTE: Although some organizations have incorrectly argued that their policy of immediately selling these securities effectively makes this a cash transaction, such a transaction must be broken out into its individual components: a gift of securities (noncash transaction) and then the sale of these securities (cash transaction).

If the organization obtains a gift of securities and then decides to hold the securities, then the only disclosure would be the noncash transaction—as no cash has been generated or utilized.

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§21.43 c. Contribution of Long-Lived Assets

Similar to the contribution of securities, contributions of long-lived assets constitute noncash transactions. This type of gift is reflected in the noncash transaction disclosure section. If the organization sells the fixed asset, then cash is generated that must be reflected in the statement of cash flows. However, if the long-lived asset is held by the organization, then no additional disclosure is required.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.44 d. Collections

§21.44 d. Collections

Not-for-profit organizations have the option of whether or not to capitalize any collections (see §21.61) that they may own. This decision will have an impact on the statement of cash flows.

NOTE: A majority of museums and other entities holding collections have chosen *not* to capitalize collection items.

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§21.45 (1) If Collections Are Not Capitalized

If an NPO decides not to capitalize its collection, then no asset is recorded on the statement of financial position. The collection would be stated only in a footnote disclosure as to what is owned by the organization. Any cash flows from the purchase, sale, or insurance recoveries regarding collections not capitalized by the organization are disclosed in the investing section of the statement of cash flows. See §21.38.

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§21.46 (2) If Collections Are Capitalized

As capitalized collections are similar to other fixed assets owned by the organization, all cash flows associated with the purchase, sale, or insurance recoveries of capitalized collections will be reflected in the investing section of the statement of cash flows. See §21.38.

Thus, the treatment for collections is consistent for cash flow purposes and is consistent whether the collection is capitalized or not.

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§21.47 6. Statement of Functional Expenses

In addition to a statement of activities (see §21.32), voluntary health and welfare organizations (see §21.92) must also present a statement of functional expenses. The purpose of this statement is to provide additional information regarding the organization's service efforts and how the expenses are being incurred.

The statement of functional expenses takes the functional expense categories, as presented on the statement of activities, and further breaks these down by natural classification (*e.g.,* salaries, insurance, and utilities). For example, an organization will take the total amount spent for programs and then report how much of this total was spent for salaries, insurance, utilities, postage, and other similar expenses.

NOTE: Not-for-profit organizations other than voluntary health and welfare organizations are also encouraged to provide additional information about expenses according to their natural classification in a separate financial statement. See Statement of Financial Accounting Standards (SFAS) No. 117, ¶ 26.

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§21.48 7. Disclosures

Not-for-profit organizations are subject to disclosure requirements that are unique to the nonprofit world. See §§21.48-21.55. These disclosures are most typically presented in the footnotes to the financial statements.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.49 a. Tax-Exempt Status

§21.49 a. Tax-Exempt Status

An NPO must disclose the fact that it is a tax-exempt organization and identify the Internal Revenue Code section under which it is exempt.

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§21.50 b. Net Asset Components

Not-for-profit organizations must disclose the total amount for each net asset category: unrestricted, temporarily restricted, and permanently restricted. Additionally, the major components in each restricted net asset category must be disclosed.

Temporarily restricted net assets. The organization should disclose the types of restrictions, such as for future operations, purchase of fixed assets, or research.

Permanently restricted net assets. The organization should disclose collections (if capitalized) separately from funds that are required to be invested in perpetuity (endowments). Most organizations will also provide information regarding the purpose of the endowments (*e.g.,* to benefit research, student financial assistance, or athletics).

Unrestricted net assets. No additional disclosures are required other than the total for unrestricted net assets. However, many NPOs will disclose the amount related to fixed assets and operations.

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§21.51 c. Pledges

Contributions receivable or pledges have several required disclosures. Multi-year pledges are recorded at fair value per SFAS No. 157.

Timing. The organization must also present the expected time frame for collecting pledges. The amounts must be disclosed as the amount expected to be received within the next year, the total amount expected to be received in 1 to 5 years (as a lump sum), and the amount expected after 5 years.

Purpose. Pledges are received for multiple purposes, so the purpose of the pledges must be disclosed. This disclosure can be made in general terms, such as endowment, capital projects, or future operation.

Conditional pledges. Additionally, if any conditional pledges have been received, these should be disclosed with the associated condition that must be met before the organization is able to receive the funds. Conditional pledges are *not* recorded as either income or a receivable in the financial statements.

NOTE: For a table containing factors useful in distinguishing whether a donor has made a bona fide pledge to an NPO, see §21.98.

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§21.52 d. Investment Unitization

Pooling. Charitable organizations may receive contributions from hundreds or thousands of donors, and may have as many individual endowment funds. Instead of maintaining hundreds or thousands of separate investment accounts with brokers, NPOs commonly pool their investment funds. This allows them to have a larger sum of money to invest and may allow them to participate in types of investments for which smaller investors may be ineligible.

Tracking required. If an NPO pools its funds, then it must be able to track each endowment's portion of the total investment pool (similar to a mutual fund). In these cases, the organization will use the method called "unitization" to track the ins and outs of the investment pool.

Disclosures. An organization must disclose the number of units within its investment pool, as well as the market value of a unit at the end of the fiscal period. If more than one net asset category participates in the investment pool, it is common for organizations to disclose how many units are held by each net asset category.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.53 e. Fundraising Expenses

§21.53 e. Fundraising Expenses

Not-for-profit organizations must disclose the amount of funds expended for fundraising efforts. This disclosure requirement includes salaries, as well as other related expenses, such as postage and printing.

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§21.54 f. Contributed Services

Some NPOs receive volunteer services from their supporters. In some situations, the NPO can recognize the fair value of these services.

Recognition. Statement of Financial Accounting Standards (SFAS) No. 116 provides the criteria for recognizing volunteer services. An NPO can recognize these services if they would have ordinarily been purchased by the NPO, if the services had not been contributed, and either

- Require specialized skills and are provided by individuals with those skills; or
- The services create or enhance nonfinancial assets of the NPO.

NOTE: Examples of services requiring special skills are those provided by nurses, doctors, attorneys, accountants, architects, carpenters, electricians, plumbers, and other professionals and craftsmen. SFAS No. 116, ¶9.

Fair value measure. Contributed services that create or enhance nonfinancial assets may be measured using the fair value of the services received or the fair value of the asset (or the asset enhancement stemming from those services). SFAS No. 116, ¶19. If the contributed services are going toward a capitalizable asset (*e.g.,* an architect's volunteer drafting of plans for a building), then the NPO would recognize the fair value of the contributed services as revenue and capitalize them as part of the building. However, if the contributed services do not enhance a nonfinancial asset (*e.g.,* normal legal services contributed by an attorney), then the contributed services would be recorded as revenue at its fair value and an expense would be recognized in legal expense for the same amount.

Nonskilled services. Some NPOs obtain nonskilled volunteer services, such as stuffing envelopes, making phone calls, and filing paperwork. Although the NPO might have had to purchase these services had they not been provided by volunteers, the efforts do not require a specialized skill. Therefore, the NPO may not recognize the fair value of these efforts. However, if the NPO tracks the number of volunteer hours, the NPO *may* be able to disclose in the footnotes the number of volunteer hours received during the fiscal period (and may or may not attempt to quantify the hours). If the NPO does not track the hours, a general disclosure may be presented that indicates that the organization receives a substantial amount of volunteer hours, but with no quantification.

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§21.55 g. Split-Interest Agreements

Some NPOs will establish a deferred giving program in which a donor will provide a gift to the organization in exchange for a future cash stream (*e.g.,* gift annuities and unitrusts). See §21.64.

The future liability for these payments by the NPO is calculated utilizing mortality tables and discount rates, as discussed in Not-for-Profit Entities—AICPA Audit and Accounting Guide (2009). These assumptions must be disclosed in the organization's footnotes.

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§21.56 8. Information Used by Outside Parties

Many outside parties will rely on an NPO's financial statements and related footnotes to make an independent assessment as to the organization's financial condition or effectiveness. These parties will use different information to make their assessments, and one matter may be more important to one third party than another. This presents a challenge for organizations because they don't know who is using their financial statements and for what purpose.

Key measurements used by third parties (including rating agencies) include:

- Fundraising expenses as compared to funds raised;
- Whether temporarily restricted assets are being accumulated and for what purpose;
- The estimated age of the fixed assets;
- Whether unrestricted net assets are being used to cover operating shortfalls;
- Whether the investment returns are more or less than the amount spent;
- Whether net investment returns (after the spending policy is applied) are keeping up with inflation;
- What portion of expenses are going for programs;
- Collectibility of receivables;
- How dependent the organization is on gifts;
- What percentages of total assets are pledges and fixed assets;
- Expected cash from pledges next year;
- Whether cash flow from operations is a net cash inflow or net cash outflow; and
- Whether investments are being sold to cover cash demands.

These items are some of the criteria that third parties will use to evaluate an NPO. Alternatively, independent third parties may conduct their own separate evaluation and then publish their rating of the organization. In addition to the standard rating agencies (*e.g.,* S&P, Moody's, and Fitch's), there are also the Better Business Bureau and other "watchdog" groups. Although these groups publish their criteria, there may not be consistent factors between them and, in fact, there may be conflicting criteria.

PRACTICE TIP: Management should be aware of these third parties and determine which are the most significant for the particular organization.

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§21.57 9. External Versus Internal Reporting

External reporting. For external reporting, NPOs are required to follow generally accepted accounting principles (GAAP) (see §21.3). This requirement allows for some reasonable comparability between like-kind organizations, and ensures that items are being recorded in a consistent manner and that the basis behind some reported amounts are provided (*i.e.,* discount rates). Reporting under GAAP requires NPOs to record revenue and expenses on the accrual basis—recording revenue if the earnings process is complete even if cash is not received (then recording a receivable) or recording expenses as the goods or services have been received, though payment has been made (then a payable is recorded).

Internal reporting. For internal reporting, many organizations report on a cash basis, and they may only report on the accrual basis once a year—for their year-end financial statements. The reason for this reporting is that management is usually focused on cash, ensuring that enough is received to meet the demands of its employees and vendors.

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§21.58 VI. CONTRIBUTIONS, PLEDGES, AND NONCASH TRANSACTIONS

The hallmark of the NPO is the solicitation and receipt of resources for which the contributing party expects to receive nothing of value in exchange for support of the organization's mission. Resource providers have various ways to provide support for NPOs, and each method has unique accounting characteristics.

An NPO must answer two questions when determining how and when to record revenue:

(1) Is it a contribution or an exchange transaction (see §21.59)?

(2) Is it restricted, unrestricted, conditional, or unconditional (see §21.60)?

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§21.59 A. Contribution or Exchange Transaction?

Contribution. A contribution is "an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by an entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, services, and unconditional promises to give those items in the future." Statement of Financial Accounting Standards (SFAS) No. 116, ¶5.

A promise to give consists of "a written or oral agreement to contribute cash or other assets to another entity; however, to be recognized in financial statements there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable." Statement of Financial Accounting Standards (SFAS) No. 116, ¶6.

For a table of factors to be considered in assessing whether a donor has made a bona fide pledge to a donee, see §21.98.

Exchange transactions are reciprocal transfers in which parties transfer something of approximately equal economic value to the other. See SFAS No. 116, ¶48. Examples include purchasing assets or paying salaries.

