Attorney General's Guide for Charities

Best practices for nonprofits that operate or fundraise in California

California Department of Justice

Charitable Trusts Section

Protecting Charitable Assets and Donations for the People of California

MESSAGE FROM THE ATTORNEY GENERAL

What makes California great? The generous people who live here. Californians are big-hearted and charitable. We step up to help those in need, whether in response to natural catastrophes, man-made tragedies, or families struggling in our local communities. In 2019, charities operating in California reported receiving over $293 billion in revenue, an increase of $57 billion from 2017.

We put our faith in charities to carry out our charitable intent, and many charities work tirelessly to serve our local communities. Day in and day out, they provide critical assistance to families during challenging times, exemplifying what it means to be a good neighbor. Whether they provide scholarships to our future leaders, help our veterans, or deliver meals to our seniors, the charities of California are living proof of our state's unique spirit of giving.

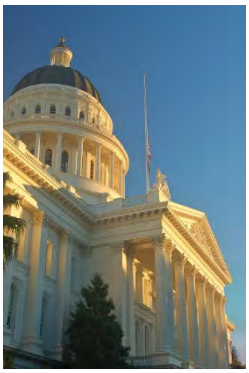
As the chief law enforcement officer in the state, I am committed to protecting donors and charitable assets, and ensuring that donations are not diverted or misspent. The Guide for Charities was published to give charities the tools they need to comply with our laws. It seeks to promote best practices to help directors and officers of charities better understand their responsibilities.

I hope charities find this guide helpful as they continue to make a real difference in the lives of Californians. The California Department of Justice stands ready to support their efforts to serve the great people of our state.

Sincerely,

ROB BONTA Attorney General

INTRODUCTION



Welcome to the California Attorney General's Guide for Charities. We hope that charitable organizations – including charities, charitable trusts, and other nonprofits – and fundraising professionals find this guide to be an invaluable resource to help them understand their responsibilities and comply with California law.

HOW THIS GUIDE IS ORGANIZED

Chapter 1 provides an overview of the charitable sector and explains the most common legal forms of charitable organizations that may be created under the statutes of California. Chapter 2 explains the steps of forming a nonprofit corporation, while Chapter 3 explains the tax-exempt application process. Chapter 4 provides information about legal requirements involving employment practices. This guide also explains other obligations, including fiscal responsibility requirements in Chapter 5, government reporting requirements in Chapter 6, director and officer obligations in Chapter 7, membership rights in Chapter 8, and fundraising obligations in Chapter 9. Chapter 10 and Chapter 11 explain the Attorney General's oversight over charities and nonprofit transactions. Meanwhile, Chapter 12 discusses the Attorney General's oversight of charitable trusts, religious nonprofits, and non-California entities.

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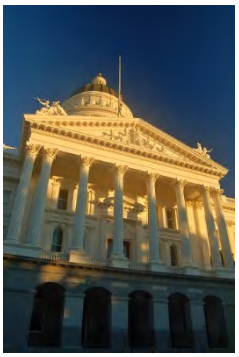

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CHAPTER 1 UNDERSTANDING THE CHARITABLE SECTOR

In This Chapter

- Charitable Sector Overview
- The Legal Forms of Charitable Organizations

CHARITABLE SECTOR OVERVIEW

Charities represent an important economic sector in California and significantly impact the communities they serve. In January 2021, there were over 118,000 charitable organizations registered with the Attorney General's Registry of Charitable Trusts. As of June 2019, these registered charities reported total revenues over $293 billion and total assets over $854 billion.

Historically, charities 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 government assistance.

Courts in California define "charitable purpose" very broadly.

In common usage, the term "charity" refers to an organization that provides charitable programs or sets aside any funds to be used for charitable purposes. Courts in California define "charitable purpose" very broadly to include the following:

- Relief of poverty;
- Advancement of education or religion;
- Promotion of health;
- Governmental or municipal purposes; and
- Other purposes beneficial to the community.[1]

Put another way, a central aspect of being a charitable organization is to benefit a significant segment of the community, as opposed to specific, private individuals.

As a result of the public benefits provided, charities are granted special legal status and benefits not available to for-profit enterprises. One such benefit is that charities can qualify for tax-exempt status. The IRS and California Franchise Tax Board administer and provide parameters on what a charitable organization must do to obtain and retain tax-exempt status. This tax-exempt benefit reflects the public policy favoring

[1] (*Lynch v. Spilman*, (1967) 67 Cal.2d 251, 261; *Estate of Breeden* (1989) 208 Cal.App.3d 981, 985; Rest.3rd Trusts, § 28.)

charitable giving and the recognition that many charities relieve the government from the burden of financing various community and human services. Also, state and federal tax laws[2] encourage the making of charitable gifts, which support the existence of charitable organizations.

The Attorney General has oversight over charities, charitable trusts, as well as individuals and other organizations who hold charitable assets[3] or engage in fundraising for charitable purposes.[4]

"Is Our Organization a Charity?"

Many people contact the Attorney General's Registry of Charitable Trusts to ask if their organization in California is a charity. If the organization is classified as a California nonprofit public benefit corporation[5] or has received federal tax exemption under Internal Revenue Code section 501(c)(3), it is considered a charity.

Note, however, this guide frequently uses the term charity to include other legal forms of charitable organizations, such as charitable trustees and unincorporated associations.

THE LEGAL FORMS OF CHARITABLE ORGANIZATIONS

California statutes establish the types of charitable organizations that may be formed in California. A charity may operate in California under any of

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[2] (E.g., Rev. & Tax. Code, §§ 17201, 24357-24359.1; Int.Rev. Code, § 170.)

[3] (E.g., Gov. Code, § 12580 et seq., known as the Supervision of Trustees and Fundraisers for Charitable Purposes Act; Corp. Code, § 5250 [nonprofit public benefit corporations]; Corp. Code, § 7240 [nonprofit mutual benefit corporations]; Prob. Code, §§ 17200-17210 [voluntary trusts]; Civ. Code, §§ 2223-2224.5 [involuntary trusts]; Cal. Code Regs., tit. 11, § 300 et seq.; *In re Los Angeles County Pioneer Society* (1953) 40 Cal.2d 852; *Holt v. College of Osteopathic Physicians and Surgeons* (1964) 61 Cal.2d 750, 754; *Hart v. County of Los Angeles* (1968) 260 Cal.App.2d 512, 517 [Attorney General authority includes trusts exempted from Supervision of Trustees and Fundraisers for Charitable Purposes Act]; *Estate of Clementi* (2008) 166 Cal.App.4th 375; *Summers v. Colette* (2019) 34 Cal.App.5th 361, 370-71.)

[4] (E.g., Gov. Code, § 12580 et seq.; Bus. & Prof. Code, § 17510 et seq. [charitable solicitations]; Cal. Code Regs., tit. 11, § 300 et seq.; *People v. Orange County Charitable Services* (1999) 73 Cal.App.4th 1054, 1074-1076.)

[5] (Corp. Code, § 5110 et seq.)

several legal forms, including as a nonprofit corporation, trust, or unincorporated association. Yet regardless of the legal form chosen, this

does not provide the charitable organization with the tax-exempt benefits described above. As discussed in Chapter 3, obtaining tax-exempt status involves another process after the organization has been legally formed.

Nonprofit Corporate Forms

Most California charities are organized as nonprofit corporations.[6] The three most common types of nonprofit corporations under California law are:

1. Public benefit corporations;
2. Mutual benefit corporations; and
3. Religious corporations.

Public Benefit Corporations

The majority of the registered nonprofit corporations in California are organized as public benefit corporations.

The majority of the registered nonprofit corporations in California are organized as public benefit corporations.

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. However, the failure of a public benefit corporation to qualify for income tax exemption does not necessarily free the organization and its responsible directors or officers from accountability of charitable assets.

