

GUIDE TO TAX-EXEMPT NPOS Part 2 Articles & Bylaws

Part 2 of a quick look at what it takes to set up a charitable-purpose nonprofit corporation in California and Arizona, motivate a Board of Directors, obtain and keep tax-exempt status, and maintain funding to permit the team to achieve charitable goals.

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CHAPTER 2. The Articles of Incorporation

The formation and operation of nonprofits and religious entities are governed by state law. For our purposes, these are:

1. the California Nonprofit Public Benefit Corporation Law (Corp Code §§ 5110 et seq.),
2. the California Nonprofit Religious Corporation Law (Corp Code §§ 9110 et seq.), and
3. the Arizona Nonprofit Corporation Act (ARS 10-3101, et seq.)

2.1. The required terms of the Articles

In Arizona, a nonprofit corporation's Article must include the following, although it may contain additional provisions:

- (1) the corporate name;
- (2) brief statement of the corporation's business affairs;
- (3) the name and address of the initial directors;
- (4) the name, address, and signature of the statutory agent;
- (5) the street address of the corporation, not P.O. box;
- (6) the name and address of each incorporator;
- (7) whether or not the corporation will have members; and
- (8) the signature of each incorporator.

In California, a nonprofit corporation's Article must include the following, although it may contain additional provisions:

- (1) the corporate name;
- (2) brief statement of the corporation's business affairs;
- (3) the name and address (but not the signature) of the statutory agent;
- (4) the street address of the corporation, not P.O. box;
- (5) the name (but not the address) of each incorporator;
- (6) if the corporation will have members then it must state so; and
- (7) the signature of each incorporator.

The Articles are signed by the "Incorporator", who the IRS called a "nominee". This can be anyone retained or authorized to file documents to create the entity. Usually this is an attorney but can be any person, and in California the Articles may be signed by all of the initial Directors as Directors. Unless the initial Directors' names will draw donations or soothe needed egos, keep it simple and use a single third party, like an attorney, who will then step aside. As noted above, some states such as Arizona require all of the Incorporators to execute the Articles and initial Annual Report and Certificate of Disclosure.

2.2. Language for tax exemption

Importantly, the Articles must contain certain terms to permit later qualification as a 501(c)(3) tax-exempt entity. Forms provided online by many states (including both California and Arizona) are NOT fully compliant with IRS requirements for tax exemption. Therefore, consider using a form of Articles drafted with legal assistance.

The Articles for every public benefit nonprofit corporation should include the following language:

[1]. This corporation is a nonprofit public benefit corporation and is not organized for the private gain of any person. It is organized under the California Nonprofit Public Benefit Corporation Law, California Corporations Code §§ 5110, et seq., as it may be amended from time to time.

[OR]

[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 Arizona Nonprofit Corporation Act, Arizona Revised Statutes Sections 10-3101, et seq., as it may be amended from time to time.

Then follow up for either state with language like the following on the charitable or other qualifying purpose, such as:

[3]. The specific charitable purpose of this corporation is to [*state Charitable Purpose*].

[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 Section 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 Section 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 Section 170(c)(2) or the corresponding provision of any future United States internal revenue law.

Also include language to the following effect concerning the prohibition against any political or legislative activities:

[5]. No substantial part of the activities of this corporation shall consist of carrying on propaganda, or otherwise attempting to influence legislation, and this corporation shall not participate or intervene in, including publishing or distributing statements, any political campaign on behalf of, or in opposition to, any candidate for public office.

Finally, include language about what happens to the entity's assets, all charitable assets held in trust, were the corporation to dissolve:

[6]. All corporate property is irrevocably dedicated to the charitable purposes set forth above in Sections [3 and 4]. No part of the net earnings or assets of this corporation shall inure to the benefit of any of its directors, trustees, officers, members, or of any private person.

[7]. 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*], provided that the organization has established its tax-exempt status under Internal Revenue Code Section 501(c)(3), or corresponding provisions of any future federal Internal Revenue Code law.

The articles must provide that upon dissolution the entity's remaining assets will be transferred to another 501(c)(3) organization. The identity of the future transferee is necessarily made by the Board as part of its due diligence during the winding up and dissolution of the entity.

In addition, for private foundations, I suggest adding paragraphs that address their special requirements:

[8]. 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.

[9]. 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.

[10]. 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.

[11]. 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.

[12]. 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.

2.3. Statutory Members?

Most states permit the nonprofit's Articles to create a special category of "Statutory Members", who are individuals or entities given legally recognized membership rights under state law. Arizona requires that a nonprofit's Articles specify whether or not it will have members.

A Statutory Member typically receives legally enforceable voting rights on key issues, including for example electing board members, mergers and dissolutions, and amending the Article of Incorporation and the Bylaws. If a nonprofit has Statutory Members, it must honor their rights and maintain accurate membership records, follow the rules on admitting or terminating memberships, and provide notice of membership meetings with members having an opportunity to be heard and vote on matters within their powers. It is usually a method used by established organizations to encourage donations and active community support from an established fan base.