Combined transactions. Some transactions include components of both contribution and exchange transactions. For example, a membership fee to the zoo may provide the donor with free tickets; the ticket component of the transaction is an exchange, with the remainder of the membership fee treated as a contribution. Generally, government grants and contracts are exchange transactions as they expect the NPO to provide a service in order to "earn" the grant (*e.g.,* receiving $5 for every meal provided to an indigent person).

For a table of factors useful in distinguishing contributions from exchange transactions, see §21.95. For a table of indicators useful for determining the contribution and exchange portions of membership dues, see §21.96.

Recording. Exchange transactions are recorded as revenue when the exchange has been satisfied or the service provided. If an advance is received on exchange transactions, such as an advance on a governmental grant, it would be reflected as a refundable advance because it would need to be returned if not "earned" by the NPO. Exchange revenues are always unrestricted.

If an NPO determines that it has received a contribution, the NPO must then characterize the nature of the contribution. See §21.58.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.60 B. Is Transaction Restricted, Unrestricted, Conditional, or Unconditional?

§21.60 B. Is Transaction Restricted, Unrestricted, Conditional, or Unconditional?

To determine the accounting for transactions in which an entity voluntarily transfers assets to an NPO, it is first necessary to assess the extent of discretion that the NPO has over the use of the assets that are received. If the NPO has little or no discretion, the transaction is an agency transaction (see §21.79). If the NPO has discretion over use of the assets, the transaction is a contribution, an exchange, or a combination of the two (see §21.59). Variance power is the *unilateral power* to redirect the use of the transferred assets to an entity or individual other than the specified beneficiary or beneficiaries. If the NPO has variance power, the transfer is a contribution.

The following discussion assumes that the NPO has received a contribution. The NPO must then assess whether the contribution is received with donor-imposed conditions, donor-imposed restrictions, or both.

Donor-imposed conditions. A donor-imposed condition specifies a future and uncertain event whose occurrence or failure to occur permits the donor a right to the return of the contributed assets or releases the donor from its obligation to transfer the assets. See Statement of Financial Accounting Standards (SFAS) No. 116, ¶7. One of the most common examples of a condition is a donor stating that the NPO has been named as a beneficiary in his or her will; although the donor will ultimately die, the donor may subsequently amend the will such that it is uncertain that the bequest will be in effect at the donor's ultimate death. Another example of a donor-imposed condition would be requiring that the NPO satisfy a matching requirement to receive the contribution; if the NPO fails, the donor has the right to the return of the assets or is released from the obligation to transfer assets in the future.

Some gifts may be conditional, but the conditions may be met in stages. For example, a donor may say, "I will give you $5 for every $10 that you raise, up to a maximum contribution of $100,000." If the NPO raised $20,000 in the first year, $10,000 of the match condition would have been satisfied. However, a promise that contains a condition is considered to be unconditional if the possibility that the condition will not be met is remote. For example, a promise that is conditioned on the NPO meeting administrative requirements, such as the filing of an annual financial report, should not be considered conditional if the likelihood of not satisfying the administrative requirements is remote.

Donor-imposed restrictions. A donor-imposed restriction is a stipulation specifying a use for a contribution that is more specific than the relatively broad limits circumscribed by the NPO's nature and stated purpose and from the environment in which it operates. See Not-for-Profit Entities—AICPA Audit and Accounting Guide ¶5.32 (2009); see also SFAS No. 116, ¶7. Restrictions may be expressed explicitly by the donor in a written or oral communication accompanying the contribution or result implicitly from the circumstances surrounding the solicitation. An example of the latter is a gift to a capital campaign in response to a letter outlining the campaign to raise funds for a new building.

Restrictions may also be either time or purpose restricted, or a combination of both. For example, a purpose restriction would be "here is $10,000 for Program A." A time restriction may be, "I will provide you $10,000 next year for Program A." Some restrictions may also permanently limit the organization's use of contributed assets, such as an endowment gift.

Donor-imposed restrictions on an organization's use of a contributed asset may be temporary or permanent.

PRACTICE TIP: Distinguishing between a condition stipulated by a donor and a restriction on the use of a contribution imposed by a donor may require the exercise of judgment. Because of the uncertainty surrounding whether and when a condition will be satisfied, conditions imposed by resource providers may cast doubt on whether the donor truly has made a contribution. Therefore, donor-imposed conditions should be substantially met by the organization before the receipt of assets (including contributions receivable) is recognized as a contribution. In contrast to donor-imposed conditions, donor-imposed restrictions limit the use of the contribution, but they do not change the transaction's fundamental nature from that of a contribution.

Recognition. Unconditional contributions should be recorded as revenue in the period received. Depending on the kind of benefit received, the NPO would also record:

- An increase in assets (*e.g.,* cash, securities, contributions receivable, property, and equipment);
- A decrease in liabilities (*e.g.,* accounts payable or notes payable); or

- An expense (*e.g.,* donated legal services).

Unconditional contributions and promises to give should be recorded when they are received. Unconditional promises to give with payments due in future periods should be recorded as temporarily restricted contributions unless the donor expressly stipulates, or circumstances surrounding the receipt of the promise clarify, that the donor intended the gift to support activities of the current period.

Unconditional contributions and promises to give that are restricted would be recorded as either permanently restricted or temporarily restricted revenue, depending on the nature of the donor's restriction, at the time the promise is made. The temporarily restricted classification should be used for contributions if the limitations are temporary (*e.g.,* a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

Expirations of donor-imposed restrictions on contributions should be reported in a statement of activities as reclassifications, decreasing temporarily restricted net assets and increasing unrestricted net assets. The expiration of donor-imposed restrictions should be reported in the period when:

- A donor-stipulated time has elapsed (*e.g.,* a 10-year pledge that is in year 2, so a portion of the time restriction has been satisfied); or
- A contribution for a donor-restricted purpose for which the restriction has been fulfilled by the organization (*e.g.,* the restriction on a contribution to spend $1000 on Program X expires when expenses for Program X have been incurred).

NOTE: If a donor stipulates more than two restrictions, the expiration of the restriction should be reported in the period in which the last remaining restriction is satisfied.

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§21.61 1. Contributed Services

Contributed services is an area that is frequently questioned. Contributions of services must be recognized if the services received (Statement of Financial Accounting Standards (SFAS) No. 116, ¶9):

- Create or enhance nonfinancial assets; or
- Require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation.

Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen.

Not-for-profit organizations that receive contributed services must include additional disclosures in their footnotes regarding the programs or activities for which those services were used. These disclosures must identify the nature and extent of contributed services received as well as indicate the amount recognized as revenues for that given period. SFAS No. 116, ¶10.

PRACTICE TIP: Not-for-profit organizations are encouraged to disclose the fair value of contributed services received but not recognized as revenues to the extent practicable. SFAS No. 116, ¶10. For example, the disclosure might read: "During the year, more than 100 volunteers donated 5000 hours of time to our organization that is not reflected in the Statement of Activities."

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§21.62 2. Contributed Goods, Including Gifts in Kind

Some NPOs receive noncash assets—such as property, equipment, and inventory—from resource providers. Reporting these transfers, sometimes referred to as gifts in kind (GIK), agency transactions, or contributions, depending on the extent of discretion that the NPO recipient has over the use or subsequent disposition of the assets.

If GIK receipts are not agency transactions (see §21.79), the noncash assets received by the NPO should be recognized as contributions when received from or unconditionally promised by the donor. Gifts in kind that can be used or sold should be measured at fair value. "In determining fair value, organizations should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the organization, including discounts based on that quantity if the assets had been acquired in exchange transactions. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (a) used internally by the not-for-profit organization or for program purposes or (b) sold by the organization, the item received should not be recognized." Not-for-Profit Entities—AICPA Audit and Accounting Guide ¶5.55 (2009).

Not-for-profit organizations may also receive unconditional contributions of the use of utilities or of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset. Organizations receiving such contributions should recognize contribution revenue in the period in which the contribution is received and expenses in the period the utilities or long-lived assets are used. If the transaction is an unconditional promise to give for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets, similarly to a multi-year pledge. Unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title to the long-lived asset may be received in connection with leases or may call for lease payments at amounts below the fair rental value of the property. In such circumstances, the NPO should report a contribution for the difference between the fair rental value of the property and the stated amount of the lease payments, if any.

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§21.63 3. Collections

One unique aspect of certain NPOs, such as museums, relates to collection items. An NPO is not required to recognize collection items (*i.e.,* contributions of art works, historical treasures, and similar items) if the collection satisfies all of the following conditions (Statement of Financial Accounting Standards (SFAS) No. 116, ¶11):

- The items are held for the purposes of public viewing, education, or public service research rather than financial gain;
- The items are protected, preserved, and kept unencumbered; and
- The items are subject to an organizational policy requiring that the proceeds from collection items sales be used to acquire other works for collections.

An NPO may choose whether or not to capitalize collection items. See §§21.44-21.46. Contributed collection items should be recognized as revenue if the NPO capitalizes the collection. The majority of museums and other entities with collections have chosen to *not* capitalize collection items.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.64 4. Split-Interest Agreements

§21.64 4. Split-Interest Agreements

Some donors enter into trust or other arrangements under which NPOs receive benefits that are shared with other beneficiaries. These arrangements, commonly known as split-interest agreements, take one of the following forms:

- Charitable lead trust (NPO is trustee);
- Charitable lead trust (NPO is not trustee);
- Perpetual trust held by a third party;
- Charitable remainder trust (NPO is trustee);
- Charitable remainder trust (NPO is not trustee);
- Charitable gift annuity; and
- Pooled (life) income fund.

Recognition and measurement principles for these complex arrangements are discussed in great detail in Not-for-Profit Entities—AICPA Audit and Accounting Guide, chap 5 (2009).

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VII. ACCOUNTING FOR INVESTMENTS, ENDOWMENTS, AND BOARD-DESIGNATED FUNDS (INCLUDING QUASI-ENDOWMENTS)

§21.65 A. Valuation: Current Guidance

Purchased assets are initially recorded at their acquisition cost (including brokerage and other transaction fees), and contributed assets are initially recorded at their fair value on the date of donation. The current accounting guidance, as specified in Statements of Financial Accounting Standards (SFAS) No. 124, requires that equity securities be carried at fair value, when fair value is readily determinable. In addition, all debt securities (with limited exceptions) are also required to be carried at fair value. SFAS No. 124, ¶7.

NOTE: Equity securities that are accounted for under the equity method, investments in consolidated subsidiaries, and investments in derivative instruments subject to SFAS No. 133 (accounting for derivative investments and hedging activities) are exempt from this requirement. SFAS No. 124, ¶5.

Readily determinable fair value. The fair value of an equity security is considered "readily determinable" if any of the following three criteria is satisfied (see SFAS No. 124, ¶3):

- Sales prices (or bid-and-asked quotations) are currently available on a securities exchange registered with the Securities Exchange Commission (SEC) or in the over-the-counter market, if those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations (NASDAQ) systems or by Pink Sheets LLC (see http://www.pinksheets.com);

NOTE: The fair value of restricted stock meets this criteria if the restriction terminates within 1 year.

- For equity securities traded only in a foreign market, if that foreign market is of a breadth and scope comparable to one of the above-mentioned American markets;
- For mutual fund investments, if the fair value per unit is determined and published and operates the basis for current transactions.