Public benefit corporations (except, for example, educational institutions and hospitals) must register and report to the Attorney General's Registry of Charitable Trusts.[7]

Mutual Benefit Corporations

Mutual benefit corporations[8] are organized most often for the benefit of their own members. They may not be formed exclusively for charitable purposes. Examples include private homeowners' associations, private clubs, and trade and professional associations. Mutual benefit corporations may qualify for different income tax benefits than public

[6] (Corp. Code, §§ 5000-10841.)
[7] (Gov. Code, §§ 12585, 12586, subd. (a); Cal. Code Regs., tit. 11, §§ 300-307.)
[8] (Corp. Code, § 7110 et seq.)

benefit corporations. Because they serve their members and are not formed exclusively for charitable purposes, they are not considered charities and are typically exempt from registration and reporting requirements with the Attorney General's Registry of Charitable Trusts. But if a mutual benefit corporation solicits donations for a charitable program or holds some of its assets for charitable purposes, it must register and report on those charitable assets.

Religious Corporations

Religious corporations[9] are organized for religious purposes. They are usually exempt from income tax, and are not required to register or file annual financial reports with the Attorney General's Registry of Charitable Trusts. See Chapter 12 for more information.

A religious organization may also be legally formed as a "corporation sole,"[10] which is another type of corporation specific to religious purposes.

Trusts

A trust[11] may be created by language in a will or written trust instrument. The trust creates legal obligations for the person, called a "trustee," who holds title to and manages the assets of the trust.

When the trust has a charitable purpose, the trust is called a "charitable trust."[12] Charitable trusts are subject to the Attorney General's oversight and the trustees must register and file annual reports.[13] For more information, see Chapter 12.

Charitable Trustees

It is not essential to form a nonprofit corporation, trust, or other legal entity to hold assets for a charitable purpose.[14] In California, any individual or organization that solicits charitable funds is considered a "charitable trustee" or "trustee for charitable purpose,"[15] and is accountable for such funds.

In addition, the failure of a trustee for charitable purposes to qualify for income tax exemption does not necessarily free the trustee from

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[9] (Corp. Code, § 9110 et seq.)
[10] (Corp. Code, § 10000 et seq.)
[11] (E.g., Prob. Code, §§ 15200-15210.)
[12] (E.g., *Estate of Clementi* (2008) 166 Cal.App.4th 375, 385.)
[13] (Gov. Code, §§ 12582, 12585, 12586, subd. (a); Cal. Code Regs., tit. 11, §§ 300-307.)
[14] (E.g., Civ. Code, §§ 2223-2224.5.)
[15] (E.g., Bus. & Prof. Code, § 17510.8; Gov. Code, § 12582.)

accountability of charitable assets. An example of a charitable trustee is a commercial fundraiser, also referred to as fundraising professional, who solicits donations. Given he or she holds or controls assets for charitable purposes, this type of fundraiser is considered a charitable trustee. A commercial fundraiser is required to register and file annual financial reports with the Attorney General's Registry of Charitable Trusts even though they are not operating a tax-exempt organization.[16]

Unincorporated Associations

Any individual or group of persons who operates a charitable organization, but does not create a nonprofit corporation or a trust, may be treated under California law as an "unincorporated association."[17] Unincorporated associations that solicit charitable donations are under the oversight of the Attorney General and must register and file annual reports.[18] Under this classification, the individuals may be exposed to substantial risk of personal liability if the association is sued.

Other Legal Forms

Although charities may be formed as limited liability companies[19] or limited partnerships,[20] exercise caution and consult with legal counsel before using these legal forms. To the extent a limited liability company or limited partnership accepts property to be used for charitable purposes, these entities are also considered charitable trustees and are required to register and report to the Attorney General's Registry of Charitable Trusts.[21]

Additionally, there are two for-profit corporate forms in California that allow organizations to pursue worthy purposes and to provide a return to shareholders, but without the tax-exempt benefits that nonprofits typically enjoy.

- Social purpose corporations[22] describe their purposes in their articles of incorporation. Directors take into account these purposes as well as the overall prospects of the corporation in

[16] (Gov. Code, §§ 12581-12582, 12599, subds. (a)-(c) & (g); Cal. Code Regs., tit. 11, § 308.)
[17] (Corp. Code, § 18000 et seq.)
[18] (Gov. Code, §§ 12581, 12585, 12586, subd. (a); Cal. Code Regs., tit. 11, §§ 300-307.)
[19] (Corp. Code, § 17701.01 et seq.)
[20] (Corp. Code, § 15900 et seq.)
[21] (Gov. Code, §§ 12582, 12585, 12586, subd. (a); Cal. Code Regs., tit. 11, §§ 300-307.)
[22] (Corp. Code, § 2500 et seq.)

their decision-making.[23] The organization's annual report must include "management discussion and analysis" of the steps taken to pursue the corporation's purpose.[24]

- Benefit corporations[25] pursue a material and positive impact on society and the environment as measured by a third party standard. Directors of benefit corporations consider the interests of the corporation as an entity, the corporation's workforce, the environment, and society. It is designed for social enterprises to pursue both for-profit and nonprofit objectives. With this corporate form, corporate officers and directors may take into account a triple bottom line of "profit, people, and planet" when making business decisions.

As for-profit entities, social purpose corporations and benefit corporations are accountable to their shareholders, although the laws governing them also require posting of specified information to their websites for a measure of public accountability.[26] They are also distinguished from more traditional charitable organizations that require a greater measure of public accountability and transparency, including oversight by the Attorney General (unless deemed charitable trustees). Consult with legal counsel before using these corporate forms as well.

[23] (Corp. Code, § 2700.)
[24] (Corp. Code, § 3500.)
[25] (Corp. Code, § 14600 et seq.)
[26] (Corp. Code, § 3500 [social purpose corporation's annual report must be available on the corporation's web site or through similar electronic means]; Corp. Code, § 14630 [benefit corporation's annual benefit report must be posted to the corporation's web site or available on request, and sent to shareholders].)

CHAPTER 2 HOW TO FORM A PUBLIC BENEFIT CORPORATION

In This Chapter

- Introduction
- Preliminary Considerations: Is Forming a Nonprofit Corporation the Right Option?
- Steps to Form a Public Benefit Corporation
- Frequently Asked Questions

INTRODUCTION

As discussed in Chapter 1, charities in California are typically formed as public benefit corporations, the most popular type of nonprofit corporation.

This guide does not discuss the advantages or disadvantages of forming a charity as a public benefit corporation compared to other corporate forms, or as trusts. Nor does this guide address how public benefit corporations are formed in other states. Contact legal counsel for such guidance.

The basic steps and minimum requirements for forming a public benefit corporation are summarized in this chapter. However, forming the entity as a public benefit corporation does not make the organization tax-exempt under state or federal law. For discussion of tax exemption as a charity, see Chapter 3.

PRELIMINARY CONSIDERATION: IS FORMING A NONPROFIT CORPORATION THE RIGHT OPTION?

Although public benefit corporations may qualify for important benefits, including exemption from income tax, they are subject to important legal restrictions. One critical restriction is that the assets of a public benefit corporation are considered irrevocably dedicated to charitable purposes, and cannot be distributed for private gain.[1] If the corporation's board of directors later decides they do not wish to operate the corporation as a charity, they may dissolve the corporation, but cannot take back its assets. Legally, those assets must be used for the charitable purposes for which they were raised, and must be transferred to another nonprofit that has the same or similar purposes. Therefore, it is important to carefully consider the practical implications before taking any steps to form a public benefit corporation. Some important factors to consider:

[1] (E.g., Corp. Code, §§ 5130, 5237, 5410.)

- What is the purpose of the new organization? Will it be operated exclusively for charitable purposes, or might there also be a business or commercial purpose?
- Are other organizations addressing the same charitable need that will compete for funds and resources? If other charities provide the same service, would it be better to collaborate with them, rather than form a new entity?
- Are the potential benefits of nonprofit status important to the founders and donors (for example, exemption from income tax, property tax, and reduced-rate mailing privileges)? If so, will the corporation be prepared to maintain compliance with government regulations and filing requirements for nonprofits? See Chapter 6.
- How important is the confidentiality of executive compensation, corporate transactions, and other financial information?
- How much flexibility over operations is desired?
- What are the projected expenses and sources of revenue? Will donations or grants be an important source of revenue or will the corporation seek investors?
- What are the government regulations and filing requirements for nonprofit corporations as compared to for-profit business corporations?
- How will any "surplus" revenue be used?
- How do the standards of liability for directors vary between nonprofit and for-profit corporations, and as compared to trusts and unincorporated associations?

