

Everything you wanted to know about starting a California Nonprofit*

*But were afraid to ask

Prepared by: Alejandro Soschin

INTRODUCTION TO THIS GUIDE

This overview of how to start a California nonprofit is intended to help staff and volunteers and others who serve as directors, officers or fundraisers for nonprofit charitable organizations. It provides basic information and answers to questions frequently asked about charitable entities. In addition, the guide highlights some of the more important California laws affecting the creation and operation of nonprofit charitable corporations. This guide is not intended as a substitute for legal advice or tax consultation from private attorneys or tax experts. Depending on the circumstances, it may be important for your organization to hire a private attorney to assist with specific legal questions.

Historically, nonprofits were developed to meet certain needs of society. They were formed to do “public good” and to provide aid to segments of the community that fell outside of the general scope of public assistance. In common usage, the term “charity” refers to an organization that performs charitable programs or sets aside any funds to be used for charitable purposes. As the nonprofit sector in our state has evolved, there are more issues being addressed by more organizations than ever before. While the landscape keeps changing, it is helpful to refer to some basic elements that remain vital for any and all initiatives that may at some point become officially recognized nonprofit entities.

WHAT IS A “CHARITABLE PURPOSE”?

California common law defines “charitable purpose” very broadly to include relief of poverty, advancement of education or religion, promotion of health, governmental or municipal purposes, and other purposes that are beneficial to the community. Federal and California tax laws define charitable purposes more specifically for exemption from income tax. Federal and state laws have been enacted to encourage the making of charitable gifts and to facilitate the operation of charitable organizations. These laws reflect the public policy favoring charitable giving and recognize that many charities relieve the public tax rolls from the burden of financing human and community services. As a result, certain benefits and privileges are conferred on charities that are not available to for-profit businesses.

If an organization is classified as a California nonprofit public benefit corporation or has received federal tax exemption under Internal Revenue Code section 501(c)(3), it is a charity. Under the traditional common law definition, charitable purposes include relief from poverty, advancement of education, religion and other purposes beneficial to the community.

Under the federal tax law definition and to qualify for tax-exempt charitable status, the organization must be organized and operated exclusively for an “exempt” purpose. Exempt purposes are religious, charitable, scientific, testing for public safety, literary, education, fostering national and international sports competition, or the prevention of cruelty to children or animals. In addition to these requirements, federal tax law also requires that there must be no “private” inurement or improper private benefit to anyone in a position of control over the charitable organization, and that the organization not engage in activity on behalf of political candidates or carry on substantial lobbying activity.

As of August 2014, there were over 75,000 501(c)(3)’s registered in California. These registered charities reported total revenues of over \$200 billion and total assets of over \$300 billion. Charities represent an important economic sector in California and have the ability to make a significant impact on the communities they serve. If you have an issue that you are passionate about, it is likely that there may be a number of enterprises that are devoting time and resources to addressing it in some fashion in our community.

EXEMPTION FROM INCOME TAX

One of the most important benefits available to a charity is its ability to qualify under federal and state income tax laws for “tax exempt status.” Income tax exempt status may confer on the charitable organization exemption from payment of income tax and also allow charitable donors to deduct from their taxable income contributions made to the organization. This is not an insignificant factor, as many NPOs derive substantial funding and support from donors that receive a tax deduction for their contribution. While at various times there has been discussion about this tax benefit, as of this writing it

remains a key driver of income generation for programs big and small across the state.

LEGAL FORMS FOR CALIFORNIA NONPROFITS

A charitable entity may operate in California under any of several legal forms, including a nonprofit corporation, a trust or an unincorporated association. Most California charities are organized as nonprofit corporations. The three most common types of nonprofit corporations under California law are: **public benefit corporations, mutual benefit corporations and religious corporations.** The majority of the registered nonprofit corporations in California are organized as public benefit corporations.

Public Benefit Corporation

Under California law, a public benefit corporation must be formed for public or charitable purposes and may not be organized for the private gain of any person. A public benefit corporation cannot distribute “profits,” gains or dividends to any person. Public benefit corporations often qualify for exemption from income tax. Public benefit corporations (except for educational institutions and hospitals) must register and report to the **Attorney General’s Registry of Charitable Trusts.**

Religious Corporation

Religious corporations are organized for religious purposes. They are usually exempt from income tax and are not required to register or report to the California Attorney General. A religious organization may also be formed as a corporation solely.

Mutual Benefit Corporation

Mutual benefit corporations are organized most often for the benefit of their own members. They may not be formed exclusively for charitable purposes. If a mutual benefit corporation holds some of its assets for charitable purposes, however, it must register and report on the charitable assets to the Attorney General.