Investments without readily determinable fair value. For investments that do not have a readily determined fair value (*e.g.,* nonmarketable investments or alternative investments), NPOs may elect to carry these investments at fair value (see Not-for-Profit Entities—AICPA Audit and Accounting Guide, chap 8, App A (2009)). When an NPO elects *not* to carry the investments at fair value, the investments are referred to as cost-method investments and may be carried at the lower of historical cost or fair value, which is really impaired cost. See Financial Accounting Standards Board (FASB) Staff Position 124-1. Impairment indicators that could indicate the fair value of the investment include (FASB Staff Position 124-1, ¶10):

- A significant deterioration in the investee's earnings performance, credit rating, asset quality, or business prospects;
- A significant adverse change in the investee's regulatory, economic, or technological environment;
- A significant negative change in the general market condition of the geographic area where or the industry in which the investee operates;
- A bona fide offer to purchase, the investee's offer to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment; and
- Factors causing significant concerns about whether the investee will continue as a going concern, including negative operational cash flows, lack of working capital, and failure to satisfy statutory capital requirements or debt covenants.

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§21.66 1. Investment Income

Investment income includes dividends, interest, rents, royalties, and similar payments and should be recognized as earned. Investment income should be reported as an increase in unrestricted, temporarily restricted, or permanently restricted net assets, depending on donor stipulations on the use of the income. For example, if the income is not subject to any donor-imposed restrictions on its use, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity with the income to be used to support a specified program. In this situation, the initial gift creates permanently restricted net assets, and the investment income is temporarily restricted for the support of the donor-specified program. When the restrictions on the income are met, the statement of activities should report a reclassification from temporarily restricted net assets to unrestricted net assets. See Statement of Financial Accounting Standards (SFAS) No. 117, ¶¶19-23.

A statement of activities must ordinarily report the gross amounts of revenues and expenses. However, the statement may report investment revenue net of related expenses (including custodial and investment advisory fees) if the amount of the related expenses is disclosed either in the statement itself or in notes to financial statements. SFAS No. 117, ¶24.

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§21.67 2. Unrealized and Realized Gains and Losses

Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income, and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (*e.g.,* when the investments are carried at fair value), but not in others (*e.g.,* when the investments are carried at cost). To the extent that unrealized gains and losses are recognized, they should be reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period. See Statement of Financial Accounting Standards (SFAS) No. 117, ¶22.

Realized gains and losses arise from selling or otherwise disposing of investments and are reported in the statement of activities as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. Unrealized versus realized gains and losses need not be separately disclosed in the statement of activities. If realized gains and losses result from the disposition of investments for which unrealized gains and losses have been recognized in the statement of activities for prior reporting periods, the amount reported in the statement of activities as gains or losses on the sale or other disposition of the investments should exclude amounts previously recognized in the statement of activities.

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§21.68 3. Donor-Restricted Endowment Funds

A donor's stipulation requiring a gift to be invested for a specified term or in perpetuity creates a donor-restricted endowment fund. See Statement of Financial Accounting Standards (SFAS) No. 124, ¶11. An express donor restriction or relevant law may require an NPO to treat gains and losses (net appreciation) as subject to the same donor stipulation unless the donor specifies to the contrary. Accordingly, absent donor stipulations or law to the contrary, donor restrictions on the use of income of an endowment fund also extend to the net appreciation on the endowment fund. In contrast, if the donor permits the NPO to select investments, any resulting gains are not permanently restricted unless the donor or the law requires that an amount be retained permanently. These gains are unrestricted if the investment income is unrestricted, or are temporarily restricted if the donor temporarily restricts investment income. SFAS No. 124, ¶11.

PRACTICE TIP: Not-for-profit organizations must assess the relevant facts and circumstances of their endowment gifts and applicable law to determine if net appreciation on endowments is unrestricted or permanently restricted. SFAS No. 117, ¶125.

Losses on investments of a donor-restricted endowment fund, absent donor restriction or law to the contrary, reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Remaining losses reduce unrestricted net assets. SFAS No. 124, ¶12. However, if losses reduce the assets of a donor-restricted endowment fund below the level mandated by donor stipulations or law, any subsequent gains that restore the fair value of the fund assets to the requisite level are classified as increases in unrestricted net assets. SFAS No. 124, ¶13.

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§21.69 4. Disclosures

Statement of activities. Not-for-profit organizations must disclose the following for each period for which an NPO presents a statement of activities (Statement of Financial Accounting Standards (SFAS) No. 124, ¶14):

- The composition of investment return, addressing investment income, net gains or losses on investments reported at fair value, and net realized gains or losses on investments reported at other than fair value; and
- If investment return is separated into operating and nonoperating amounts, a reconciliation of investment return to amounts reported in the statement of activities.

Statement of financial position. Not-for-profit organizations must disclose the following for each period for which an NPO presents a statement of financial position (SFAS No. 124, ¶15):

- The aggregate carrying amount of investments, segregated by major types (*e.g.,* equity securities, corporate debt securities, and real estate);
- The basis for ascertaining the carrying amount for investments, not including debt securities and equity securities with readily determinable fair values;
- The means and significant assumptions that the NPO used to estimate fair values;
- The aggregate amount of the deficiencies for all donor-restricted endowment funds, if the assets' fair value is less than the level required by donor stipulations or applicable law as of the reporting date; and
- The nature of and carrying amount for each single investment or group of investments that represents a significant concentration of market risk (SFAS No. 124, ¶16).

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§21.70 5. Pooled Investments

An NPO may pool all or part of its investments for portfolio management purposes. The number and the nature of the pools may vary from organization to organization.

Once a pool is established, ownership interests are initially assigned to the various pool categories based on the fair value of the cash and securities placed in the pool by each participant. Current fair value is used to determine the number of units allocated to additional assets placed in the pool and value withdrawals from the pool, much like a mutual fund. Investment income and realized gains and losses (and any recognized unrealized gains and losses) would then be allocated equitably to each pool participant based on the number of units assigned to each. The valuation (*e.g.,* monthly or quarterly) would also determine when participants may add to or liquidate portions of their pool investment.

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§21.71 6. Spending Rate

Some NPOs manage their investments on a total return basis. Under the total return concept, organizations focus on the overall return on their investments, including both investment income and net appreciation. They then use a spending-rate formula to determine how much of that return will be used for current operations.

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) prescribes guidelines for the expenditure of endowment funds in the absence of explicit donor restrictions. UPMIFA provides more flexibility to organizations for handling "underwater "situations (*i.e.,* when the fair value of the fund is temporarily less than historic dollar value) by eliminating the historic dollar value concept. However, elimination of the historic dollar concept raises questions about the potential impact of that change on net asset classifications. For detailed discussion of UPMIFA, see chap 16.

NOTE: The Uniform Management of Institutional Funds Act of 1972 (UMIFA) (former Prob C §§18500-18509) was the model act on which most states based their laws governing the investment and management of donor-restricted endowment funds. UMIFA allowed only for the spending of the net appreciation on endowment investments in excess of the "historic dollar value" of the underlying gifts. In "underwater" situations, no further spending was permitted. Thus, donor-restricted endowments would be maintained in the permanently restricted net asset category at historic cost, or corpus, value unless the donor specifically stated that a portion of investment income was to be added to the historic basis. However, almost all states have adopted UPMIFA, the amended model act.

In August, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position 117-1 (endowments of not-for-profit organizations: net asset classification of funds subject to enacted version of UPMIFA, and enhanced disclosures for all endowment funds) that provides guidance concerning:

- The disclosures that NPOs should make with regard to their endowment funds; and
- The effect of a state's adoption of UPMIFA on the classification of net assets related to donor-restricted endowment funds of NPOs in that state.

The key provisions require expanded disclosures for all donor-restricted and board-designated endowment funds, whether or not the NPO is subject to UPMIFA, including (FASB Staff Position 117-1, ¶¶10-11):

- A description of the board's interpretation of the law governing the net asset classification of donor-restricted endowment funds;
- A description of the NPO's endowment spending policies;
- A description of the NPO's endowment investment policies and the means used to achieve the NPO's objectives;
- The composition of the NPO's endowment by net asset classification as of the end of the relevant period, separating donor-restricted endowment funds from board-designated endowment funds; and
- A reconciliation of the beginning and ending balances of the NPO's endowment, in total and by net asset class.

Not-for-profit organizations must also provide information about the nature and types of permanent or temporary restrictions and the aggregate amount of any deficiencies for all donor-restricted endowment funds. See FASB Staff Position 117-1, ¶12; see also SFAS No. 117, ¶¶14-15 and SFAS No. 124, ¶15.

NOTE: The Staff Position provides an illustrative example of these required disclosures. See FASB Staff Position 117-1, App. C.

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§21.72 B. Valuation: New Guidance

SFAS No. 157. For fiscal years beginning after November 15, 2008, a new and significant accounting pronouncement will apply to fair value measurements of financial assets. Statement of Financial Accounting Standard (SFAS) No. 157 establishes a framework for measuring fair value using GAAP, specifically defines "fair value," and mandates certain disclosures about fair value measurements. Because fair value is the relevant measurement attribute, SFAS No. 157 also applies under other accounting pronouncements that require or permit fair value measurements. Although SFAS No. 157 does not require any new fair value measurements, some entities may need to revise their accounting practices. SFAS No. 157 ¶1.

Implementation dates. Specific implementation dates are as follows (see SFAS No. 157, ¶¶36-39):

- For financial assets, liabilities and nonfinancial assets, and liabilities recognized or disclosed at fair value on a recurring basis, the new statement is effective for periods beginning after November 15, 2007. For calendar fiscal year ends (FYEs) of December 31, the implementation date is January 1, 2008. For June 30 FYEs, the implementation date is July 1, 2009.
- For other nonfinancial assets and liabilities, the new statement is effective for periods beginning after November 15, 2008. For December 31 FYEs, the implementation date is January 1, 2009. For June 30 FYEs, the implementation date is July 1, 2010.
- The implementation date will be applied prospectively (similar to the change in the estimate) as of beginning of the fiscal year in which the statement is initially applied.

Key definitions for assessing the above implementation dates are:

- "**Financial asset**" includes cash, evidence of an ownership interest in an entity, or a contract that conveys a right to receive cash or exchange other financial instruments.
- "**Financial liability**" includes a contract that imposes an obligation to deliver cash or exchange other financial instruments.

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§21.73 1. "Fair Value" Under SFAS No. 157

Fair value is a pervasive concept in current accounting guidance. There are 67 Financial Accounting Standards Board (FASB) statements that require or permit the use of "fair value." Statement of Financial Accounting Standard (SFAS) No. 157 will provide a common definition of fair value and require additional disclosure in the notes to the financial statements. Although the new statement does not state *when* to use fair value, it states *how* to determine fair value when that is the measurement basis permitted or required in existing pronouncements.

Other standards that will be affected. The following are standards that are specific to NPOs that will be impacted by SFAS No. 157:

- SFAS No. 116 (contributions);
- SFAS No. 124 (marketable securities);
- SFAS No. 136 (beneficial interests);
- SFAS No. 159 (contributions receivable, split-interest obligations, other); and
- Financial Accounting Standards Board (FASB) NPO Mergers & Acquisitions Exposure Draft (this is a proposed FASB statement that is not final).

In addition, the new statement will affect many generally accepted accounting principles (GAAP) standards that also apply to NPOs, such as asset impairments, asset retirement obligations, derivatives, nonmonetary transactions; and pension assets.

"Fair value" defined. This statement clarifies that "[f]air value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." SFAS No. 157, ¶5. The exchange price is the price that could be obtained in the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). This distinction is the key difference in applying SFAS No. 157.