This guide may help to answer some of these preliminary questions; however, it does not constitute legal advice. Additional guidance from a qualified attorney or other tax expert may be appropriate.

STEPS TO FORM A PUBLIC BENEFIT CORPORATION

A California public benefit corporation may be formed by completing the steps summarized here:

1. **Choose a corporate name.** The first step is to identify an appropriate and available name for the corporation, which is a distinct legal entity under California law. California law does not require any particular words (such as "incorporated" or "inc.") to be included in the name of a public benefit corporation, but it prohibits the use of a name that is likely to mislead the public or is the same name of an existing corporation.[2] Once a corporate name is

[2] (Corp. Code, § 5122, subd. (b).)

selected, request a free preliminary check of the availability of that name by submitting a Name Availability Inquiry Letter to the California Secretary of State, by mail or in person. To reserve an available name, this can be done for a fee and for a period of 60 days by submitting a completed Name Reservation Request Form to the Secretary of State, by mail or in person. For additional information, contact the Secretary of State or view its Name Availability website.

2. **Draft and file articles of incorporation with the Secretary of State.** A new corporation is "born," that is formed, when persons acting as "incorporators" or the initial board of directors, file what is called "articles of incorporation" with the Secretary of State.[3] The articles of incorporation of a California public benefit corporation must state the name of the corporation, particular language indicating the corporation is a public benefit corporation and is not organized for the private gain of any person, the corporation's public and/or charitable purposes, the name and address of the corporation's agent for service of process, and the initial street and mailing addresses of the corporation.[4] The articles of incorporation may contain additional provisions as set forth in California's Corporations Code.[5] There are also special requirements for the articles of incorporation if the organization has been operating as an unincorporated association that is now incorporating.[6] If the corporation plans to apply for exemption from federal income tax under Internal Revenue Code section 501(c)(3), or for property tax exemption in California, the articles of incorporation must also contain particular statements regarding the corporation's purposes and the distribution of its assets upon its dissolution. For sample articles of incorporation, see the Secretary of State's Form ARTS-PB-501(c)(3).

3. **Draft the bylaws of the corporation.** Bylaws serve as the operating manual for the corporation and set forth the basic rules for the corporation's governance, including how directors and officers are elected and removed, how board and membership meetings may be called, how certain corporate decisions are made, how committees operate, and other key provisions. The Corporations Code specifies the rules regarding provisions that must be included in the bylaws, provisions that may be modified in

[3] (Corp. Code, § 5120.)
[4] (Corp. Code, § 5130.)
[5] (Corp. Code, §§ 5131-5132.)
[6] (Corp. Code, § 5121.)

the bylaws, and default provisions that apply if the bylaws are silent.[7]

4. **Draft an 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 members of the board of directors by signing an "action by sole incorporator." If desired, the incorporator may take other actions at the same time, including adopting the bylaws, appointing the initial officers, and authorizing the opening of bank accounts.[8]

5. **File an application for a federal Employer Identification Number with the IRS.** Once confirmation has been received that the articles of incorporation has been filed with the Secretary of State, the corporation has been formed and one may apply for a federal employer identification number online. One may also apply by mail, fax, or phone in some circumstances by using Form SS-4. See Chapter 4 for more information.

6. **Hold the first meeting of directors.** Shortly after the corporation is formed, the first meeting of the board of directors should be held. Agenda items for the first meeting typically include adopting bylaws, electing officers, adopting a conflict of interest policy, establishing a bank account, setting the accounting year, planning a budget for the first year, and adopting procedures for safekeeping of minutes, bylaws, and other corporate records. It is important for someone (often the corporate secretary) to record and keep minutes of all meetings of the board of directors and all committees, and to certify those minutes are true copies.[9]

7. **File a Statement of Information with the Secretary of State.** The Statement of Information, Form SI-100, must be filed with the Secretary of State within 90 days of filing the initial articles of incorporation, and may be filed online for most organizations. Most California nonprofit corporations have to file this form again at least every second year during the life of the corporation. See Chapter 6.

8. **Register with the Attorney General's Registry of Charitable Trusts.** All California public benefit corporations, and other persons or entities holding assets in trust for charitable purposes

[7] (See generally Corp. Code, §§ 5150-5153, 5211-5222, 5224-5225, 5227.)
[8] (Corp. Code, § 5134.)
[9] (Corp. Code, § 5215.)

in California, must register with the Attorney General's Registry of Charitable Trusts within 30 days of first receiving the assets. The initial registration is completed by filing the Initial Registration Form (Form CT-1), along with a copy of the corporation's articles of incorporation, bylaws, and a registration fee. Also provide copies of the corporation's application for recognition of federal tax exemption and the determination letter issued by the IRS, if this process has begun or been completed. All California public benefit corporations required to register with the Registry of Charitable Trusts must also renew their registration by filing an Annual Registration Renewal Free Report (Form RRF-1). If applicable, an Annual Treasurer's Report (Form CT-TR-1) must also be filed. See Chapter 6.

9. **File applications for tax exemptions with the IRS and California Franchise Tax Board (FTB).** California nonprofit corporations are not automatically exempt from income or other applicable taxes. If the corporation desires to be recognized as exempt from federal income tax, it should file Form 1023 or Form 1023-EZ with the IRS as appropriate. If the corporation also desires to be exempt from the California franchise tax (including the minimum franchise tax of $800 that applies to most California corporations), it should file Form 3500 with the FTB. If the corporation has already been recognized as exempt by the IRS, Form 3500A may be used to obtain recognition of exemption from the FTB. See Chapter 3 for more information.

10. **Determine whether there are any additional permits, licensing, or registration requirements at the local, state, or federal level, and establish procedures to ensure satisfaction of ongoing filing requirements.** It is important to ensure the organization has satisfied and continues to satisfy all filing, registration, permit, and licensing requirements. These filing requirements are not optional; they are legal requirements mandated by law. The failure to abide by these requirements may lead to the assessment of late fees and penalties, the loss of tax-exempt status, and the forfeiture of corporate status. Avoidable penalties generally constitute waste of charitable assets and damage to the charity. Also, a director who has committed a breach of fiduciary duty or breach of trust by allowing avoidable penalties may be liable for any damage to the charity.[10]

[10] (E.g., Bus. & Prof. Code, § 17510.8; Corp. Code, §§ 5210, 5231, 5239.)

FREQUENTLY ASKED QUESTIONS

"What is the simplest legal form to use in creating a charity?"

The public benefit corporation is the recommended legal form for most California charities. The procedures for operation and the rights and duties of directors, officers, and members are more clearly set forth for public benefit corporations. This may be helpful during the operating life of the corporation.

"Is it necessary to hire an attorney to form a public benefit corporation?"

No, California law does not require an attorney to form a corporation. However, as noted earlier, there are many questions to review and consider before deciding to form a public benefit corporation. An attorney who specializes in the area of nonprofit corporations could assist in this review, and guide the organizers through the steps to incorporate and apply for tax exemption.

"How does a nonprofit obtain tax-exempt status?"

A public benefit corporation is not automatically tax-exempt. To obtain exemption from federal income tax, it is necessary to apply to the IRS for recognition as an exempt organization under Internal Revenue Code section 501(c)(3). Most California charities also apply to the FTB for parallel exemption from California income taxes. If the organization does not obtain recognition of exemption from California income taxes, it may be subject to the minimum franchise tax (currently $800) annually, even if it has no profits. The basic steps and the necessary application forms are described in Chapter 3.

"How does a charitable organization register with the Attorney General's Registry of Charitable Trusts?"

Registration with the Attorney General's Registry of Charitable Trusts is required for all California public benefit corporations and other types of organizations that hold assets for a charitable purpose. The requirements, instructions, helpful webinars and forms are available on the Attorney General's Charities website. The initial registration is completed by filing the Initial Registration Form (Form CT-1), along with a copy of the corporation's articles of incorporation, bylaws, and a registration fee. Also provide copies of the corporation's application for recognition of federal tax exemption and the determination letter issued by the IRS, if this process has begun or been completed. Note that all California public benefit corporations must also renew their registration annually by filing an Annual Registration Renewal Fee Report (Form RRF-1). If applicable, an Annual Treasurer's Report (Form CT-TR-1) must also be filed. See Chapter 6 for more information.

