

## **FORMING A NEW CHARITY IN CALIFORNIA: WHAT TO EXPECT**

While no two situations are identical, and many variations and alternatives are possible for each step described below, a typical formation process at Adler & Colvin for a new California charity might look like this:

### ***Step 1: Form a California nonprofit public benefit corporation***

- We start by making sure the chosen name is available and reserving it.
- We then turn to corporate governance, drafting the governing documents (articles of incorporation and bylaws).
- The articles are signed by the incorporator and we file them with the California Secretary of State's office (which starts the new entity's legal existence).
- We obtain a tax ID number for the new entity.
- We draft a document through which the incorporator adopts the bylaws and puts in place the initial Board of Directors and corporate officers.
- The Board should then hold the first Board meeting to complete the formation of the corporation.

The articles and bylaws set forth the governance structure for the corporation, specifying how the Board operates, what officers the corporation will have, etc. Perhaps most importantly, the articles and bylaws explain how the Board of Directors is chosen: by Board vote, by designation by an individual or entity, by a membership, or through some combination of these. We discuss the options with the founder, including the advantages and disadvantages of each, to help founders achieve their desired results within a charitable framework.

Once the entity exists as a legal person, it has the power to enter into contracts. It can open bank accounts and write or deposit checks as soon as it has a tax ID number and officers.

Once founders decide to proceed with forming a nonprofit public benefit corporation in California, Step 1 can take as little as a week to 10 days in urgent circumstances, but typically takes a few weeks to a few months, depending on how quickly the founders can make all the decisions required, and how complex the governance structure will be. To simply draft and file basic articles of incorporation, obtain a tax ID number, and name officers – the minimum required for the corporation to exist and start doing business – takes a few days.

***Step 2: Apply for tax-exempt status to the IRS and FTB***

Having a nonprofit corporation is not the same as being tax-exempt. Organizations that are exempt under Section 501(c)(3) of the Internal Revenue Code can offer a charitable contribution deduction to their donors and receive more favorable consideration for many government and foundation grants. To obtain 501(c)(3) status, we help the new entity apply to the IRS and the California Franchise Tax Board (for the state equivalent of Section 501(c)(3), which is California Revenue & Taxation Code Section 23701d), on Forms 1023 and 3500A, respectively.

- To complete the IRS form, we start by gathering from the client extensive information about the people who will control the corporation, including directors and officers, and about the organization's plans and proposed activities.
- We provide advice as needed on tax law issues raised in the exemption application, such as private inurement, private benefit, conflicts of interest, compensation, fundraising, public support tests, lobbying activities, political activities, etc.
- We prepare a complete package of the IRS exemption application, for the client's review and signature.
- We file the exemption application with the IRS.
- We respond as needed to IRS inquiries about the organization.
- Once the IRS issues its determination letter recognizing the organization as exempt under 501(c)(3), we prepare and file Form 3500A with the FTB, attaching the IRS letter.

This process to the point of filing an exemption application with the IRS typically takes from a few weeks to a few months, depending on how quickly the client supplies us with the necessary information, the complexity of the client's plans and applicable tax law, and how busy we are at the time. It can start at the same time as Step 1, or later.

Once filed, the IRS will typically acknowledge receipt in approximately two weeks. Thereafter, the IRS screens applications, and those that it finds raise no issues of fact or law are processed within a few weeks to a few months. However, if the IRS has any issues or concerns, it assigns the application to a reviewer. The IRS informs the public, in general terms, of current processing times on its website at <http://www.irs.gov/charities/article/0,,id=156733,00.html>. For example, as of July 2008, the IRS was assigning for review applications received five months earlier. Once a file has been assigned, we expect to hear from the reviewer with follow-up questions within a few weeks. Sometimes, several rounds of questions may be required to address the reviewer's concerns fully. Assuming a favorable result is eventually reached, it could take from several weeks to several months from when the IRS assigns an application to a reviewer, to issuance of a determination letter.

We are sometimes able to speed up the review process, especially with evidence that a grant is pending and will be lost unless the new charity can provide the funder with an IRS determination letter by a specified date.

We are often asked when the new entity can begin accepting tax-deductible contributions. The answer is that, if the entity files its application within 27 months of formation, the IRS's determination of exemption will be retroactive to the date of incorporation. This assumes, of course, that the eventual IRS outcome is favorable. Until the IRS determination letter is issued, new entities should explain to potential donors that an application for tax-exempt status is pending. Donors who claim a charitable contribution deduction for their gifts before then take the risk of an adverse IRS decision.

### ***Step 3: Other initial filings***

- We prepare and file the initial Statement of Information with the California Secretary of State's office.
- We prepare and file the initial registration with the Registry of Charitable Trusts, in the office of the California Attorney General

### ***Step 4: Legal maintenance manual and corporate minute book***

We typically provide new entities with an official corporate minute book for the corporation's permanent records. We file governing documents, exemption applications, and initial corporate actions in it.

We also typically provide new entities with a legal maintenance manual, which covers a range of subjects relating to operating the new entity in compliance with its tax-exempt and nonprofit corporate status, including:

- If the organization is a public charity, basics of federal tax law governing 501(c)(3) public charities and how to maintain public charity (rather than private foundation) status
- If the organization is a private foundation, basics of federal tax law governing 501(c)(3) private foundations
- Periodic reporting obligations and public information disclosure requirements
- Overview of charitable donation and solicitation rules
- For public charities, an introduction to holding and managing donor-advised funds
- Primer on corporate governance requirements and procedures
- Guidance on directors' fiduciary duties and governance responsibilities
- Guidance on keeping the corporate minute book
- Information on recommended internal policies such as records retention and whistleblower protections
- Suggested resources for further information



The foregoing describes a typical formation and exemption process for a hypothetical new charity. In real life, no client is average, and clients should not expect their experience to mirror the description above. For example, some clients request our help with only certain aspects of the formation or exemption process in order to reduce their fees, and we are often willing to accommodate such arrangements.

Our charges associated with the total package of services described above vary greatly with individual situations. Some costs are fixed, such as filing fees for articles of incorporation, state registrations, and tax-exemption applications. These typically total approximately \$1,000. Our standard legal fees are based on time spent, and vary depending on the seniority of the biller. Many factors affect the time required, including, among others: the amount and quality of information the new charity's founders can provide; depth of counseling needed on structural and operational choices; and the nature, complexity, and innovativeness of the charity's proposed structure and activities. Requiring us to educate and coordinate multiple decisionmakers; changing decisions once made; and no or non-responsive answers to our questions necessitating

follow-up, can drive up fees substantially even without any unusual legal issues. As a result, it is difficult to estimate total legal fees in advance. An ordinary, straight-forward formation and exemption project generally costs between \$10,000-\$20,000 in legal fees, plus costs, although fees above and below the range do occur.

In addition to the basic package of formation and exemption services, new charities or their founders often need additional help, such as:

- deciding whether a charity is the right vehicle in light of goals and founders interests, as opposed to operating as a for-profit, a fiscally-sponsored project, or under some other tax-exempt status than 501(c)(3)
- advising on membership structures or other complex governance arrangements
- interfacing as needed with regulatory agencies after applications have been filed, including drafting supplemental responses to IRS questions on the application
- preparing grant agreements and grant administration forms
- drafting agreements such as corporate name licenses or cost-sharing contracts with affiliated entities
- preparing or reviewing fiscal sponsorship arrangements while IRS determination is pending
- assisting with corporate governance beyond the basics, such as drafting meeting minutes or resolutions needed for client-specific situations

We provide such assistance as needed and requested. These services are generally not included in the basic estimate.

*Any tax advice contained in this handout was not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.*