Mutual benefit corporations may qualify for different income tax benefits than public benefit corporations. Familiar examples of mutual benefit corporations include private homeowners associations, private clubs, and trade and professional associations.

Trusts

A trust may be created by language in a will or in a written trust instrument. The trust creates legal obligations for the person (“trustee”) who manages the assets of the trust. A trust for charitable purposes can be enforced by the Attorney General, and the trustee must register and report to the Attorney General.

It is not essential to form a nonprofit corporation, a trust or other legal entity to create a charity. In California, any individual or organization who solicits funds and represents that such funds will be used for charitable purposes may be held to be a “trustee for charitable purpose” and accountable for such funds. In addition, the failure of a public benefit corporation or trust to qualify for exemption from income tax does not necessarily free the organization and its responsible directors, officers or trustees from accountability as a charity.

Any individual or group of persons who operates as a charitable organization, but does not create a nonprofit corporation or a trust, may be treated under California law as an “unincorporated association.” Under this classification, the individuals may be exposed to substantial risk of personal liability if the organization is sued. Again, it may be advisable to see the advice of an experienced legal provider in determining which form is best suited to your purposes.

HOW TO CREATE A NONPROFIT IN CALIFORNIA

This section highlights how to organize an entity in the form that most new charities in this state select, the California nonprofit public benefit corporation. A corporation is a distinct legal entity under California law. A new corporation is “born” when its **articles of incorporation** are filed with the Secretary of State. The basic steps and minimum

requirements for forming a public benefit corporation are summarized below.

Why start a Nonprofit in the first place?

Before we get started, the first question to ask is if you really want to create a new charitable organization at all? Although public benefit corporations may qualify for many important benefits, including exemption from income tax, they are also subject to important legal restrictions. One very critical restriction is that the assets of a public benefit corporation must be irrevocably dedicated to charitable purposes, and cannot be distributed for private gain. If the organizers of a public benefit corporation later decide that they do not wish to operate the corporation as a charity, they may terminate the corporation, but they cannot take back its assets. Legally, those assets belong to charity, and must be transferred to another charity that has the same or similar purposes.

It is important to consider carefully the goals of the new organization before taking any steps to form a public benefit corporation. There are many factors to consider before choosing the legal form for the organization and evaluating whether the advantages of income-tax exemption outweigh the legal restrictions on public benefit corporations.

Aside from legal considerations, there are many nonprofits that are often competing with each other for scarce resources. Many times, they offer the same services and even go after the same clients, with duplication of effort and diminished effectiveness as a result. It is often a worthwhile investment in time and effort to scan the market and ensure that any new entity under consideration will be adding a new dimension to the common good. That is not to say that nonprofits should not compete with one another. Rather, it just is good practice to see if helping an existing program be more effective might not be a better usage of resources that starting a whole new organization from scratch.

Some questions that the founders should be considering on both legal and strategic fronts are:

- What are the purposes of the new organization?
- What are the projected income needs and sources of income?
- Will donations or grants be an important source of income?
- How will any “surplus” income be used?
- Are various benefits of nonprofit status important (for example, reduced-rate mailing privileges)?
- Is exemption from income tax important?
- What are the government regulations and filing requirements regarding nonprofit corporations as compared to for-profit business corporations?
- What additional requirements apply to tax-exempt charities?
- Who will make sure the new entity complies with them?
- Are qualified and interested people available to serve as directors?
- Will any payments be made by the organization to its founders, directors, or officers?
- What are the limitations on such payments applicable to a public benefit corporation?
- What alternate legal forms exist for creating a charity?
- How do the standards of liability for directors vary between nonprofit and for-profit corporations, and as compared to trusts and unincorporated associations (or other possible forms of organization)?
- Will the organization have members, and will they be voting members?

- Will the organization have chapters or other related groups?
- How much flexibility of operation is desired?
- How long is the entity anticipated to be in existence?

After going through these kinds of questions, if there is still a commitment to become a nonprofit, then the steps that follow will get you on the path.

THE 10 ESSENTIAL STEPS TO INCORPORATE AS A CALIFORNIA PUBLIC BENEFIT CORPORATION

1. Choose a corporate name. You may clear and reserve the corporate name by contacting the Secretary of State's office. After clearing the corporate name, you can reserve it by paying the appropriate fee to the Secretary of State. For additional information, you contact the [Secretary of State's office](#).