CHAPTER 3 OBTAINING TAX-EXEMPT STATUS

In This Chapter

- Introduction
- Requirements for Tax-Exempt Status
- How to File for Tax-Exempt Status
- Public Charity or Private Foundation?
- Unrelated Business Income Is Taxed
- Property Tax Exemption
- Sales Tax Exemption
- Frequently Asked Questions

INTRODUCTION

One benefit to being a charity is that charities can obtain exemptions from paying federal and state income taxes. Obtaining tax-exempt status also allows donors to obtain a tax deduction for their gifts to the charity. The initial steps in the process of obtaining recognition as a charitable organization exempt from paying federal or state taxes are:

1. Forming a nonprofit corporation or other suitable nonprofit entity under the laws of a state (e.g., see Chapter 2); and

2. Applying for tax-exempt status with the IRS, by completing and filing Form 1023 or Form 1023-EZ (as discussed below).

There are several different kinds of tax-exempt designations permitted by the Internal Revenue Code. Most public benefit corporations apply for and hold tax-exempt status through Internal Revenue Code section 501(c)(3). Having “section 501(c)(3) status” qualifies the organization to be both tax-exempt and to receive tax deductible donations.

Charitable public benefit corporations incorporated or operating in California also typically seek exemption from state income tax under California’s Revenue and Taxation Code section 23701d.

REQUIREMENTS FOR TAX-EXEMPT STATUS

To obtain tax-exempt status under Internal Revenue Code section 501(c)(3), an organization must operate in compliance with certain restrictions:

- The organization must have a charitable purpose;
- Private benefits to individuals with control over the organization are prohibited;
- The organization cannot promote or oppose candidates for public office; and

- Lobbying activities are restricted.[1]

A tax-exempt charitable organization under Internal Revenue Code section 501(c)(3) must be "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…, or for the prevention of cruelty to children or animals."[2] In other words, the organization must satisfy, what the IRS calls, "organizational" and "operational" tests.[3]

The organizational test is met if the articles of incorporation or similar founding document includes language limiting the purposes of the organization to one or more of the exempt purposes specified in Internal Revenue Code section 501(c)(3). A more detailed discussion on permissible section 501(c)(3) activities is included in Chapter 3 of IRS Publication 557, *Tax-Exempt Status for Your Organization*. In addition, the founding document must require the organization to expressly dedicate its assets to exempt purposes in the event of dissolution.

The operational test requires the organization to be primarily engaged in charitable activities which accomplish one or more of the exempt purposes specified in Internal Revenue Code 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.[4] 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.

The organization is also required to serve public, rather than private interests; generally, this means that its activities benefit a large and indefinite class of individuals, as opposed to a small, identifiable group. In particular, the organization may not be organized or operated for impermissible private interests, such as those of specifically designated individuals, the founder of the organization, the founder's family, or persons or companies controlled by such private interests.[5]

To obtain recognition of tax-exempt status in California, public benefit corporations may also be required to show that at least 51% percent of the organization's directors or their close relatives are "disinterested

[1] (See generally Int.Rev. Code, § 501(c)(3).)
[2] (Int.Rev. Code, § 501(c)(3).)
[3] (26 C.F.R. § 1.501(c)(3)-1(a) (2020).)
[4] (26 C.F.R. § 1.501(c)(3)-1(c)(1) (2020).)
[5] (26 C.F.R. § 1.501(c)(3)-1(d)(ii) (2020).)

persons," as defined in California Corporations Code section 5227. Also see Chapter 7.

The law of tax-exempt organizations is highly complex, and this discussion is only intended as a broad overview of the requirements for exemption. Organizations with special problems or that need more assistance should consult a qualified attorney or tax expert.

HOW TO FILE FOR TAX-EXEMPT STATUS

Obtaining federal tax exemption under Internal Revenue Code section 501(c)(3) requires submission to the IRS of an Application for Recognition of Exemption under Section 501(c)(3); either the full Form 1023 or the streamlined application Form 1023-EZ, if eligible.

Form 1023 is available in standard PDF and accessible PDF versions. It generally must be filed within 27 months (15 months plus an automatic 12-month extension) from the end of the month of incorporation, together with a fee. If filed within the 27-month period, tax-exempt status – if granted by the IRS – will be retroactive to the date of incorporation. When Form 1023 is filed after the 27-month period, the IRS grants section 501(c)(3) status retroactive to the date postmarked on the application envelope, absent certain circumstances. More information regarding the criteria and procedures for applying for federal tax exemption can be found in IRS Publication 557, *Tax-Exempt Status for Your Organization*.

Form 1023-EZ can only be filed at Pay.gov. Organizations that project to have annual gross receipts of less than $50,000 in each of the first three years of operations may be eligible to file Form 1023-EZ if they meet certain criteria. If an organization expects receipts to exceed $50,000 in any of the next three years, it is ineligible to use Form 1023-EZ. To determine if an organization qualifies, complete the Form 1023-EZ Eligibility Worksheet reflected in the Instructions for Form 1023-EZ.

A similar procedure at the state level requires the filing of Form 3500 with the California Franchise Tax Board (FTB), together with a filing fee. Alternatively, an organization may wait until it receives federal tax-exempt status and then file with the FTB its short exemption form, Form 3500A. The FTB will notify the applicant of its decision on exempt status, and also sends instructions for the annual filing of its Form 199. Note that the organization's state tax return may need to be filed before the IRS has notified the organization of its tax-exempt status; therefore, it may be prudent for the organization to file a taxable entity return or Form 3500 contemporaneously with IRS Form 1023 or Form 1023-EZ.

More About IRS Form 1023

In general, Form 1023 requires the organization to submit the following documents and information:

- A conformed copy of the organization's articles of incorporation (trust instrument, or other founding document);
- The bylaws (if a nonprofit corporation);
- A conflict of interest policy (although technically not required, the IRS strongly suggests every organization adopt a conflict of interest policy; the Instructions for Form 1023 include a sample document that can be used);
- Employer Identification Number of the organization (to obtain this number, see Chapter 4);
- A statement of receipts and disbursements;
- A current balance sheet; and
- Other financial information, including a proposed budget for the current and following two years in the case of newly formed organizations.

Form 1023 also asks for information regarding the organization's activities, governance structure, and finances. For more information, see the IRS' Life Cycle of an Exempt Organization website. This describes all of the interactions a charitable organization will have with the IRS throughout its life, from application to dissolution.

It is important to retain copies of all of the organization's founding records, including applications for tax-exempt status. Note that federal tax law requires charitable organizations make available for public review at their principal offices copies of their exemption application, and annual returns (Form 990, Form 990-EZ, or Form 990-PF) for the three most recent years. Individuals who have been denied access to copies of the exemption application or the annual return of a charitable organization may call IRS Customer Account Services at (877) 829-5500; or write to Internal Revenue Service, TE/GE Division Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

Organizations that qualify for exemption under Internal Revenue Code section 501(c)(3) will be classified by the IRS as either a "public charity" or "private foundation."

PUBLIC CHARITY OR PRIVATE FOUNDATION?

Organizations that qualify for exemption under Internal Revenue Code section 501(c)(3) will be classified by the IRS as either a "public charity" or "private foundation." Most organizations (with a few exceptions, such as churches) are presumed to be private foundations unless they receive a determination from the IRS that they are a public charity.

An organization will be classified by the IRS as a public charity if it receives a certain percentage of its total support from government sources, other public charities, or from a broad base of individual donors. Nonprofits should be aware that achieving public charity status based on public donations is a complex calculation and early consultation with a tax professional is recommended.

A charity's classification as a private foundation carries some disadvantages, including an excise tax on the organization's net investment income, certain limitations on the deductibility of charitable contributions by individual donors, a wide range of operational requirements and restrictions, and additional reporting requirements. Private foundations are subject to taxes for the following actions:

- Acts of self-dealing;
- Failure to distribute five percent of its investment asset base, in the form of a qualifying distribution;
- Holding too great a percentage of a trade or business enterprise (known as excess business holdings);
- Investments that jeopardize the foundation's ability to carry out its charitable purposes; and
- Engaging in taxable expenditures such as for lobbying (with exceptions), political activity (with exceptions), grants to individuals (without prior IRS approval), or non-charitable purposes.