NOTE: Historically, "value" would be what a buyer paid for an item. However, the concept of "fair value" is understood to be different from cost if acquisition item is a foreclosed or distressed property; in this case, the buyer hopes that the purchase price of a foreclosed house is lower than the fair value. This is the same concept under SFAS No. 157: what someone would be willing to pay to acquire the asset in an orderly (*i.e.,* not distressed) transaction.

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§21.74 2. Key Definitions and Concepts

In addition to "fair value," other key definitions and concepts expressed in Statements of Financial Accounting Standards (SFAS) No. 157 include:

- "**Market participants**" are buyers or sellers in the principal (or most advantageous) market for an asset or liability.
- "**Principal market**" is the market with the greatest volume or level of activity in which the NPO could sell the asset or transfer the liability.
- "**Highest and best use**" is the highest and best use of an asset from a market participant perspective, regardless of management's intended use.
- "**Fair value hierarchy**" prioritizes inputs used in valuation techniques. Techniques should maximize the use of observable inputs and minimize the use of unobservable inputs.

NOTE: The term "inputs" means the assumptions that market participants would use to price an asset or liability and includes assumptions about risk. See SFAS No. 157, ¶21.

- **Valuation techniques** refers to techniques consistent with the market approach, income approach, or cost approach that are required to be used to determine fair value (see SFAS No. 157, ¶¶18-20).
- **Orderly transaction** refers to a hypothetical transaction at measurement date and not a forced sale (see SFAS No. 157, ¶7).

NOTE: One area that is unique to NPOs is a potential donor restriction on an asset. See SFAS No. 157, App A, example 9. Generally, an NPO would need to consider if the donor restriction attaches to the asset, which could impair the exit price or fair value, or only to the NPO while the asset is in its possession, which would probably not impact the fair value.

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§21.75 3. Valuation Techniques

Statement of Financial Accounting Standards (SFAS) No. 157 discusses three specific valuation techniques:

(1) **Income approach:** The income approach uses valuation techniques to convert future amounts (*e.g.,* cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.

(2) **Market approach:** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the qualitative and quantitative measurement.

(3) **Cost approach:** The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

Inputs. In terms of valuation and related disclosure, SFAS No. 157 establishes a fair value hierarchy that prioritizes inputs to valuation techniques used to measure fair value. Valuation techniques should maximize the use of observable inputs and minimize the use of unobservable inputs:

- **Level 1 inputs:** Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets (*e.g.,* stock quotes);
- **Level 2 inputs:** Includes other than Level 1 inputs that are directly or indirectly observable in the marketplace (*e.g.,* yield curves, market data); and
- **Level 3 inputs:** Unobservable inputs (*e.g.,* a company's internal information).

EXAMPLE: An equity security that trades regularly on a public exchange such as the NYSE would be a Level 1 investment. A debt security that does not trade regularly on a public exchange, but for which there are quoted prices of similar assets in an inactive market or else yield and interest rate curves or other observable market data, could be a Level 2 investment. Everything else is Level 3. The impact of adoption of SFAS No. 157 could range from minimal to significant.

For alternative investments when the NPO has elected fair value under SFAS No. 124, the hierarchy inputs could be:

- Level 1: Quoted prices for identical assets in an active market.
- Level 2: Quoted prices of similar assets in an inactive market:
- Observable market data (*e.g.*, yield/interest rate curves); and
- Buy/sell or other equity transactions proximate to the measurement date.
- Level 3: Bid/ask spreads:
- Liquidity discounts; and
- Equity transactions not proximate to the measurement date.

The expected impact on the statement of position could be minimal to significant.

(4) **Net asset value.** The Financial Accounting Standards Board (FASB) Accounting Standards Update No. 2009-12 (ASU No. 2009-12) provides additional guidance on how companies should estimate the fair value of certain alternative investments such as hedge funds, private equity funds, and venture capital funds.

The fair value of such investments can be determined using net asset value (NAV) as a practical expedient, unless it is probable the investment will be sold at something other than NAV. In those situations, the practical expedient cannot be used and disclosure of the remaining actions necessary to complete the sale will be required.

New disclosures of the attributes of all investments within the scope of the guidance is required, regardless of whether an entity used the practical expedient to measure the fair value of any of its investments.

ASU No. 2009-12 is effective for the first annual or interim reporting period ending after December 15, 2009, with early application permitted. Reporting entities that elected to early adopt its provisions were not required to early adopt the disclosure provisions.

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§21.76 4. SFAS No. 157 Disclosures

Disclosures under Statements of Financial Accounting Standards (SFAS) No. 157 focus on the following (SFAS No. 157, ¶¶32-35):

- The extent to which companies measure assets and liabilities at fair value;
- The methods and assumptions used to measure fair value; and
- The effects of fair value measures on earnings.

Disclosure requirements vary depending on whether the asset or liability is measured on a recurring or nonrecurring basis. SFAS No. 157, ¶¶32-33.

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§21.77 5. Fair Value Option Under SFAS No. 159

Under Statement of Financial Accounting Standards (SFAS) No. 159, an NPO has the option to *elect* fair value for certain assets.

Eligible assets. In general, the following assets are eligible for the election:

- All recognized financial assets and financial liabilities, including:
- Investments accounted for under the equity method;
- SFAS No. 124 securities; and
- Alternative investments carried at cost.
- Pledges and split-interest agreements.
- Debt.
- Interest rate swaps.

Ineligible assets. In general, the following assets are not eligible for the election:

- Investments in subsidiaries required to be consolidated.
- Employer-benefit related obligations and assets (*e.g.,* pensions and post-retirement benefits).
- Financial assets and financial liabilities recognized pursuant to leases.

NOTE: Effective for fiscal years beginning after November 15, 2007, prospective application is required and any transition gain or loss is treated as a cumulative-effect adjustment. The author does not expect many NPOs to elect fair value under SFAS No. 159.

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§21.78 6. Other Valuations

Statement of Financial Accounting Standards (SFAS) No. 133, on accounting for derivative instruments and hedging activities, may apply if an NPO has entered into hedging activities to protect the valuation of an investment portfolio or interest rate swaps related to tax-exempt debt.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.79 VIII. AGENCY TRANSACTIONS AND INTERRELATED ORGANIZATIONS

§21.79 VIII. AGENCY TRANSACTIONS AND INTERRELATED ORGANIZATIONS

Some NPOs act as agents, trustees, or intermediaries helping donors to make a contribution to another entity or individual. When acting in one of those capacities, these NPOs do not receive a contribution when they receive the assets, nor do they make a contribution when they disburse the assets to the other entity or individual. Instead, they act as go-betweens, passing the assets from the donor through their organization to the specified entity or individual. When the NPO acts as an agent, trustee, or intermediary for donors who are making contributions to another entity or individual, the NPO is subject to the guidance of Statement of Financial Accounting Standards (SFAS) No. 136, which establishes standards for transactions that are referred to as agency transactions.

NOTE: Federated fundraising organizations, community foundations, and institutionally related organizations are examples of NPOs that commonly serve as agents, trustees, or intermediaries, and engage in agency transactions. However, any organization can function in these capacities.

In general, if a donor specifies a beneficiary, the recipient organization should not recognize a contribution. A donor may specify the beneficiary by name, by defining all entities that meet a set of donor-defined criteria as beneficiaries, or by actions surrounding the transfer that clarify the identity of the beneficiary. SFAS No. 136, ¶68.

The AICPA book, Not-for-Profit Entities—AICPA Audit and Accounting Guide ¶5.08 (2009), lists three examples when a donor may specify a beneficiary and the recipient organization should not recognize a contribution:

> If a donor selects a beneficiary from among a list of potential beneficiaries that have been prequalified or otherwise identified by the recipient not-for-profit organization, the assets received are not contributions to that recipient organization. Similarly, if a grantor specifies eligibility criteria and states that the grant proceeds must be transferred to all who meet those criteria, the recipient not-for-profit organization has not received a contribution even though it may be responsible for determining whether individuals or entities meet those grantor-specified eligibility criteria. Likewise, if a donor responds to a campaign request from an organization that indicates that the proceeds of the campaign will be distributed to a named beneficiary, that recipient organization has not received a contribution.

For exceptions, see AICPA Audit Guide, ¶¶5.13-5.17 (discussions of variance power and financially interrelated organizations).

Alternatively, if neither the language used by the donor, the representations of the recipient organization, nor the actions surrounding the transfers cause the donor to believe that he or she is directing the gift to a specified beneficiary, then the NPO is a donee and should recognize a contribution received (AICPA Audit Guide, ¶5.09):

> For example, an organization is a donee and should recognize a contribution if it asks the donor to select one or more fields of interest from among a list of community needs prepared by the not-for-profit organization. Similarly, if a donor uses broad generalizations to describe the beneficiaries, such as homeless individuals, the not-for-profit organization has received a contribution because the choice of the beneficiary is within its control. Likewise, if an organization asks its donors to indicate an organization for consideration by its allocation committee, the not-for-profit organization is the donee if that request is conveyed in a manner that leads the donor to conclude that its role is merely to propose possible allocations.

Variance power defined. Variance power is the *unilateral power* to redirect the use of the transferred assets to an entity or individual other than the specified beneficiary or beneficiaries. If a donor explicitly grants a recipient organization variance power and names an unaffiliated beneficiary, the recipient organization is a donee and recognizes contribution revenue. "Explicitly grants" means that the donor should explicitly refer to the recipient organization's ability to exercise variance power in the instrument that transfers the assets. "Unaffiliated" means that the beneficiary is other than the donor or the donor's affiliate as defined in SFAS No. 57. "Unilateral power" means that the recipient organization can override the donor's instructions without approval from the donor, the beneficiary, or any other interested party. Variance power provides the recipient organization with discretion sufficient to recognize a contribution received despite the specification of a beneficiary by the donor. SFAS No. 136, ¶12.

If the recipient organization is explicitly granted variance power, then the specified unaffiliated beneficiary should not

recognize its potential for future distributions from the assets held by the recipient organization. Those distributions, if they occur, should be recognized as contributions by the specified beneficiary when received or unconditionally promised. SFAS No. 136, ¶16.

Cash or other financial assets received in transactions in which an NPO is acting as an agent, trustee, or intermediary for a resource provider should be reported as increases in assets and liabilities; distributions to the specified third party beneficiaries should be reported as decreases in those accounts. Both the asset and the liability should be measured at the fair value of the assets received. If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the recipient organization may choose either to (1) report the receipt of the assets as a liability to the beneficiary concurrent with recognition of the assets received, or (2) not report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period.

In general, a specified beneficiary recognizes its rights to the assets held by a recipient organization as either a beneficial interest (an asset) or a receivable. If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary has a beneficial interest. The beneficiary would then recognize its interest in the beneficial trust as an asset and a contribution received, measuring and subsequently remeasuring it at fair value.

NOTE: For criteria to determine if the NPO has received a contribution or is functioning as an agent, see the table in §21.97.

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IX. OTHER ACCOUNTING ISSUES FOR NONPROFIT ORGANIZATIONS

§21.80 A. Federal and Government Funding

It is common for NPOs to obtain funding either from the federal government or from state and local agencies. See §§21.81-21.87. Examples of this funding include research and development funds, student financial assistance funds, and funds to provide a service to a particular sector of the population. The funding referenced in this chapter is that funding that is obtained outside of a "vendor" relationship. The NPO is not a vendor to the government agency.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.81 B. Federal Funding

§21.81 B. Federal Funding

When audit required; scope. Federal rules indicate, under Office of Management and Budget Circular A-133 (Audits of States, Local Governments, and Non-Profit Organizations), that if an organization expends federal funds in excess of $500,000 in a year, an audit in accordance with Circular A-133 must be performed. A Circular A-133 audit must be performed by the external auditors and will include:

- Expanded testing of internal controls over financial reporting;
- Testing of internal controls involving federal funds; and
- Testing that the federal funds were expended in a manner consistent for the purpose in which they were given.