2. Draft and file articles of incorporation with the Secretary of State. The articles of incorporation typically specify the purpose of the organization, its name, place of business, key officers and limitations on its operations. In California, the articles of incorporation filed with the Secretary of State (original and two copies) must include the name of the public benefit corporation, its purpose, and language ensuring that it is not organized for the private gain of any person and that it will comply with other applicable requirements (including, if tax exemption is desired, the requirements for tax exemption).

The articles of incorporation are typically signed by an "incorporator," which can be just one person but may also be signed by the initial board of directors if they are named in the articles. There is a [template](#) you can fill in and print on the Secretary of State's website. This is a good starting point but does not provide guidelines or advice on every important consideration. For example, there is no guidance on specific purpose statements.

3. Draft the bylaws of the corporation. Bylaws set out the overall structure and basic rules for operating the corporation, including how directors and officers are elected and how the governing board operates. These rules are limited by California laws and are very important to the governance of the corporation. Bylaws typically contain specific provisions detailing:

(a) The purpose or mission of the nonprofit;

(b) How directors are elected or otherwise selected (e.g., by majority vote of directors at the annual board meeting);

(c) How the board may take an action (e.g., by majority vote of directors);

(d) How board meetings are called and noticed (e.g., six times per year with 14 days advance notice by email);

(e) How board meetings are conducted (e.g., the chair of the board presides);

(f) The officers of the corporation (a president or chair of the board, secretary, and treasurer or chief financial officer are required by California law);

(g) The duties and responsibilities of each officer;

(h) The authorization of board and non-board committees (e.g., committees tasked to act with the authority of the board versus committees that can only make recommendations);

(i) The level of indemnification provided by the corporation to protect its directors, officers and other agents; and

(j) The reports due to directors (e.g., financial reports).

4. Draft action of incorporator and have it signed by all incorporators. If the articles of incorporation were signed only by an incorporator and not by the initial board of directors, the incorporator needs to appoint the first board. The incorporator may also take other actions at the same time, including adopting the bylaws, appointing the officers, and authorizing the opening of bank accounts.

5. File federal application for employer identification number (EIN) with the IRS. You can apply for an EIN by mail, fax, or phone, by using IRS Form SS-4 and following instructions that normally are available from the IRS' website.

6. File a statement by Domestic Nonprofit Corporation. The Statement by Domestic Nonprofit Corporation is sent by the Secretary of State within 90 days of filing Articles of Incorporation. You must complete and return this statement to the Secretary of

State. You will have to file this form again at least every second year during the life of the corporation.

7. Register with the Attorney General's Registry of Charitable Trusts. Charities must register with the Attorney General's Office within 30 days after receiving their first assets by filing Articles of Incorporation and bylaws with the Attorney General's Registry of Charitable Trusts and pay a registration fee. Organizations must renew registration and file financial reports annually thereafter.

8. Hold first meeting of directors. Agenda items for the first meeting typically involve organizational issues, such as adopting bylaws, electing officers, establishing a bank account, setting the accounting year and basic accounting procedures, planning a budget for the first year, and adopting procedures for safekeeping of minutes, bylaws, and other corporate records. If not meeting in person, and to the extent permitted by the organization's bylaws, the directors may take these actions by "unanimous written consent," which requires the signatures of all directors. It is important for the corporate secretary to record and keep minutes of all meetings (and unanimous written consents) of the board of directors and board committees.

Directors: Every Corporation must have directors and officers. Legally, a public benefit corporation (may operate with only one director. However, most charities operate with three or more directors, which is strongly recommended. In addition to directors, every public benefit corporation is required to have a president, a chief financial officer and a secretary. Additional officers may be appointed. The powers, duties, and liabilities of directors and officers of public benefit corporations are governed by California statutes. Directors are required to discharge their duties consistent with a fiduciary obligation to the charity.

The directors of a nonprofit public benefit corporation are responsible for conducting the corporation's affairs and for exercising the powers of the corporation. Directors may delegate many of their powers to others, such as officers and employees, but the directors are ultimately responsible for all corporate decisions. Directors may be elected (usually by members) or designated (by the board of directors or other persons). The provisions for election, resignation, removal,

terms of office, quorum necessary for action by directors, action by executive committee, delegation of powers, and other important issues affecting directors are generally covered by California statutes. Provisions governing these matters should be set forth clearly in the corporation's bylaws.

9. File application for exemption from federal income taxes with the IRS and state income taxes with the California Franchise Tax Board. Use IRS Form 1023 for the federal income tax application and FTB Form 3500 for the state income tax application.

10. Review the corporation's need for state and local permits and licenses and establish procedures to meet deadlines for required periodic filings with the IRS, FTB, Secretary of State and Attorney General. This procedure is important to keep the organization in good standing and avoid the need to pay delinquency fees.