An organization may avoid being classified as a private foundation under certain conditions, if it:

- Meets the IRS' definition of a church, school, or hospital;
- Relies primarily on income earned from its charitable activities provided to the general public (such as museums); or
- Maintains a supporting relationship with one or more public charities or government entities (this relationship requires the organization to be organized and operated exclusively for such public charities or government entities, among other requirements).[6]

For more information on classification as a public charity or private foundation, review Chapter 3 of IRS Publication 557, *Tax-Exempt Status for Your Organization*.

[6] (Int.Rev. Code, § 509(a)(3).)

UNRELATED BUSINESS INCOME IS TAXED

Regardless of the classification as a public charity or private foundation, organizations with section 501(c)(3) status are subject to taxes on income derived from actively conducted business activities that are not substantially related to the organization's exempt purposes.[7] Business activities do not become "related" to the charitable purpose just because the proceeds are used for the exempt purpose. The IRS defines an organization's activity as unrelated business, and hence subject to income taxes, if it meets three requirements:

1. It is a trade or business;
2. It is regularly carried on; and
3. It is not substantially related to furthering the exempt purpose of the organization.[8]

In determining the third criteria, a central question is whether the business activity contributes importantly to accomplishing the organization's tax-exempt purpose or not. For example, if a charity is a museum and operates a cafeteria for use by its visitors during visiting hours, the cafeteria can be viewed as contributing importantly to the museum's tax-exempt purpose as it helps attract visitors and allows them to spend more time viewing the museum's exhibits. Hence, operating the cafeteria would be deemed a related business and its income would not be taxed. However, if the same museum has a theater auditorium and regularly operates it as a motion picture theater for the public when the museum is closed, this would not contribute importantly to the museum's purpose. Such activity would be deemed an unrelated business, and its income would be taxed.

There are several exclusions and exceptions to the rules governing unrelated business income. For example, the definition of unrelated business income does not include the following activities: dividends, interest, certain other investment income, and royalties. In addition, any trade or business is excluded where substantially all of the work is performed for the organization without compensation (i.e., volunteer labor). For further information, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

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[7] (See generally Int.Rev. Code, §§ 501(b), 511(a).)
[8] (See generally Int.Rev. Code, § 513(a).)

Organizations that generate unrelated business income must file IRS Form 990-T and FTB Form 109. See also Chapter 6.

PROPERTY TAX EXEMPTION

The California State Board of Equalization and local county assessors administer the welfare exemption from property taxation.[9] In general, the welfare exemption from local property taxes is available for property of organizations that:

1. Are formed and operated exclusively for qualifying purposes (religious, scientific, hospital, or charitable);
2. Use their property exclusively for those qualifying purposes; and
3. Have a current tax exemption letter from the IRS or FTB.

There are many requirements for obtaining a welfare exemption from property taxes. For further information, see the Board of Equalization's Publication 149, *Property Tax Welfare Exemption*. See also Chapter 6.

SALES TAX EXEMPTION

A charity that sells items may be required to collect and remit state sales taxes on goods sold. In California, as administered by the California Department of Tax and Fee Administration, there is no general exemption from sales tax for charities. Rather, a variety of narrow exemptions apply to certain charitable activities. For further information, see Department of Tax and Fee Administration Publication 61, *Sales and Use Taxes: Exemptions and Exclusions*, and Chapter 6.

FREQUENTLY ASKED QUESTIONS

"Can we solicit donations pending review of our tax exemption applications with the IRS and FTB?"

Yes, but the donor's contributions will not qualify as charitable deductions until tax-exempt status is obtained. Newly formed nonprofit organizations should not state they have obtained recognition of tax-exempt status until recognition is officially granted. This is particularly important for organizations that wish to fundraise during the period after either Form 1023 or Form 1023-EZ has been filed, but before receiving confirmation of tax-exempt status from the IRS.

Once granted, the tax-exempt status is generally retroactive to the date of organization). Contributions made after the date of organization would then be deemed tax-deductible. However, if the organization ultimately

[9] (Rev. & Tax. Code, § 214 et seq.)

does not qualify for exemption, the contribution would not be tax-deductible.

"If the IRS denies the application by our organization for recognition of income tax exemption, what can we do with the funds already donated to the organization?"

In almost all cases, funds collected by a charitable organization are irrevocably dedicated to charitable purposes. Even if the organization fails to be recognized as tax-exempt by the IRS, the funds must be used for charitable purposes and cannot be refunded to the donors.

In special circumstances, such as where an organization was formed as a public benefit corporation by mistake, where its organizers intended it to be a mutual benefit corporation, and where all the funds received were dues from members, the organization may be allowed to terminate as a charity and refund the dues and other assets to members, rather than to charity. However, the Attorney General's written consent must be obtained if the organization was formed as a public benefit corporation.[10]

"Our charitable organization has special tax problems. Where can we find an expert on charitable tax-exempt organizations?"

The law on charitable tax-exempt organizations is complex and specialized. When hiring a tax attorney or other tax expert, be certain the person is knowledgeable about this particular area of tax law. Ask the tax attorney or accountant if they have worked with nonprofits before agreeing to retain them. One may contact any of the following for referrals to tax experts in the area of expertise sought:

- A local county bar association referral service;
- Accredited law schools in a local region usually have a tax specialist on their faculty who may be able to refer an attorney who specializes in tax-exempt organizations; and
- Large charitable organizations nearby may be able to provide the names of tax experts who have assisted their organizations.

"If our charity is recognized as exempt from federal and state income taxes, does the charity have to pay property tax on property it owns? Does the charity have to pay sales tax on items it sells?"

A charity exempt from income tax may still have to pay property taxes and sales taxes. The rules that apply to exemption from property and sales taxes are different from the rules for exemption from income tax. Contact the Board of Equalization and the applicable local county assessor's office for additional information on property taxes, and the Department of Tax & Fee Administration regarding sales taxes.

[10] (Corp. Code, § 5813.5.)

"Our charity lost its tax-exempt status with the IRS and FTB. Do we still have to register and report to the Attorney General's Registry of Charitable Trusts? And what can we do to get our tax-exempt status back?"

Even without tax-exempt status, a charity is required to register and file annual financial reports with the Attorney General's Registry of Charitable Trusts because it holds charitable assets. Charities that have lost tax-exempt status may be able to have such status reinstated. See the resources on the IRS' website, Revoked Reinstated Learn More, and the FTB's website, Charities and Nonprofits.

CHAPTER 4 CHARITIES AS EMPLOYERS

In This Chapter

- Introduction
- Application for Federal Employer Identification Number
- Employer Wage Reporting, Taxes, and Withholding Requirements
- Personnel Policies
- Compensation Issues
- Fair Treatment/Anti-Discrimination Practices
- Workplace Safety Rules
- Independent Contractors
- Volunteers and Interns
- Frequently Asked Questions

INTRODUCTION

A number of state and federal laws govern the relationship between employers and employees. This chapter describes a few of the important legal obligations of employers, as well as those applying to organizations that receive services through independent contractors and volunteers. Most of these laws and obligations apply equally to nonprofit and for-profit organizations.

APPLICATION FOR FEDERAL EMPLOYER IDENTIFICATION NUMBER

The IRS uses an identification number system in its administration of tax laws, including tax exemption laws. This identification number is known by a number of names and abbreviations, including “federal tax identification number” (sometimes abbreviated to FEIN) and “employer identification number” (EIN). The nine-digit number is the organizational equivalent of an individual’s Social Security number.

Entities must obtain this identification number even if they do not plan to hire employees. If employees are to be hired, an organization must apply for an identification number within seven days of paying wages that are subject to the Federal Insurance Contributions Act.[1] The IRS also advises organizations to be formed legally before applying for an identification number.[2]

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[1] (26 C.F.R. § 31.6011(b)-(1)(a)(2) (2019).)

[2] (E.g., IRS, *Employer ID Numbers*, <https://www.irs.gov/businesses/small-businesses-self-employed/employer-id-numbers> [last updated Apr. 14, 2021].)