To perform this audit, the external auditors will need copies of any agreements with the federal government, so that they are aware of the specific requirements attached to the particular funds. This audit also typically involves organization employees outside of the business office, as they are responsible for the proper spending of the funds and conducting the research or providing the specified services.

Yellow book standards. Circular A-133 audits are conducted under generally accepted government auditing standards, known as "Yellow Book standards." These standards provide additional independence requirements to which the external auditors must adhere, and may further limit any additional services the external auditor might provide to the organization.

NOTE: Federal grants and contracts usually also involve periodic reporting to the funding agency as to the progress or outcome achieved with the funds. These are nonfinancial reports and are ordinarily not reviewed by the external auditors.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.82 C. Nonfederal Government Funding

§21.82 C. Nonfederal Government Funding

An NPO may receive funding from government agencies such as states, cities, and counties. These funds may require separate audits by external auditors, or that the external auditor include these funds within his or her Office of Management and Budget Circular A-133 (Audits of States, Local Governments, and Non-Profit Organizations) audit report and subject those funds to testing in a manner similar to Circular A-133 requirements. The NPO should ensure that such funds do not contain federal awards, which could trip the Circular A-133 audit requirement.

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§21.83 1. Tax-Exempt Financing

Tax-exempt debt. In many situations, NPOs are eligible to issue debt in the public market for which the interest paid to the bondholders is exempt from federal or state tax. This tax-exempt debt is usually issued through a conduit entity because NPOs are typically prohibited from issuing public debt directly. The conduit entities may include state agencies, county agencies, or cities.

The ability to issue debt that is exempt from certain income taxes typically allows NPOs to issue debt at lower interest rates than debt issued by for-profit entities. However, tax-exempt debt has certain restrictions on what the funds can be used for (*e.g.,* it cannot be used for religious purposes and must be spent within a specified period of time).

Taxable debt. Not-for-profit organizations can also issue normal or taxable debt, in which the bondholders would have to pay federal and state income tax on the interest earned. The upside to this type of debt is that there are no restrictions on its use. However, on the downside, the interest rate is generally greater than for tax-exempt debt. Taxable debt is issued in a manner consistent with tax-exempt debt.

Through these arrangements, the conduit agency is directly responsible for repaying of the debt and the NPO is responsible for making payments to the conduit agency before the date payments are required to the bondholders.

Reporting requirements. Public debt requires the organization to periodically report the funds spent to date and the purposes for which the funds were spent, as well as to demonstrate compliance with certain covenants that may have been included within the borrowing agreement. These covenants should be carefully monitored by management and the board to ensure that the organization does not violate any of the covenants. Any violation of debt covenants could cause all of the remaining debt associated with that specific issuance to be due and payable.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.84 2. Functional Expenses

§21.84 2. Functional Expenses

Not-for-profit organizations are required to report their expenses by their functional purpose (or functional category). These categories could include, *e.g.,* Program, Instruction, Academic Support, Management and General, and Auxiliary.

NOTE: The definitions of the functional expense categories are specified in the Not-for-Profit Entities—AICPA Audit and Accounting Guide (2009), as well as in certain industry-specific literature (*e.g.,* materials produced by the National Association of College and University Business Officers).

PRACTICE TIP: Expenses should be coded when recorded into the appropriate functional expense category so that no additional work is required at the end of the fiscal year to produce the required information for the external auditors.

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§21.85 3. Fundraising Expenses and Joint Costs

Not-for-profit organizations commonly solicit funds through a variety of means, including direct mailing campaigns, phone solicitations, and special events. It is not uncommon for these fundraising efforts to include aspects of other activities or purposes. That is, some NPOs might include an educational piece of material (*i.e.,* what their programs accomplish) with a plea for donations. This type of mailing would include both a fundraising component as well as a program, or educational, component.

Allocation of costs. The costs of the solicitation must be allocated between functional categories. The American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 98-2. Management must determine the audience, purpose, and content of a solicitation to determine if any of the costs should be allocated to a functional expense other than fundraising. (Such an allocation could be important to the organization because certain donors and evaluation methods examine the organization's cost to raise a dollar.) The AICPA SOP 98-2 provides the specific criteria that an organization must use for this analysis.

If any expenses are identifiable to another function and those expenses can be clearly identified, then they can be recorded into the other functional expense category. If such a determination is not possible, then the unidentifiable expenses are recorded as fundraising expenses.

PRACTICE TIP: Generally accepted accounting principles (GAAP) require NPOs to separately disclose the cost of fundraising annually.

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§21.86 4. Special Events

Many NPOs hold various fundraising events. Some of these events are annual recurring events (*e.g.,* president's dinner) where the attendees (donors) receive a direct benefit (*e.g.,* dinner or a concert), while other events could be considered unusual and one-time events (*e.g.,* 100th Anniversary gala). The accounting rules could require an organization to report these items differently in its statement of activities (see §§21.31-21.34).

Recurring events. For recurring events with a direct donor benefit, the organization must report the gross revenue from the event and the gross amount of the cost of the event (including the direct donor benefit).

EXAMPLE: An organization holds a president's dinner. Total revenue from the event (ticket sales) is $1000, and the cost to put on the event was $800. The organization would report gross revenue of $1000 and gross expenses of $800, for net revenue of $200.

One-time events. If the organization holds a one-time event, then it may elect to report the activity on a net basis or a gross basis. Factors that should be considered in determining the reporting basis include amounts involved (on both a gross and net basis) and materiality to the financial statements, the potential audience for the financial statements, and the NPO's emphasis on transparency.

For further discussion, consult the Not-for-Profit Entities—AICPA Audit and Accounting Guide (2009).

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§21.87 5. Allocation of Overhead Costs

An NPO may incur certain direct expenses that that are recorded in total but benefit multiple departments or functions. Electricity is one such example. If an organization does not have a separate meter for each department, then it will receive one electric invoice for the entire organization. If separate meters were installed for each department, then each meter's invoice would be recorded to the specifically related functional expense category. If separate recording is not possible, the expenses must be allocated to the various departments or functional expense categories using a methodology that is both reasonable and consistent year-to-year.

PRACTICE TIP: Management should discuss the recording methodologies with the external accountants to ensure that they concur with the methodology used.

Allocation is commonly accomplished by, *e.g.,* square footage used, number of employees, or phone lines. Different methodologies may be used for different expenses. For example, if the organization receives only one telephone bill, it probably does not make much sense to allocate the bill based on square footage instead of the number of phone lines in each department.

Some functional expenses an NPO incurs will benefit more than one functional expense category. For example, the cost of the physical plant department (or facilities management) benefits the entire organization. Accounting guidance requires that these expenses be allocated across the different functional expense categories using a methodology that is reasonable and consistent year-to-year. Again, square footage is the most common methodology management uses.

In allocating expenses, management first allocates direct expenses to all the various departments, including electricity, sewer, depreciation, and interest. After allocating direct expenses, management then allocates the expenses that support multiple departments.

NOTE: The financial statements from peer organizations can provide good examples of the types of functional categories that the NPO should consider.

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.88 X. ACCOUNTING FOR CERTAIN SPECIFIC NONPROFIT ORGANIZATIONS

§21.88 X. ACCOUNTING FOR CERTAIN SPECIFIC NONPROFIT ORGANIZATIONS

Not-for-profit organizations are a type of tax classification rather than just an industry, and within the not-for-profit world, there are many types of organizations. See §§21.89-21.93.

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§21.89 A. Health Care Providers

If the financial statements of NPOs were arrayed along a continuum based on complexity, the financial statements of most health care providers would be among the most complex. Although many health care providers may receive support from religious and fraternal organizations, individuals, corporations, and other donors or grantors, most are essentially self-sustaining—that is, they finance their capital needs primarily from the proceeds of debt issues and their operating needs largely from revenues from health care services provided. Health care providers have a separate audit guide, and are required to present their statement of activities (see §21.32) on an operating or nonoperating basis with those revenues that can be included in specifically defined operations.

The AICPA continues to be the primary source of guidance relating to specific accounting principles for health care organizations. The AICPA guide, Health Care Organizations—AICPA Audit and Accounting Guide (2008) applies to entities possessing both of the following characteristics:

- The principal operations involve providing health care services to individuals; and
- The organization is basically self-sustaining from fees charged for services.

Consequently, health care organizations whose primary sources of income are contributions rather than fees for services are considered to be voluntary health and welfare organizations (see §21.92). Voluntary health and welfare organizations follow the guidance in another guide, Not-for-Profit Entities—AICPA Audit and Accounting Guide (2009).

NOTE: For further discussion of accounting principles applicable to health care organizations, consult Gross, McCarthy & Shelmon, Financial and Accounting Guide for Not-for-Profit Organizations (7th ed 2005).

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§21.90 B. Colleges and Universities

Colleges and universities are among the most important and influential types of nonprofit institutions. While their accounting requirements follow those outlined throughout this chapter, colleges and universities will tend to have more split-interest agreements (see §21.64), as well as more true and quasi-endowment funds, when compared to other NPOs. Colleges and universities also tend to receive substantial grants from the federal government for student financial aid and/or research and development, both of which are core to their operations. In addition, these entities typically have larger accounts receivable (*e.g.,* student accounts receivable) than many other types of NPOs.

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§21.91 C. Governmental Colleges, Universities, and NPOs

The Governmental Accounting Standards Board (GASB) is a private, not-for-profit organization that was formed in 1984 to set accounting and financial reporting standards for state and local governments. The GASB's oversight and rules extend to include public colleges and universities (*e.g.,* University of California) as well as not-for-profits associated with such universities (*e.g.,* University of California, Los Angeles (UCLA) Foundation). The accounting requirements of GASB are similar to what has previously been discussed in this chapter, but there also are significant differences, primarily in financial statement presentation and required disclosures, that are beyond the scope of this chapter. For further guidance, consult Gross, McCarthy & Shelmon, Financial and Accounting Guide for Not-for-Profit Organizations (7th ed 2005).

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§21.92 D. Voluntary Health and Welfare Organizations

Before the issuance of Statements of Financial Accounting Standards (SFAS) Nos. 116 and 117, there were three separate audit guides for NPOs: (1) colleges and universities, (2) voluntary health and welfare organizations, and (3) certain non-profits. These entities were all combined into one audit guide with the issuance of SFAS Nos. 116 and 117. However, one basic difference remains: the requirement that voluntary health and welfare organizations must continue presenting a statement of functional expenses as one of their basic financial statements. A statement of functional expenses is useful in associating expenses with the service efforts and accomplishments of NPOs.

Voluntary health and welfare organizations are defined as organizations formed for the purpose of performing voluntary services for various segments of society. They are tax-exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare organizations concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of society in general and, in many situations, those of specific individuals. As a group, voluntary health and welfare organizations include NPOs that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services.

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§21.93 E. Private Foundations

"Private foundations" are defined in IRC §509. These organizations generally do not solicit funds from the public but are supported principally by endowment income and gifts from the initial donor or family. The primary issue is the recording of grants payable, which tends to be more significant to private foundations than other entities.