2.3.1. California Statutory Members

In California, Corporations Code section 5310(a) provides that "A corporation may admit persons to membership, as provided in its articles or bylaws, or may provide in its articles or bylaws that it shall have no members. In the absence of any provision in its articles or bylaws providing for members, a corporation shall have no members." The term "member" is then defined at section 5056(a)-(b) :

“(a) ‘Member’ means any person who, pursuant to a specific provision of a corporation’s articles or bylaws, [1] has the right to vote for the election of a director ... on a disposition of all or substantially all of the assets ... or on a merger or on a dissolution [or] ... [2] is [both a] designated in the articles or bylaws as a member and [b] ... has the right to vote on changes to the articles or bylaws.

Thus, there are two recognized categories of members defined in the statute (Statutory Members) with greater and lesser voting rights. The next subsection tells us that membership may involve a mix of rights, which may exclude any voting rights at all.

(b) The articles or bylaws may confer some or all of the rights of a member ... upon any person or persons who do not have any of the voting rights referred to in subdivision (a).”

The situation is further clouded because the term “member” standing alone is ambiguous. Corp Code section 5332(a) states that a corporation “may refer to persons associated with it as ‘members’ even though such persons are not [voting] members within the meaning of Section 5056...”.

2.3.2. Arizona Statutory Members

The Arizona Revised Statutes contain Chapters 29 and 30 in Title 10 which detail the many rights, notices, and procedures required for members. ARS 10-3601 provides that the “articles of incorporation or bylaws may establish criteria or procedures for admission of members and continuation of membership.” It requires that “No person shall be admitted as a member without that person's consent. Consent may be express or implied.”

Section 10-3610 explains in part that “All members have the same rights and obligations with respect to voting, dissolution, redemption and transfer, unless the articles of incorporation or bylaws establish classes of membership with different rights or obligations or otherwise provide.” Membership are freely transferrable unless the Articles or Bylaws provide otherwise. (ARS 10-3611)

Sections 3701-3732 provide excruciating detail on member meetings and Sections 3630-3637 guide the filing and litigation of derivative actions by Statutory Members. The terms and obligations of membership are generally controlled by the Articles and/or Bylaws, although the Board can set or waive fees. Fees are significant because income generation is often a key motivation for Statutory Memberships.

An entity should NOT have Statutory Members unless and until its size and donation model make the significant costs, hassles, and delays worthwhile. A non-voting group of supporters can be encouraged, however, who may feel like they belong in some special way and donate accordingly. It must be clear and in writing that such a loose association does not constitute Statutory Membership.

2.4. Enhanced director protections?

Arizona conditionally requires some form of indemnification of Directors: "Unless limited by its articles of incorporation, a corporation shall indemnify a director who was the prevailing party, on the merits or otherwise, in the defense of any proceeding to which the director was a party because the director is or was a director of the corporation against reasonable expenses incurred by the director in connection with the proceeding." (ARS 10-3852) An Officer is also entitled to indemnification to the same extent as a Director, and may apply to a court for indemnification and reimbursement of advanced expenses. (ARS 10-3856) Indemnification is also governed by ARS 10-3850 to 3858.

California provides limited protections for unpaid Directors and Officers. They will not be held liable for monetary damages to a third party if the wrongful act or omission was done (1) in good faith, and (2) within the scope of duty, and (3) if the damages caused by the act or omission are covered pursuant to a liability insurance policy issued to the corporation. (Cal Corp § 5239) Note the need for liability coverage.

In addition, California also permits that any agent, including Directors and Officers, "may" request advanced costs or indemnification concerning "any threatened, pending or completed action or proceeding, whether civil, criminal, administrative or investigative." (Cal Corp § 5238)

You should decide whether to include enhanced protections for your Board members and Officers. In addition to insurance protection, the Articles can limit Director and Officer liability and provide for their indemnification in the event of personal liability. For example, the Articles might include language that:

[1]. No director shall be personally liable to the corporation or its members for monetary damages for any action taken, or any failure to take any action, as a director, except for liability for (i) the amount of financial benefit received by a director to which he or she is not entitled, (ii) intentional misconduct or a knowing violation of law, or (iii) acts or omissions not in good faith.

Another level of protection is to require the nonprofit to indemnify its Director and Officers for any damages, judgment, or the like they suffer in their capacity as agents of the entity. Here broader language can be used.

[2]. The Corporation shall indemnify its directors, officers, employees, and agents to the fullest extent permitted by [*California / Arizona*] law, as it exists now or may be amended.

[3]. The Corporation shall indemnify its directors and officers, and may in the Board's discretion indemnify its employees and agents, to the fullest extent permitted by [*California / Arizona*] law, as it exists now or may be amended.