TAX EXEMPTION APPLICATION—THE PROCESS EXPLAINED

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

What exactly is a 501(c)(3) Organization?

A section 501(c)(3) organization must be “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes.” To qualify, an organization must satisfy an **organizational test** and an **operational test**.

The **organizational test** is met if the **articles of incorporation** include language limiting the purposes of the organization to one or more of the exempt purposes set forth in section 501(c)(3) and do not empower the organization to engage in any substantial activities which do not further one or more exempt purposes. In addition, the organizational documents (or applicable state law) must require the organization to expressly dedicate its assets to exempt purposes in the event of a dissolution.

The **operational test** requires the organization to be **engaged one or more of the exempt purposes** specified in section 501(c)(3). The test will not be met if “more than an insubstantial part” of the organization’s activities is not in furtherance of exempt purposes. Examples of impermissible conduct include diversion of charitable assets to private individuals, excessive compensation to officers and directors, and engaging in certain prohibited political activities, such as participation in political campaigns on behalf of or in opposition to candidates for public office or substantial lobbying.

To obtain recognition of tax-exempt status in California, nonprofit California public benefit corporations also may be required to show that no more than 49 percent of the organization’s directors are

“interested persons” or their close relatives, as defined in California Corporations Code section 5227.

Applying for federal tax exemption with the Internal Revenue Service (IRS) and receive a determination letter from the IRS.

Completing the Form 1023 application for exempt status under Internal Revenue Code (IRC) Section 501(c)(3) may be the most challenging part of the startup process. It is a legally-driven and comprehensive inquiry covering 11 Parts and 8 Schedules. Luckily, in 2013 the IRS added new tools and instructional videos to their website to help you understand and file it correctly.

A critical section for careful completion is Part IV, Narrative Description of Your Activities, which asks: for each past, present, or planned activity, include information that answers the following questions.

- What is the activity?
- Who conducts the activity?
- When is the activity conducted?
- Where is the activity conducted?
- How does the activity further your exempt purposes?
- What percentage of your total time is allocated to the activity?
- How is the activity funded?
- List any alternate names under which you operate, including any “aka” (also known as) or “dba” (doing business as) names.

Form 1023 also requires information regarding (a) organizational structure; (b) compensation and other financial arrangements with officers and directors, and certain highly paid employees and independent contractors; (c) members and other individuals and organizations that receive benefits from the organization; (d) organizational history (e.g., an organization that was spun off or previously fiscally sponsored by another organization may need to complete an additional schedule as a successor organization); (e) specific activities; and (f) actual and/or projected statement of

revenues and expenses (which should be consistent with any identified activities).

Part X is designed to determine the organization's classification as either a private foundation or a public charity. Public charity status is generally the more favorable tax status, but requires an organization to meet certain requirements. For most organizations, this means passing a public support test over a five-year measuring period. For organizations that will receive a large bulk of their support from few sources over their first five years, monitoring and managing of the public support ratio may be critically important.

The filing fee for Form 1023 is currently \$850 for all but the smallest organizations.

The IRS may typically take 3-4 months or longer to process a Form 1023 application for exempt status. However, the waiting period may be much longer if the application contains errors, omissions, or other information that require additional development by a special IRS department.

While all the information here is a helpful starting point, it is important to note that this is just that, a starting point. This is a journey you are undertaking, and one that will require some hard work, research, perseverance, patience and creativity. Along with the passion that brought you here in the first place, by reviewing the steps and resources found along this and other guides, you will be better prepared to develop your ideas and turn them into a solid organization that can help make our community the best it can be! So onward and upward!

Further Resources:

I. Government Agencies

IRS (Federal tax exemption and reporting compliance)

(877) 829-5500

<http://www.irs.gov/>

California Franchise Tax Board (California tax exemption)

(916) 845-4171

<http://www.ftb.ca.gov/>

California Secretary of State (Filing articles of incorporation,
Annual Statement of Officers)

(916) 653-6814

<http://www.ss.ca.gov/>

Name Availability Unit

(recorded information on how to obtain)

(916) 657-5448

California Board of Equalization (Property taxes and sales taxes)

(800) 400-7115

<http://www.boe.ca.gov/>

California Employment Development Department (California payroll taxes)
(888) 745-3886
www.edd.ca.gov

California Attorney General's Office Listings:
Los Angeles: Charitable Trusts Section Office of the Attorney General
300 South Spring Street, Room 1702
Los Angeles CA 90013

San Francisco: Charitable Trusts Section Office of the Attorney General
455 Golden Gate Avenue, Suite 11000
San Francisco CA 94102-7004