According to the AICPA guide, Not-for-Profit Entities—AICPA Audit and Accounting Guide ¶10.06 (2009), unconditional promises to give should be recognized when the donor is obligated to transfer the promised assets in the future. The duty to transfer ordinarily arises when the donor approves a specific grant or when the recipient is notified. If a donor expressly reserves the right to rescind an intended gift, or if the express terms of a solicitation permit the donor to rescind, the donor should not recognize the promise to give. When payments on an unconditional promise will be made to a recipient over several accounting periods and the recipient is not subject to heightened performance requirements, the foundation should recognize a liability and an expense for the entire amount payable, measured at fair value. If the determination of fair value is based on the present value of the amounts to be paid, the discount rate should be determined when the unconditional promise to give is initially recognized. On the other hand, conditional promises to give should only be recognized when the conditions are substantially met.

For detailed discussion of private foundations, see chap 4.

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§21.94 XI. TRENDS IN FINANCIAL ACCOUNTING AND REPORTING FOR NOT-FOR-PROFIT ORGANIZATIONS; IMPORTANT WEBSITES

In 2008, FASB guidance affecting NPOs developed significantly. The coming years should also be particularly challenging as organizations begin to adopt Statements of Financial Accounting Standards (SFAS) No. 157 (fair value measurements; see §§21.72-21.76) and SFAS No. 159 (fair value option for financial assets and financial liabilities; see §21.77).

In addition, NPOs will continue to face challenges as they apply the "Day 2" accounting and measurement date provisions under SFAS No. 158 (employers' accounting for defined benefit pension and other postretirement plans).

In August 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position 117-1, providing guidance concerning endowment fund disclosures and the effect of the adoption of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510) on the classification of net assets related to donor-restricted endowment funds of NPOs in that state. By all appearances, FASB Staff Position 117-1 will increase the required disclosures for all endowments, not just those in states that have enacted UPMIFA.

In 2008, the IRS released the redesigned Form 990, Return of Organization Exempt from Income Tax. The redesign is the first comprehensive overhaul of the Form 990 in 30 years. Organizations will begin using the redesigned form for years beginning in 2008, and fiscal year taxpayers will use the new form for years ending in 2009. The IRS has indicated the Service may use the new Form 990 as a starting point for any redesign of the Form 990-PF for Private Foundations. On completing the redesigned Form 990, see §§12.2-12.21. On completing the Form 990-PF, see §12.24.

The credit crunch has been felt throughout the economy, particularly its ripple effects on the municipal market. The Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system was launched in 2009, providing investors and other interested parties access to the audited financial statements, material event notices, and other continuing disclosure documents filed by not-for-profit and governmental municipal bond issuers.

In addition, the advent of the International Financial Reporting Standards (IFRS) in the United States elevates concerns among not-for-profits and governmental business-type activities (BTAs) related to the comparability of financial reporting. Preparers, auditors, and financial statement users currently struggle with interpreting measurement differences in financial statements prepared under standards issued by FASB and GASB, which increasingly appear to be taking different paths on recognition and measurement guidance for similar transactions. The IFRS interjects a third set of standards.

Regulatory changes are also possible in the municipal securities market, a primary source of capital for many not-for-profit and governmental organizations. The events of the credit crisis demonstrated that the municipal market has become inextricably intertwined with the United States financial system as a whole and thus subject to regulatory oversight.

Finally, with respect to regulatory compliance issues, the American Recovery and Reinvestment Act of 2009 (ARRA) (Pub L 111-5, 123 Stat 115) brings the promise of new funding opportunities, but with significant monitoring, oversight, and reporting requirements that go well beyond what currently exists. The Higher Education Opportunity Act (Pub L 110-315, 122 Stat 3078) brings with it numerous changes to student financial aid regulations, but implementing regulations have not been finalized.

All of these developments indicate that the complexities of the accounting and reporting environment for NPOs continues to grow. Further, the increasing need to provide services in an efficient and effective manner puts additional pressures on NPOs. Because the issues in this area are emerging, the status of the resources cited in this chapter is subject to frequent changes. The latest status of these issues can be found on the following websites:

- American Institute of Certified Public Accountants (AICPA) (http://www.aicpa.org)
- Financial Accounting Standards Board (FASB) (http://www.fasb.org)
- United States Government Accountability Office (GAO) (http://www.gao.gov)

- Governmental Accounting Standards Board (GASB) (http://www.gasb.org)
- Internal Revenue Service (IRS) (http://www.irs.gov). In particular, see the section for "Charities & Non-Profits."
- Office of Management and Budget (OMB) (http://www.whitehouse.gov/omb)

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XII. TABLES AND DIAGRAMS

§21.95 A. Table: Indicators Useful in Distinguishing Contributions From Exchange Transactions

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Indicators Useful in Distinguishing Contributions From Exchange Transactions

Indicator	Contribution	Exchange Transaction
Recipient not-for-profit organization's (NPO's) intent in soliciting the asset [1]	Recipient NPO asserts that it is soliciting the asset as a contribution.	Recipient NPO asserts that it is seeking resources in exchange for specified benefits.
Resource provider's expressed intent about the purpose of the asset to be provided by recipient NPO	Resource provider asserts that it is making a donation to support the NPO's programs.	Resource provider asserts that it is transferring resources in exchange for specified benefits.
Method of delivery	The time or place of delivery of the asset to be provided by the recipient NPO to third-party recipients is at the discretion of the NPO.	The method of delivery of the asset to be provided by the recipient NPO to third party recipients is specified by the resource provider.
Method of determining amount of payment	The resource provider determines the amount of the payment.	Payment by the resource provider equals the value of the assets to be provided by the recipient NPO, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided.
Penalties assessed if NPO fails to make timely delivery of assets	Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NPO is not penalized for nonperformance.)	Provisions for economic penalties exist beyond the amount of payment. (The NPO is penalized for nonperformance.)
Delivery of assets to be provided by the recipient NPO	Assets are to be delivered to individuals or organizations other than the resource provider.	Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider.
[1] This table refers to assets. Assets may include services. The terms assets and services are used interchangeably in this table.		

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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.96 B. Table: Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues

§21.96 B. Table: Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues

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Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues

Indicator	Contribution	Exchange Transaction
Recipient NPO's expressed intent concerning purpose of dues payment	The request describes the dues as being used to provide benefits to the general public or to the NPO's service beneficiaries.	The request describes the dues as providing economic benefits to members or to other organizations or individuals designated by or related to the members.
Extent of benefits to members	The benefits to members are negligible.	The substantive benefits to members (*e.g.,* publications, admissions, educational programs, and special events) may be available to nonmembers for a fee.
NPO's service efforts	The NPO provides service to members and nonmembers.	The NPO benefits are provided only to members.
Duration of benefits	The duration is not specified.	The benefits are provided for a defined period; additional payment of dues is required to extend benefits.
Expressed agreement concerning refundability of the payment	The payment is not refundable to the resource provider.	The payment is fully or partially refundable if the resource provider withdraws from membership.
Qualifications for membership	Membership is available to the general public.	Membership is available only to individuals who meet certain criteria (*e.g.,* requirements to pursue a specific career or to live in a certain area).

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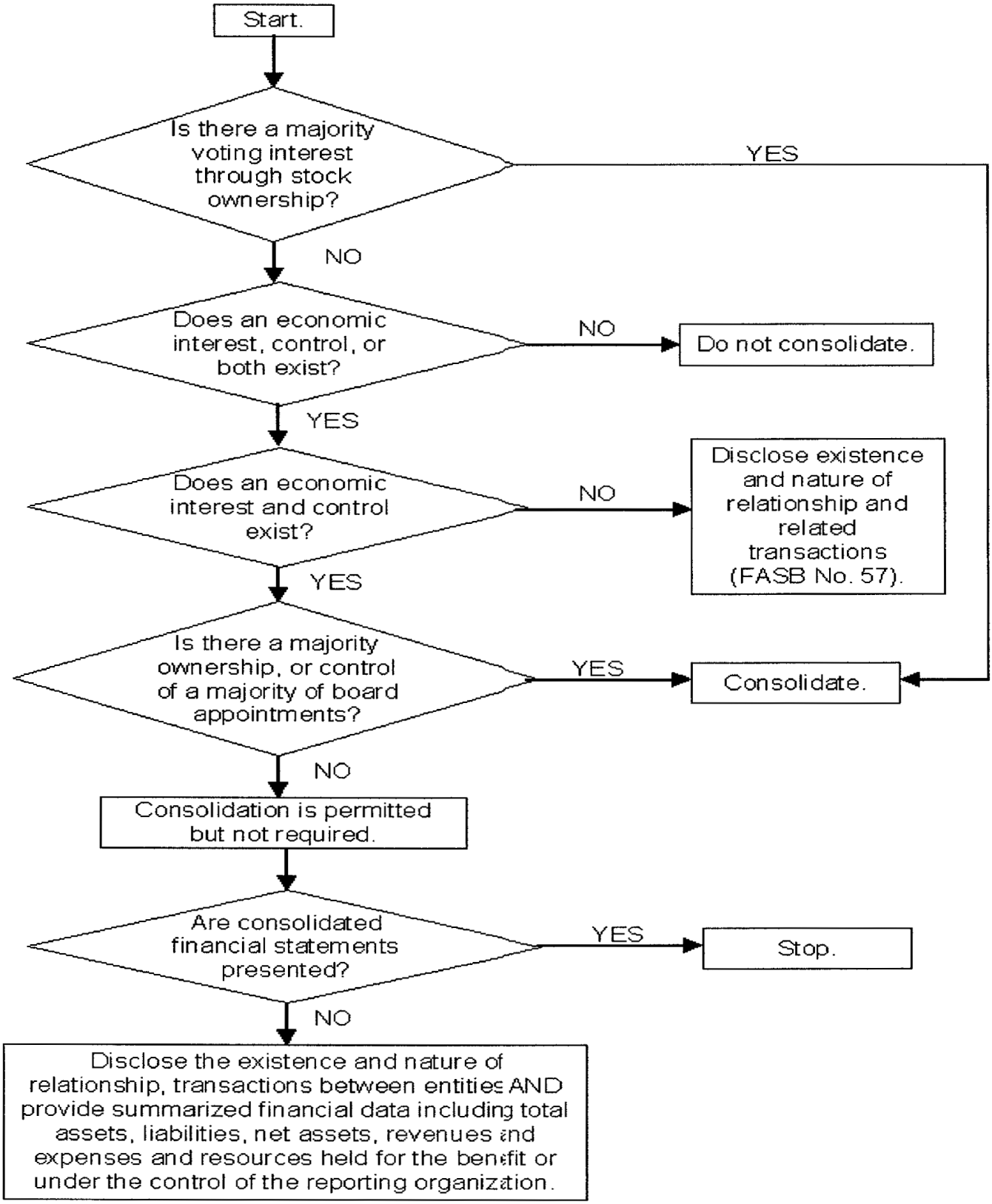
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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.97 C. Chart: Relationship With Another Not-for-Profit Organization

§21.97 C. Chart: Relationship With Another Not-for-Profit Organization



Relationship With Another Not-for-Profit Organization



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Source: Business Law/Advising California Nonprofit Corporations/21 Financial Accounting for Not-for-Profit Organizations/§21.98 D. Table: Factors to Be Considered in Assessing Whether a Donor Has Made a Bona Fide Pledge to a Donee