Alternatively, you might consider using something like the following if the situation seems to warrant it:

[4]. The Corporation shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he or she is or was an agent of the Corporation, to the fullest extent permitted by the [*California Nonprofit Public Benefit Corporation Law / Arizona Nonprofit Corporation Act*].

Director & Officers (D&O) Insurance is to be preferred but new and cash-strapped entities may not be able to afford it. The Board should at the least fully investigate obtaining one or more of the forms of available insurance because it is increasingly important.

2.5. The Statutory Agent for Service or Registered Agent

Every corporation requires an agent for service of process (aka statutory agent), upon whom legal and official documents may be served on behalf of the entity. This person or company must reside, or be based, in the state in which the entity is created. If a lawsuit is served on the agent, it is the same as being served on the corporation. Therefore, if the corporation does not timely respond, a default judgment may be obtained against it.

The agent may be any resident adult individual, and the location may be the entity's office. But consider hiring a professional "registered agent", which is a company registered with the Secretary of State whose only job is to receive formal notices and lawsuits on behalf of its clients, and then immediately forward them to the various entities. The Secretary of State or ACC must be notified immediately when a corporation changes its agent, and an ongoing professional agent is one less matter to juggle.

In California you may simply name the agent in the Articles and arrange later for any required service agreement. In Arizona, you must obtain the Agent's signature on the Articles or by separate document, and submit this to the ACC with the Articles.

2.6. Filing the Articles

Most states permit articles to be submitted online but the possible range of provided or accepted forms may not meet your needs. In Arizona and California the Articles must be signed by every Incorporator (or by all of the initial directors).

2.6.1. California filings

In California, to file a proper set of nonprofit Articles you must deliver or send in your hardcopy with a cover letter and \$30.00 fee. The documents must be sent by mail or overnight delivery to "Secretary of State, Business Entities Filings Unit, 1500 11th Street, 3rd Floor, Sacramento, CA 95814" [or P.O. Box 944260, Sacramento, CA 94244-

2260.] The telephone number is 916-657-5448. The Secretary of State's website and customer service are both terrible. Using legal counsel or a paid filing service is advisable.

2.6.2. Arizona filings

In Arizona an Incorporator submits the required filing packet to the Arizona Corporation Commission by mail or in person. The packet consists of the Articles of Incorporation, a Certificate of Disclosure (Form C003), the fee, cover letter, and a Statutory Agent Acceptance if the Articles are not already countersigned by the agent. Mail or overnight to "Arizona Corporation Commission Corporations Division - Examination Section 1300 W. Washington St., Phoenix, Arizona 85007". The telephone is 602-542-3026. The ACC has prepared a handy guide to forming nonprofits in Arizona (Instructions C011i). Both Form C003 and Instructions C011i are included in FORM 3 of class materials.

CHAPTER 3. The Bylaws

The Bylaws are the internal rules governing how the Board, its Officers, and the corporation must conduct its operations, hold meetings, and take certain actions. While certain provisions, like Statutory Members, can be created by way of the Bylaws, most major matters are covered in the Articles. The Bylaws terms, therefore, are largely boilerplate, with only a few variables, but include some important items. For example, the Bylaws typically set the number and terms of Directors and contain important details on notices for, and the conduct of, meetings. The Bylaws are not public, except to any statutory members, but will be provided to the IRS as part of a Form 1023 application and larger donors and donor website may want to review its terms.

Absent some other specification, Directors serve for one year. In California their term cannot be more than six (6) years (if no Members, 4 years if Members) (Cal Corp. § 5220) California requires certain officers be appointed: (1) a President or CEO and/or a Chairperson of the Board; (2) a Secretary; and (3) a Treasurer and/or CFO. (Cal Corp § 5213) Arizona does not specify nonprofit officers other than to require that the Bylaws or the Board "shall delegate to one of the officers responsibility for preparing minutes of the directors' and members' meetings and for authenticating records of the corporation." (ARS § 10-3840)

One area of the Bylaws the Board should review carefully involves requirements in the form, content, and length of advance notice for meetings, the agendas for meetings, and other corporate actions. Means of communication have changed and the Bylaws should reflect practical means to provide actual notice to Directors. For example, e-mail is now ubiquitous but fax machines are largely limited to tax practitioners. Overnight delivery to home or office provides for tracking and proof of receipt, but can be expensive, while certified mail may not result in actual receipt. Another common issue involves whether notices of board meetings, regular and/or special, must state a purpose(s) and are then limited to those matters.

If you want the corporation to authorize someone to file the Form 1023

application tax-exemption, consider providing for the position in the Bylaws. For example, a Chief Compliance Officer could be empowered to file the application, and once the exemption was granted resign from the position. While the corporation can authorize an IRS representative to act on its behalf using a Form 2848 Power of Attorney, this power does not permit that person to submit the online application.