Trusts and estates may also need to obtain this number to report income they may earn.[3]

See the IRS' Employer ID Numbers website or Publication 1635, *Employer Identification Number Understanding Your EIN*, for options in obtaining this identification number. The online approach is the fastest; other options include applying by fax and mail. There is no charge to obtain the number.

EMPLOYER WAGE REPORTING, TAXES, AND WITHHOLDING REQUIREMENTS

Even when a charitable organization's revenue is exempt from paying federal and state taxes, the income paid to staff as wages generally are subject to taxes. As a result, when tax-exempt organizations pay their staff, they are obligated to report that income, and make tax and withholding payments to federal and state governments.

Employers must withhold federal income tax from wages paid to their employees. In addition, employers must withhold Social Security and Medicare taxes from their employees' wages, while also paying the employers' share of these taxes. These requirements are sometimes referred to as "FICA payments," which stands for the Federal Insurance Contributions Act.[4] Certain high income individuals may be subject to additional Medicare taxes.[5] In addition, employers pay federal unemployment tax, unless the entity is specifically exempt from applicable requirements, such as organizations that hold federal income tax-exempt status through Internal Revenue Code section 501(c)(3).[6] These are sometimes referred to as "FUTA payments," which stands for the Federal Unemployment Tax Act.[7] The IRS explains these requirements in Publication 15 (Circular E), *Employer's Tax Guide*.

The following is a list of forms and withholding returns that employers must both maintain and file with the federal government:

- Employee's Withholding Certificate, Form W-4;
- Employment Eligibility Verification, Form I-9;

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[3] (IRS, *Employer Identification Number Understanding Your EIN* Publication 1635 <https://www.irs.gov/pub/irs-pdf/p1635.pdf> [last updated Feb. 2014].)
[4] (Int.Rev. Code, §§ 3101-3128.)
[5] (Int.Rev. Code, § 3101(b).)
[6] (Int.Rev. Code, §§ 3301, 3306(c)(8).)
[7] (Int.Rev. Code, §§ 3301-3311.)

- Employer's Federal Quarterly Withholding Returns, Form 941, and bank deposits of withheld income taxes and Social Security taxes;
- Annual Federal Wage and Tax Statement, Form W-2; and
- Employer's Annual Federal Unemployment Tax Return, Form 940.

California also requires employers to withhold state income tax from wages paid to employees. There are also three other state payroll taxes:

- State disability insurance, which are withheld from employees' wages;
- Unemployment insurance, which the employer pays; and
- Employment training tax, which the employer also pays.

California's Employment Development Department (EDD) administers these requirements. The EDD explains employer obligations in Publication DE 44, *California Employer's Guide*. Withholding requirements are strictly enforced. Failure to comply may result in penalties against the organization, its directors, and employees. The penalty is generally equal to the tax evaded or not collected.

Unless a waiver is received, employers must electronically file their state employment tax returns, wage reports, and payroll tax deposits with the EDD through an e-Services for Business account. Other filings, such as registering for an employer payroll tax account number and reporting new employees, can also be submitted electronically. Applicable forms and instructions are also listed on EDD's Payroll Taxes – Forms and Publications website.

See Chapter 6 for other reporting requirements required by law.

PERSONNEL POLICIES

Legally, a charitable organization is treated like any other employer. To promote evenhanded personnel practices and avoid misunderstandings with employees (which can lead to lawsuits), it is a best practice to put personnel policies in writing. The organization's personnel policies should include policies pertaining to:

- Hiring (including the organization's commitment to equal employment opportunity);
- Performance evaluation and review procedures;
- Working hours and any flex time;
- Leave policies, including sick leave, vacation leave, and family medical leave;
- Employee benefits, including health and insurance plans;
- Expense reimbursement requirements;

- Discrimination, harassment, and grievance procedures;
- Discipline and termination procedures;
- Whistle-blower protection;
- Workplace safety and injury prevention;
- Volunteers and interns;
- Employee privacy; and
- Policies about the use of the organization's assets and authority to speak to third parties on behalf of the organization.

These policies must be consistent with federal, state, and any local laws. They should also be consistent with one another. Another sound employment practice is to have written job descriptions or duty statements for all employees. Personnel policies are typically assembled into staff and volunteer handbooks that can be shared when an individual joins the team. As part of this process, individuals must sign a form acknowledging they have received and read the information. Employers must also post a variety of notices in the workplace to help employees understand their rights. Additional information and sample notices are available from the United States Department of Labor and California Department of Industrial Relations websites.

COMPENSATION ISSUES

Minimum Wage

Federal, state, and local laws specify what minimum wage rates employees must be paid. In 2021, the minimum wage in California was $13 or $14 per hour depending on the number of employees. California law also mandates the California minimum wage will increase to $15 an hour by 2023.[8] Several California municipalities have minimum wage laws that must be reviewed by employers operating within their jurisdiction. The California Department of Industrial Relations' Minimum Wage website answers questions on the intersection of federal, state, and local minimum wage requirements and exceptions. The website also enables employers to verify the current minimum wage rates in California.

Other Wage and Hour Issues

Charitable organizations are subject to the employment rules addressing overtime pay, required break periods, recordkeeping, and related issues under both federal[9] and state[10] law. The United Sates Department of Labor administers federal wage and hour laws and provides helpful information about these laws on its Wages and the Fair Labor Standards Act website. The Department of Industrial Relations administers

[8] (Lab. Code, § 1182.12.)
[9] (29 U.S.C. § 201 et seq.)
[10] (Cal. Code Regs., tit. 8, § 11000 et seq.)

California's laws, and answers Frequently Asked Questions on its website.

Charitable employers should be especially careful to classify employees correctly for purposes of exemption from overtime status under federal and state wage and hour laws. The use of staffing agencies and other sources of full- or part-time workers may cause a charity to be deemed a joint or co-employer with unexpected liability for compensation, taxes, and other employer liabilities.

Excessive Compensation Issues

As part of their supervision of charitable organizations and their assets, the IRS and Attorney General may review compensation paid to an organization's higher-level employees. The goal of this review is to ensure charitable assets are not being diverted for private gain.

As part of their supervision of charitable organizations and their assets, the IRS and Attorney General may review compensation paid to an organization's higher-level employees. The goal of this review is to ensure charitable assets are not being diverted for private gain.

The IRS looks at whether compensation packages are reasonable based on a comparative analysis of what similar organizations would pay for such services under similar circumstances. For more information about how the IRS approaches this issue, see its Intermediate Sanctions – Compensation website. More specifically, the IRS has a three-step process organizations should follow to demonstrate that a compensation package is reasonable.

Larger organizations must disclose their compensation practices in their annual informational returns (Form 990). Penalties for missteps in this area may include sanctions for both the organization and management. In severe situations, the organization's tax-exempt status may be revoked.

Likewise, the Attorney General may audit an organization if there is suspicion of unreasonable compensation. California law requires the board of directors or its equivalent to review and approve the compensation, including all benefits, paid to the president or chief executive officer, treasurer or chief financial officer, and/or those with comparable powers, duties, or responsibilities, to assure that the compensation is just and reasonable.[11] This review is required initially upon hiring, whenever the terms of employment is renewed or extended, and whenever the officer's compensation is modified. For more information, see Chapter 7.

FAIR TREATMENT/ANTI-DISCRIMINATION PRACTICES

Generally, charitable organizations are subject to the same laws governing the terms and conditions of employment and prohibitions on discrimination that apply to for-profit corporations. Under federal, state,

[11] (Gov. Code, § 12586, subd. (g); Cal. Code Regs., tit. 11, § 312.1.)

and local law, a nonprofit employer may not refuse to hire an applicant, or treat an employee less favorably in the terms and conditions of employment, or terminate an employee, because of the race, color, religion, gender, gender identity, pregnancy, marital status, disabling condition, age, or national origin of the applicant or employee.

Is a Nonprofit Organization a "Covered" Employer?

The federal Age Discrimination in Employment Act[12] governs employers of 20 or more employees. The federal Americans with Disabilities Act[13] governs employers of 15 or more employees. California's Fair Employment and Housing Act[14] governs certain nonprofits with five or more employees. A private employer is also covered by the federal Family and Medical Leave Act[15] and the California Family Rights Act[16] if it employs 50 or more employees for each working day during each of 20 or more calendar workweeks in the current or preceding calendar year.