§21.98 D. Table: Factors to Be Considered in Assessing Whether a Donor Has Made a Bona Fide Pledge to a Donee

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Factors whose presence may indicate a bona fide pledge was made	**Factors whose presence may indicate a bona fide pledge was *not* made**
Factors related to the solicitation process	
• There is evidence that the recipient explicitly solicited formal pledges. • Public announcement of the pledge has been made (by donor or donee).[1] • Partial payment on the pledge has been made (or full payment after Balance Sheet date).	• The "pledge" was unsolicited or the solicitation did not refer to pledges. • No public announcement has been made. • No payments have yet been made, or payments have been irregular, late, or less than scheduled amounts.
Factors related to the "pledge" itself	
• There is written evidence created by the donor that clearly supports the existence of an unconditional promise to give. (This factor, if present, would normally be considered determinative.) • The evidence includes words such as: • Promise • Agree • Will • Binding • Legal • The pledge appears to be legally enforceable. (Consult an attorney if necessary.) • There is a clearly defined payment schedule, stated in terms of either calendar dates or the occurrence of specified events whose occurrence is reasonably probable.	• There is no written evidence[2], the only written evidence was prepared by the donee, or written evidence is unclear. • There is written evidence, but it includes such words as: • Intend • Plan • Hope • May • If expected • Legal enforceability is questionable, or explicitly denied. • A payment schedule is not clearly defined, or events are relatively unlikely to occur.
• The calendar dates or events comprising the payment schedule will (are	• The time (period) of payment contemplated by the donor is

expected) to occur within a relatively short time[3] after the balance sheet date (or in the case of events, have already occurred). • The amount of the pledge is clearly specified or readily computable. • The donor has clearly specified a particular purpose for the gift— *e.g.,* endowment, fixed assets, loan fund, retire long-term debt, specific program service. The purpose is consistent with ongoing donee activities.	relatively far in the future. • The amount is not clear or readily computable. • The purpose is vaguely stated or not specified, or is inconsistent with donee activities.
Factors relating to the donor	
• There is no reason to question the donor's intent to fulfill the pledge. • The donor has a history of making and fulfilling pledges to the donee of similar or larger amounts.	• Collectibility of the gift is questionable. • Factor not present
Factors relating to the donee	
• The donee has indicated that it would take action to enforce collection if necessary, or has a history of doing so. • The donee has already taken specific action in reliance on the pledge or publicly announced that it intends to do so.[4]	• It is unlikely (based on donee's past practices) or uncertain whether the donee would enforce the "pledge." • No specific action has been taken or is contemplated.

NOTES:

[1]The announcement would not necessarily have to be made to the general public; announcement in media circulated among the constituency of either the donor or donee would suffice. Examples include newsletters, fundraising reports, annual reports, or a campus newspaper. In the case of announcements by the donee, there should be a reasonable presumption that the donor is aware of the announcement and has not indicated any disagreement with it.

[2]The pledges can be considered bona fide under some circumstances. In the case of oral pledges, much greater weight will have to be given to other factors if the existence of a bona fide pledge is to be asserted.

[3]What constitutes a relatively short time has to be determined in each case. The longer the time contemplated, the more weight will have to be given to other factors in assessing the existence of a pledge. In most circumstances, periods longer than 3 to 5 years would likely be judged relatively long.

[4]Types of specific action contemplated include:

- Commencing acquisition, construction, or lease of capital assets or signing binding contracts to do so;
- Making public announcement of the commencement or expansion of operating programs used by the public (*e.g.,* opening a new clinic, starting

a new concert series, or presenting a special museum exhibit);
- Indicating to another funder that the pledge will be used to match part of a challenge grant from that funder;
- Soliciting other pledges or loans for the same purpose by explicitly indicating that "X has already pledged";
- Committing proceeds of the pledge in other ways such as awarding scholarships, making pledges to other charities, or hiring new staff (where such uses are consistent with either the donee's stated purposes in soliciting the pledge or the donor's indicated use of the pledge).

Comment: This table is a list of factors that may be helpful to:

- **Donees**—in assessing whether a pledge (unconditional promise to give-as contemplated in SFAS No. 116, ¶¶5-7, 22, 23) has, in fact, been made; or
- **Auditors**—in assessing the appropriateness of the client's judgment.

The list of factors is not intended to be used in deciding on proper accounting (for either the pledge asset or the related revenue or net assets) or to assess collectibility, although some of the factors may be relevant to those decisions as well. In many situations, no single factor is necessarily determinative by itself; all relevant factors should be considered together.

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Appendix

City and County Offices for Charitable Solicitation Information

The following lists contains the addresses and telephone numbers of some city and county offices where information on local charitable ordinances can be obtained, but this list may not be all-inclusive. Although the information was accurate at the time of publication, it changes frequently, and this list is intended only to be a starting point of reference to obtain the necessary information on local ordinances.

COUNTIES

Alameda County
Sheriff's Department
Eden Township Substation
15001 Foothill Blvd.
San Leandro, CA 94578
(510) 667-7721

Calaveras County
Treasurer-Tax Collector
Government Center
891 Mt. Ranch Rd.
San Andreas, CA 95249
(209) 754-6350

El Dorado County
Sheriff's Dept., Civil Division
300 Fair Lane
Placerville, CA 95667
(530) 621-5665

Humboldt County
Tax Collector's Office
Attention: Business Licenses
825 Fifth St., Rm. 125
Eureka, CA 95501-1100
(707) 476-2450

Kings County
Clerk of Board of Supervisors
County Government Center
1400 W. Lacey Blvd.
Hanford, CA 93230
(559) 582-3211, Ext. 2362

Lake County
Office of County Sheriff
1220 Martin St.
Lakeport, CA 95453
(707) 262-4200

Los Angeles County
Business License Commission
Kenneth Hahn
Hall of Admin., Rm. 374
500 W. Temple St.

Los Angeles, CA 90012
(213) 974-7691

Madera County
Treasurer/Tax Collector
200 West 4th St.
Madera, CA 93637
(559) 675-7713

Marin County
County Clerk's Office
Hall of Justice
3501 Civic Center Dr.
Rm. 247
Mailing Address:
P.O. Box E
San Rafael, CA 94903
(415) 499-6452

Merced County
City Manager's Office
678 W. 18th St.
Merced, CA 95340
(209) 385-6834

Mono County
County Administrative Office
P.O. Box 696
Bridgeport, CA 93517
(760) 932-5410

Orange County
County Clerk Recorder
Charitable Solicitations Unit
12 Civic Center Plaza, Rm. 101
Santa Ana, CA 92701-0238
(714) 834-2500

Placer County
Treasurer-Tax Collector
Business License
2976 Richardson Dr.
2nd Floor
Auburn, CA 95603
(530) 889-4120

San Bernardino County
Clerk of Board of Supervisors
385 N. Arrowhead Ave.
2nd Floor
San Bernardino, CA 92415
(909) 387-3841

San Diego County
County Sheriff's Department
Licensing Division
John F. Duffy Admin. Center
9621 Ridgehaven Court
Mailing Address:
P.O. Box 939062

San Diego, CA 92193-9062
(858) 974-2020

San Francisco County
Police Department
Permits
850 Bryant St., Rm. 458
San Francisco, CA 94103
(415) 553-1115

Sutter County
Sheriff Department
1077 Civic Center Blvd.
Yuba City, CA 95993
(530) 822-7307

CITIES

Alameda
Central Permit Office
2263 Santa Clara Ave.
Alameda City Hall, Rm. 190
Alameda, CA 94501
(510) 747-6800

Albany
Finance Department
405 Kains Ave.
Albany, CA 94706
(510) 528-5730

Alhambra
Finance Department
111 S. First St.
Alhambra, CA 91801
(626) 570-5020

Anaheim
Business License Program
200 S. Anaheim Blvd., Rm. 136
Anaheim, CA 92805
(714) 765-5194

Arcata
City Manager's Office
736 F St.
Arcata, CA 95521
(707) 822-5953

Arroyo Grande
Financial Services Department
P.O. Box 550
Arroyo Grande, CA 93421
(805) 473-5438

Auburn
Admin. Services, Finance Div.
1225 Lincoln Way, Rm. 1
Auburn, CA 95603
(530) 823-4211, Ext. 114

Avalon
Recreation
430 Avalon Canyon Road
Mailing address:
P.O. Box 707
Avalon, CA 90704
(310) 510-1987

Azusa
Business Licensing Section
729 N. Azusa Ave., Suite 2B
Azusa, CA 91702
Attn: Naomi Narvaez
(626) 812-5249

Bakersfield
Treasury Division
Financial Services
1501 Trixtun Ave.
Bakersfield, CA 93301
(661) 326-3762

Baldwin Park
Office of the City Clerk
14403 E. Pacific Ave.
Baldwin Park, CA 91706
(626) 960-4011

Barstow
Finance Department
City Hall
220 E. Mountain View St.
Suite A
Barstow, CA 92311
(760) 255-5116

Bell
Finance Department
6330 Pine Ave.
Bell, CA 90201
(323) 588-6211

Bellflower
Community Dev. Dept.
Bellflower City Hall
16600 Civic Center Dr.
Bellflower, CA 90706
(562) 804-1424, Ext. 2008

Bell Gardens
Community Dev. Dept.
7100 South Garfield Ave.
Bell Gardens, CA 90201
(562) 806-7700

Berkeley
Finance Department
1947 Center St.
Berkeley, CA 94704
(510) 981-7200

Beverly Hills
Police Department
Solicitations Advisory
Commission
464 N. Rexford Dr.
Beverly Hills, CA 90210
(310) 285-2102

Blythe
City Clerk
235 N. Broadway
Blythe, CA 92225
(760) 922-6161, Ext. 241

Brawley
Finance Department
400 Main St.
Brawley, CA 92227
(760) 344-1550

Brea
Business License Division
1 Civic Center Circle
Brea, CA 92821
(714) 990-7686

Burbank
License & Code Servs. Div.
333 E. Olive Ave.
Burbank, CA 91510
(818) 238-5280

Campbell
Police Department
70 N. First St.
Campbell, CA 95008
(408) 866-2121

Carpinteria
Community Dev. Dept.
5775 Carpinteria Ave.
Carpinteria, CA 93013
(805) 684-5405, Ext. 451

Carson
Business Licensing Division
701 E. Carson St.
Carson, CA 90749
(310) 952-1748

Ceres
Finance Department
2720 Second St.
Ceres, CA 95307
(209) 538-5768

Cerritos
Business License Department
18125 S. Bloomfield Ave.
Cerritos, CA 90703
(562) 916-1236

Chino
Finance Department
Business Licensing
13220 Central Ave.
Mailing address:
P.O. Box 667
Chino, CA 91708-0667
(909) 591-9818

Chowchilla
City Hall, Administration
130 S. Second St.
Civic Center Plaza
Chowchilla, CA 93610
(559) 665-8615

Chula Vista
Police Department Licensing
276 Fourth Ave.
Chula Vista, CA 91910
(619) 691-5151

Cloverdale
Business License Department
124 N. Cloverdale Blvd.
Mailing address:
P.O. Box 217
Cloverdale, CA 95425
(707) 894-2521

Colfax
City Clerk's Office
33 S. Main St.
Mailing address:
P.O. Box 702
Colfax, CA 95713
(530) 346-2313

Colton
Business License Department
650 N. La Cadena Dr.
Colton, CA 92324
(909) 370-5099

Concord
Business License Center
1950 Parkside Dr.
Concord, CA 94519
(925) 671-3300