Sacramento: Charitable Trusts Section
Office of the Attorney General
1300 I Street
P.O. Box 944255
Sacramento CA 94244-2550

Registry of Charitable Trusts
P.O. Box 903447
Sacramento CA 94203-4470

California Attorney General's Charitable Trusts website:
www.ag.ca.gov/charities/

Public Inquiry Unit: Telephone: (916) 322-3360 or 1-800-952-5225
(for copies of publications)

II. Legal Services

A. Legal Aid Societies.

Local chapters in many counties may provide low cost legal services to qualifying organizations. Usually at least three main factors are considered to determine if the organization qualifies for low cost legal aid: (1) the income level of members or targeted service beneficiaries (Is it below the federal poverty level?); (2) the assets of the members

(Are they relatively low?); and (3) and the type of services provided by the organization. Charities that serve the needs of low-income individuals are usually given priority. If an organization meets the above criteria, it may receive either direct legal services or referral to another agency. See your local telephone directory for listings of Legal Aid Societies.

B. National Economic Development & Law Center.
2201 Broadway, Suite 815, Oakland, CA
94612. Telephone: (510) 251-0600.

If a charitable organization is organized primarily to serve economic development projects, the Center may be able to assist it with legal services. The Center is funded by various government and private sources to help nonprofit organizations that serve low income persons. www.nedlc.org

C. Regional Legal Clinics and Referral Services.

The services listed below may provide free legal services to qualifying nonprofit organizations or refer them to other agencies. Some of the listed services have income or service restrictions.

San Francisco Lawyer's Committee for Civil Rights of the San Francisco Bay Area.
131 Steuart St., Suite 400, San Francisco, CA 94105.
Telephone: (415) 543-9444 (serves organizations that provide assistance to low-income persons) - www.lccr.com

Bar Association of San Francisco's Volunteer Legal Services Program.
465 California St., San Francisco, CA 94104.
Telephone: (415) 989-1616 - www.sfbar.org/vlsp

California Lawyers for the Arts.
Fort Mason Center Bldg. C, Room 255, San Francisco, CA
94123.
Telephone: (415) 775-7200 (referral service for various arts organizations only) - www.calawyersforthearts.org

Bet Tzedek
145 S. Fairfax, Suite 200, Los Angeles, CA 90036.
Telephone: (323) 939-0506 - www.bettzedek.org

San Diego Volunteer Lawyer Program.
1333 7th Ave., San Diego, CA 92101.
Telephone: (619) 231-8585: (same eligibility requirements as Legal Aid Societies. Services are limited to organizational and operational problems of charitable groups. Needs will be assessed and referral made to other services.) - www.sdcb.org

III. Management and Operations Assistance

A. Nonprofit Management

Training Center for Nonprofit Management.
606 South Olive Street, Suite 2450, Los Angeles,
CA 90014. Telephone: (213) 623-7080 - www.cnmsocal.org

CompassPoint Nonprofit Services
706 Mission St., San Francisco, CA 94103. Telephone: (415)
541-9000. www.compasspoint.org

California Association of Nonprofits, Inc.
520 South Grand Avenue, Suite 695, Los Angeles, CA
90071. Telephone: (213) 347-2070. www.canonprofits.org

National Council for Nonprofit Associations
- www.ncna.org

Independent Sector
- www.independentsector.org

BoardSource
- www.boardsource.org

National Center for Charitable Statistics
(NCCS) - www.nccsdataweb.urban.org

Philanthropic Research, Inc. (Guidestar) -
www.guidestar.org

Internet Nonprofit Center
- www.nonprofits.org

United Way

Many local United Ways offer management and technical assistance programs for interested charitable organizations. Charities do not have to be funded by United Way to participate in these training programs. For additional information, contact the United Way in your area.

B. Fundraising Research and Training:

The Foundation Center

312 Sutter Street, Suite 606, San Francisco, CA 94108.
(415) 397-0902 (Self-help library on grants, fundraising techniques, and corporate philanthropy. The library is open to public free of charge.) - www.fdncenter.org/sanfrancisco

California Community Foundation Funding Information Center

445 South Figueroa Street, Suite 3400, Los Angeles, CA 90071.
Telephone: (213) 413-4130 (resources for nonprofits listed on website) www.calfund.org

Center for Nonprofit Management

1000 N Alameda St #250, Los Angeles, CA 90012
Telephone: (213) 687-9511
www.cnmsocal.org

The Grantsmanship Center

P.O. Box 17220, Los Angeles, CA 90017. (213) Telephone: 482-9860
(offers training in searching for grants, writing grant proposals and negotiating with funding sources) www.tgci.com