Religious organizations may be exempt from some of the above laws and restrictions.

WORKPLACE SAFETY RULES

Federal and state law also impose various requirements on employers involving workplace safety, including a requirement to prepare an injury and illness prevention program. For more information on these requirements, see the Department of Labor's Occupational Safety and Health Administration Employer Responsibilities website, as well as the Department of Industrial Relations' Cal/OSHA website.

Also, California imposes strict liability for on-the-job injuries. Insurance is available from both the State Compensation Insurance Fund or private carriers. For more information, visit the Department of Industrial Relations' Employer Information website, and the State Compensation Insurance Fund's Employers website.

INDEPENDENT CONTRACTORS

When charitable organizations retain independent contractors, additional legal requirements arise from these arrangements. As with any contract, it is good practice to put such agreements in writing so both parties are clear on the scope of the agreement, and to minimize misunderstandings.

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[12] (29 U.S.C. § 621 et seq.)
[13] (42 U.S.C. § 1201 et seq.)
[14] (Gov. Code, § 12900 et seq.)
[15] (29 U.S.C. § 2601 et seq.)
[16] (Gov. Code, §§ 12945.1-12945.2, 19702.3.)

Organizations must report income over $600 paid to unincorporated independent contractors on IRS Form 1099. The basic test for determining whether a worker qualifies as an independent contractor or as an employee is whether the principal has the right to control the manner and means by which the work is performed. When the principal has the "right of control," the worker is considered an employee, even if the principal never actually exercises control. If the principal does not have the right of control, the worker will generally be considered an independent contractor.

Ultimately, the IRS (for federal employment tax purposes) and the EDD (for California employment tax purposes) decide if the people who work for a charitable organization are employees, for whom tax withholding and reporting by the employer apply, or independent contractors for whom these employer obligations do not apply.

The IRS provides guidance on this topic on its Independent Contractor (Self-Employed) or Employee website. The California agencies involved with worker classifications, including the EDD, also provide some guidance at the state level.

An employer who incorrectly classifies employees as independent contractors may be held personally liable for penalties and damages if the IRS disagrees with the classification. If an organization plans to work with independent contractors, consider consulting with an attorney or other expert about IRS guidelines for such classification.

VOLUNTEERS AND INTERNS

Volunteers and interns are a tremendous resource to the nonprofit sector. Because organizations frequently benefit from volunteer assistance in pursuing their missions, it is important that organizations understand the legal and practical differences between paid and unpaid personnel. The use of volunteers and interns entails a certain level of risk both to and from an organization, including labor law violations for misclassification of the worker as a volunteer or intern when the worker, in fact, qualifies as an employee under the law. Other issues may arise, such as liability of the volunteer or organization to third parties for acts committed by the volunteer, misappropriation by the volunteer of the organization's tangible or intangible property, and unintended tax consequences for any benefits provided to the volunteer that are not exempt (e.g., living allowances or other in-kind benefits that do not qualify as de minimis fringe benefits excluded from tax).

If the volunteer is not a true volunteer and receives some form of compensation, the labor and other laws pertaining to employees

discussed in this chapter must be followed, such as minimum wage and overtime rates and anti-discrimination standards.

Also, if the organization has an internship program, the program must meet the criteria set forth by federal and state law. Failure to meet these criteria could result in the application of labor and other laws pertaining to employees to the organization's interns. The Department of Labor's Fact Sheet 71, *Internship Programs Under The Fair Labor Standards Act*, outlines a list of criteria.

Risk Management Tips

Here are some best practices for charitable organization that use volunteers and interns:

- Document employee, intern, and volunteer policies in separate manuals;
- Provide intern and volunteer job descriptions in writing;
- Establish policies about hours of service;
- Proceed with care when paying volunteers and interns;
- Establish a grievance procedure for volunteers and interns to address any issues that may arise; and
- Verify whether volunteers and interns are covered by the organization's worker's compensation or other insurance.

FREQUENTLY ASKED QUESTIONS

"During the early years of operation, our charity had insufficient funds to pay key employees the true value of their services. Now that we have adequate revenues, can we pay our employees retroactively?"

Unless there is a contractual obligation, a charitable organization may not retroactively pay compensation or retirement benefits.[17] Moreover, charitable assets may not be distributed as profits or dividends to any person.[18] Retroactive payment of charity funds as a gift or bonus to any person may be an illegal distribution of charitable assets. A person who works as a volunteer for a charity has no legal right to payment of compensation from the charitable organization, but actual expenses may be reimbursed.

"Our charity has been sued by an employee for breach of employment contract and for discrimination. Will the Attorney General act as an attorney to defend our charity and save us the expense of hiring a private attorney?"

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[17] (*Queen of Angels Hospital v. Younger* (1977) 66 Cal.App.3d 359.)
[18] (Corp. Code, §§ 5237, 5410.)

No, the Attorney General acts to protect all beneficiaries of charitable assets against fraud and mismanagement of those assets. In other types of cases, where directors and the charitable organization are sued by employees or other persons for violations of contract, injuries, or other civil wrongs, it is the obligation of the directors to hire an attorney to defend the charitable organization.

"If an employment-related lawsuit is filed against our charity, will insurance pay for the costs of an attorney to defend the corporation and its officers and directors?"

Whether the charitable organization can look to its insurance carrier to defend the action depends on the type of insurance coverage purchased. A "general liability" insurance policy may provide for legal assistance, but may exclude coverage for employment matters.

The charitable organization, therefore, may choose to purchase "directors and officers" insurance, which covers individuals for many types of civil claims, including some employment-related lawsuits. If the corporation's employment force is large enough, the corporation may choose to obtain an "employment practices liability" policy. This type of policy usually covers the organization and all of its officers, directors, employees, agents, and subsidiaries for employment-related claims within the scope of the policy. It may be prudent to obtain coverage for volunteers and interns of the organization as well.

We just learned that an employee embezzled substantial funds from our charity. What can we do about it?

A charitable organization should take reasonable steps to try to recover the funds and refer the matter to the local police or district attorney for possible criminal prosecution. The charitable organization may also consider retaining a private attorney to file a civil suit for restitution against the employee. Directors must evaluate whether the prospect of recovery outweighs the probable costs of suit. The charity should also consult with its insurance carrier to determine if the loss is covered. Some insurance policies include coverage of employee theft and dishonesty.

The loss must also be reported in the charity's annual filings with the Attorney General's Registry of Charitable Trusts on its Form RRF-1 with an explanation of all actions taken by the charitable organization to recover the loss and prevent such occurrences from happening in the future. For more information on the Form RRF-1, including when it must be filed, see Chapter 6.

Finally, the loss must be reported to the IRS on Form 990 (specifically Part VI, item 5, for organizations required to file a full 990 tax return).

Organizations may also report the embezzlement to the IRS via Form 3949-A, which alerts the agency to suspected tax fraud (assuming the embezzler did not report the amounts taken on his or her tax filing). This form provides contact information and other information about the embezzler, which may enable the IRS to pursue the conduct as a tax evasion matter.

Additionally and as discussed in Chapter 5, directors should scrutinize the organization's internal controls practices for weaknesses. Typical practices to prevent and detect embezzlement include requiring dual signatures on checks, segregation of financial functions, proper documentation and authorization for expenses, annual inventories of equipment, background and credit checks on prospective employees, and annual audits under the supervision of a board audit committee. The organization should encourage and protect those who come forward with evidence of wrongdoing, often referred to as "whistle-blower" protection.[19]

We would like to avoid laying off some of our employees. Can we share our work force with other organizations?

Sharing of employees may be a viable option to avoid layoffs, provided the organization has the means to properly supervise and protect against potential conflicts of interest. Organizations in California can participate in a work sharing program established by the Employment Development Department, when the program's requirements are met.

[19] (Lab. Code, § 1102.5-1106.)