Corcoran
Finance Department
832 Whitley Ave.
Corcoran, CA 93212
(559) 992-2151

Corona
Finance Department
400 S. Vicentia Ave.
Corona, CA 92882

(951) 736-2275

Coronado
Office of the City Clerk
Business Licenses and
Programs
1825 Strand Way
Coronado, CA 92118
(619) 522-7320

Costa Mesa
Development Services
Department
Code Enforcement
77 Fair Dr.
Mailing address:
P.O. Box 1200
Costa Mesa, CA 92628-1200
(714) 754-5623

Covina
Business License Department
125 E. College St.
Covina, CA 91723
(626) 858-7240

Cudahy
Business License Department
5220 Santa Ana St.
Cudahy, CA 90201
(323) 773-5143

Culver City
Finance Department,
Business Zone
9770 Culver Blvd.
Mailing address:
P.O. Box 507
Culver City, CA 90232-0507
(310) 253-5870

Cupertino
Finance Department
10300 Torre Ave.
Cupertino, CA 95014
(408) 777-3221

Daly City
Business License Department
333 90th St.
Daly City, CA 94015-1895
(650) 991-8088

Davis
Finance Department
23 Russell Blvd.
Davis, CA 95615
(530) 757-5651

Delano
Finance Department

1015 11th Ave.
Delano, CA 93216
(661) 721-3300

Dixon
Finance Department
600 East A St.
Dixon, CA 95620
(707) 678-7000

Downey
Finance Department
11111 Brookshire Ave.
Mailing address:
P.O. Box 7016
Downey, CA 90241
(562) 904-7265

El Centro
Finance Department
1275 Main St.
Mailing address:
P.O. Box 2328
El Centro, CA 92244
(760) 337-4573

El Cerrito
Finance Department
10890 San Pablo Ave.
El Cerrito, CA 94530-2392
(510) 215-4310

El Monte
License and Treasury
Finance Department
City Hall East
11333 Valley Blvd.
El Monte, CA 91734
(626) 580-2031

El Segundo
Business License Department
350 Main St.
El Segundo, CA 90245
(310) 524-2317

Emeryville
Finance Department
1333 Park Ave.
Emeryville, CA 94608
(510) 596-4304

Fairfield
Police Department
Special Operations Division
1000 Webster St.
Fairfield, CA 94533
(707) 428-7509

Fillmore
Business License Department

250 Central Ave.
Fillmore, CA 93015-1907
(805) 524-3701

Fontana
City Hall
Business License Department
8353 Sierra Ave.
Fontana, CA 92335
(909) 350-7675

Foster City
Business Licensing Division
610 Foster City Blvd.
Foster City, CA 94404
(650) 286-3227

Fremont
Revenue and Taxation
39550 Liberty St.
Mailing address:
P.O. Box 5006
Fremont, CA 94537
(510) 494-4790

Fresno
Business Tax Department
2600 Fresno St.
Fresno, CA 93721
(559) 621-8000

Fullerton
Business Registration Division
303 W. Commonwealth Ave.
Fullerton, CA 92832
(714) 738-5338

Gardena
Business License Department
1700 W. 162nd St.
Gardena, CA 90247
(310) 217-9518

Garden Grove
Business Tax Division
11222 Acacia Parkway
Garden Grove, CA 92840
(714) 741-5074

Gilroy
Business License Department
7351 Rosanna St.
Gilroy, CA 95020-6197
(408) 846-0420

Glendale
Office of the City Clerk
613 E. Broadway, Rm. 110
Glendale, CA 91206
(818) 548-2090

Hanford
Finance Department
315 N. Douty St.
Hanford, CA 93230
(559) 585-2512

Hawaiian Gardens
City Clerk's Office
21815 Pioneer Blvd.
Hawaiian Gardens, CA 90716
(562) 420-2641

Hawthorne
Business License Department
4455 W. 126th St.
Hawthorne, CA 90250
(310) 349-2935

Hayward
Revenue Division
777 B St.
Hayward, CA 94541
(510) 583-4600

Healdsburg
Business License Department
401 Grove St.
Healdsburg, CA 95448-4723
(707) 431-3583

Hollister
Business License Department
375 Fifth St.
Hollister, CA 95023
(831) 636-4301

Huntington Beach
Finance Department
Fiscal Services Division
Business Licensing
2000 Main St., 1st Floor
Huntington Beach, CA 92648-2702
(714) 536-5267

Huntington Park
Business License Office
6550 Miles Ave.
Huntington Park, CA 90255
(323) 584-6232

Imperial Beach
Finance Office
825 Imperial Beach Blvd.
Imperial Beach, CA 91932
(619) 628-1365

Indio
Finance Office
100 Civic Center Mall
Mailing address:
P.O. Box 1788

Indio, CA 92202
(760) 391-4115

Irvine
Business License Department
1 Civic Center Plaza
Mailing address:
P.O. Box 19575
Irvine, CA 92623-9575
(949) 724-6310

La Canada Flintridge
City Clerk's Office
1327 Foothill Blvd.
La Canada Flintridge, CA 91011
(818) 790-8880

Laguna Beach
Business License Tax Division
505 Forest Ave.
Laguna Beach, CA 92651
(949) 497-0733

La Habra
Business License Section
201 E. La Habra Blvd.
Mailing address:
P.O. Box 785
La Habra, CA 90633-0785
(562) 905-9629

Lakewood
Finance Department
5050 Clark Ave.
Lakewood, CA 90712
(562) 866-9771, Ext. 2622

La Mesa
Business License Division
8130 Allison Ave.
La Mesa, CA 91941
(619) 667-1118

La Mirada
Finance Department
Business License Division
13700 La Mirada Blvd.
La Mirada, CA 90638
(562) 943-0131, Ext. 2331

Lancaster
Finance Department
44933 Fern Ave.
Lancaster, CA 93534-2461
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La Palma
Business License Dept.
7822 Walker St.
La Palma, CA 90623
(714) 690-3334

La Puente
Business License Department
15900 E. Main St.
La Puente, CA 91744-4719
(626) 855-1500

La Verne
Finance Department
Business Licenses
3660 D St.
La Verne, CA 91750
(909) 596-8722

Lemon Grove
Attn: Business License
3232 Main St.
Lemon Grove, CA
91945-1797
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9955 Live Oak Blvd.
Live Oak, CA 95953
(530) 695-2112

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Finance Department
1052 S. Livermore Ave.
Livermore, CA 94550
(925) 960-4310

Livingston
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1416 C St.
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100 Civic Center Plaza
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333 West Ocean Blvd.
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Long Beach, CA 90802
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3191 Katella Ave.
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Los Banos
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520 J St.
Los Banos, CA 93635
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110 E. Main St.
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(408) 399-5704

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11330 Bullis Road
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455 E. Calaveras Blvd.
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1010 10th St., Suite 2100
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415 S. Ivy Ave.
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5111 Benito St.
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Montebello
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1600 W. Beverly Blvd.
Montebello, CA 90640
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Monterey Park
Licensing Department
320 W. Newmark Ave.
Monterey Park, CA 91754
(626) 307-1338

Morgan Hill
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17555 Peak Ave.
Morgan Hill, CA 95037
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595 Harbor St.
Morro Bay, CA 93442
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500 Castro St., 2nd Floor
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955 School St.

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1243 National City Blvd.
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817 Third St.
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37101 Newark Blvd.
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Finance Department
1162 Main St.
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3300 Newport Blvd.
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12700 Norwalk Blvd.
Norwalk, CA 90650
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Finance Department
Business Licenses
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Novato, CA 94945-5054
(415) 899-8900

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Oakdale, CA 95361
(209) 845-3580

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Suite 1320
Oakland, CA 94612
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Oceanside
Financial Services Department
300 S. Ditmar St., #N
Oceanside, CA 92054
(760) 435-3878

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(805) 646-5581

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License Division
303 East B St.
Ontario, CA 91764
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300 E. Chapman Ave.
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Oxnard
Licensing Division
305 W. Third St.
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300 Forest Ave., First Floor
Pacific Grove, CA 93950
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821 Pine St., Suite A
Paso Robles, CA 93446
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11 English St.
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6615 Passons Blvd.
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Finance Department
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200 Old Bernal Ave.
Pleasanton, CA 94566
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Finance Department
Revenue Mgmt. Division
Business License Unit
P.O. Box 660
Pomona, CA 91769
(909) 620-2410

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291 N. Main St.
Porterville, CA 93257
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Business License Department
250 N. Ventura Road
Port Hueneme, CA 93041
(805) 986-6500

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City Business
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10500 Civic Center Dr.
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Rancho Palos Verdes, CA 90275
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555 Washington St.
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1017 Middlefield Road
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259 N. Wilma Ave.
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Finance Department
4045 Palos Verdes Dr. North
Rolling Hills Estates, CA 90274
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Business License Department
8838 E. Valley Blvd.
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(626) 569-2104

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200 Lincoln Ave.
Salinas, CA 93901
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300 North D St.
San Bernardino, CA 92402
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San Bruno

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San Bruno, CA 94066
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One Civic Center Dr.
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(626) 300-0705

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330 W. 20th Ave.
San Mateo, CA 94403
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Santa Ana, CA 92702
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Municipal Services Division/Business Licenses
1500 Warburton Ave.
Santa Clara, CA 95050
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809 Center St., Rm. 101
Santa Cruz, CA 95060
(831) 420-5050

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Business License Division
City Hall, Rm. 103
1685 Main St.
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Santa Monica, CA 90407-2200
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Santa Paula
Economic Development Dept.
Community Development Building
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Santa Paula, CA 93060
(805) 933-4245

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Business Taxes—Licenses
90 Santa Rosa Ave.
Santa Rosa, CA 95404
(707) 543-3170

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Business License Department
420 Litho St.
Sausalito, CA 94965

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One The Plaza
Sonoma, CA 95476
(707) 933-2237

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1414 Mission St.
South Pasadena, CA 91030
(626) 403-7257

South San Francisco
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1480 Main St.
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Suisun City, CA 94585
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650 W. Olive
Mailing address:
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Sunnyvale, CA 94088-3707
(408) 730-7444

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9701 Las Tunas Dr.
Temple City, CA 91780
(626) 285-2171

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2100 E. Thousand Oaks Blvd.
Thousand Oaks, CA 91362
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Business License
3031 Torrance Blvd.
Torrance, CA 90503
(310) 618-5828

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Ukiah, CA 95482
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34009 Alvarado-Niles Road
Union City, CA 94587
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Business License
460 N. Euclid Ave.
Upland, CA 91785
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Business License Department
650 Merchant St.
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Vacaville, CA 95696

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501 Poli St., Rm. 107
Ventura, CA 93001
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Victorville
Business License Department
14343 Civic Dr.
Mailing address:
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Victorville, CA 92393-5001
(760) 955-5072

Visalia
Finance Department
Business License Division
315 E. Acequia
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P.O. Box 4002
Visalia, CA 93278
(559) 713-4313
(559) 713-4444

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600 Eucalyptus Ave.
Vista, CA 92084
(760) 726-1340

Walnut Creek
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1666 N. Main St.
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P.O. Box 8039
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Business License Department
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1444 W. Garvey Ave.
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8200 Westminster Blvd.
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Whittier, CA 90602
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Willits
Business License Department
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Willits, CA 95490-3188
(707) 459-4601

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6550 Yount St.
Yountville, CA 94599
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Yreka, CA 96097
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