CHAPTER 5 EXERCISING FISCAL MANAGEMENT

In This Chapter

- Responsible Fiscal Management
- Preventing Internal Fraud and Theft of Charitable Assets
- Components of an Accounting System
- Frequently Asked Questions

RESPONSIBLE FISCAL MANAGEMENT

Charitable organizations, such as public benefit corporations in California, are required to maintain adequate and correct financial records and books. The board of directors should vigorously promote accurate fiscal management practices as officers, directors, and employees may be liable for "mak[ing], issu[ing], deliver[ing], and publish[ing]" any report, financial statement, balance sheet, or document "respecting the corporation or its… assets, earnings, liabilities, or accounts which is false in any material respect."[1]

While the daily operations of a charity may be delegated to reliable and competent staff, directors are required to exercise ultimate authority over all corporate activities.

Good internal controls help safeguard charitable assets, prevent loss, and ensure reliability of financial records. One of the responsibilities of a director is to make certain the charity operates in a fiscally sound manner, has mechanisms in place to keep it fiscally sound, and is properly using any restricted funds. While the daily operations of a charity may be delegated to reliable and competent staff, directors are required to exercise ultimate authority over all corporate activities.[2]

Directors may be accountable for the misappropriation, waste, or misuse of charitable assets if the loss was the result of deficient or nonexistent internal controls, lack of due care, or reasonable inquiry. Because of this, the charity's directors should play a key role in establishing internal controls for the charity. Their approval of policies and procedures determines the fiscal management system. An effective internal control system includes budgets, segregation of duties, policy and procedures manuals, clear definition of and adherence to set procedures for management authority and control, and periodic review of the control system.

Directors have an absolute right at any reasonable time to inspect and copy all books, records and documents of every kind pertaining to the corporation.[3] A realistic budget should be developed early enough so that the entire board can be involved in its review and approval before the

[1] (Corp. Code, § 6215; see also Corp. Code, §§ 6320, 6812.)
[2] (Corp. Code, §§ 5210, 5231, subd. (a).)
[3] (Corp. Code, § 6334.)

beginning of the fiscal year. Management should produce accurate income and expense statements, balance sheets, and budget status reports in a timely manner ahead of board meetings. Directors should monitor the budget and anticipated revenue. Any sizable differences between expected and actual revenue should be investigated by directors or designated officers to obtain a full explanation. The same should be done for expenditures. The directors or their designee should review the charity's bank account statements, check reconciliations, and the books of account for any obvious irregularities.

Annual independent audits can also help protect against internal fraud and fiscal mismanagement. Independent audits can be expensive, however, and may be beyond the budgets of small charities. A good alternative is to retain an independent accountant to conduct a review of the charity's financial statements, and issue a review report to the directors. Many directors seek expert advice from a professional accountant to assist in designing and implementing the fiscal management system. Choose an accountant carefully, and be specific about the charity's needs. Ask the accountant about his or her prior experience with other charitable organizations, and check references.

PREVENTING INTERNAL FRAUD AND THEFT OF CHARITABLE ASSETS

Diversion of charitable assets can occur at either the receipt or disbursement phase. The person tasked to receive and record the cash and checks could, without proper controls, deposit those funds into unauthorized bank accounts without other employees or directors becoming aware. No single employee should receive, record, deposit, and reconcile the charity's receipt of funds. Assigning different people to the separate tasks of recording receipts and making bank deposits minimizes the risk of theft and embezzlement. Also because cash is untraceable and easily lost, it is a best practice to have two employees or volunteers simultaneously count the cash to ensure accuracy.

At the disbursements level, funds are at risk when no controls are in place, or controls are not being enforced. Payment requests or requests for cash disbursement should be accompanied with invoices, receipts, or other documents showing the payments are justified and appropriate. Do not have the same person approve and make the payments, as this may facilitate embezzlement. It is best to have one employee or volunteer authorize the payment of an expense only after submission of proper receipts, bills, or invoices, and have a different employee issue the payment after proper approval has been provided.

Other internal controls to consider include the following:

- Adopt controls to monitor invoices. Software packages are available to prevent making duplicate payments on the same invoices. Beware of invoices that include rounded-amounts, have unfamiliar or fuzzy logos, have spelling errors, or have a post office box as an address. Staff should also monitor irregular invoice volume activity, and question any abnormal patterns.
- Ensure that credit card charges are made for the charity's business and not for personal expenses. Under no circumstances should the person submitting credit card charges be the same person who authorizes their payment.
- The charity's bank accounts should be reconciled periodically to ensure that disbursements match entries made in the books.
- The board should guard bank accounts and limit the number of signatories on the accounts. Another suggestion is to have two signatures on all checks drawn on the charity's bank account for expenditures over specific amounts. The dual-signature requirement reduces the risk of fraudulent practices, such as writing checks for non-existent expenses or paying fictitious creditors or phantom grantees. Checks should never be pre-signed.

COMPONENTS OF AN ACCOUNTING SYSTEM

A charity's accounting system should reflect accurate understandable data that is useful in making management decisions and preparing reports. Accounting records should generally adhere to "generally accepted accounting principles."[4] The books and records of the organization must correctly identify revenue, expenses, assets, and liabilities and have back-up documentation such as receipts, invoices, contracts, or cancelled checks.

The actual books of accounts to be maintained depend on the type of organization. For example, a grant-making organization would have different accounting needs than a nonprofit health clinic or museum. Generally, an organization's books of accounts include the following:

1. **General Ledger:** A general ledger consists of a number of accounts representing stored information about a particular kind of asset, liability, fund balance, revenue, or expense. Information is taken from the general ledger to prepare financial statements such as a balance sheet or income and expense statement. The amounts reported in the general ledger accounts are often totals

[4] (Bus. & Prof. Code, § 17510.5.)

for a given time period for various accounts detailed in subsidiary ledgers.

2. **Subsidiary Ledgers:** Subsidiary ledgers provide greater detail for a particular account. For example, an accounts receivable subsidiary ledger lists information on each customer's purchases, payments, and balance. The general ledger contains one figure representing the total for a period from all subsidiary ledgers for that account.

3. **Journals:** Information from business papers is recorded in chronological order in journals. Depending on the nature of the business, a charity may have multiple journals, such as:

    a. Sales journals record sales as they are made, with usually all information taken from invoices;

    b. Disbursement journals record cash or checks going out to pay for expenses, acquiring assets, or making grants;

    c. Receipts journals record cash or checks coming into the organization; and

    d. General journals record non-repetitive types of transactions, corrections, or adjustments.

4. **Fixed Asset Inventories:** The charitable organization should have a list of fixed asset inventory, including vehicles and equipment such as computers, printers, and other office goods. The inventory list should be annually updated, and checked to ensure that no previously recorded equipment has been lost.

In addition to an accurate system for recording fiscal data, a charity needs a filing system that allows easy access to various business documents. This helps an accountant prepare informational returns, financial reports, and management reports. A good fiscal management system allows a charitable organization to trace any transaction from the financial reports to the general ledger, subsidiary ledgers, journals, and other financial records.

FREQUENTLY ASKED QUESTIONS

"What specific fiscal management procedure will help to protect our charity against fiscal mismanagement and embezzlement?"

Generally, fiscal management policy should provide for careful periodic review of financial records by directors and independent accountants. Procedures such as a dual-signature requirement on all charity bank

accounts, periodic review of monthly statements by the board, and an annual independent audit are highly recommended.

"I was recently appointed to the board of directors of a charity, and I discovered the charity's records are disorganized and incomplete. I also suspect a former director misused the charity's funds. What should I do?"

Consider writing a report summarizing all concerns, communicate them to the board, and ensure board minutes reflect those concerns. The organization should establish controls to address those concerns and prevent future problems. The board, or a competent and trusted designee, should also conduct an independent review to investigate the conduct of the former director.

If the investigation confirms the loss, diversion, or misuse of charitable assets, the board should take appropriate action to recover these funds. This includes reporting the loss in the charity's annual filings to the Attorney General's Registry of Charitable Trusts on Form RRF-1. The loss must also be reported to the IRS on Form 990 (specifically Part VI, item 5, for organizations required to file a full 990 tax return). Organizations may also report the embezzlement to the IRS via Form 3949-A, which alerts the agency to suspected tax fraud (assuming the embezzler did not report the amounts taken on his or her tax filing).

Any person who suspects fiscal abuse regarding charity assets is encouraged to report the matter to the Attorney General's Charitable Trusts Section. Any evidence of criminal activity, such as embezzlement of charitable assets, should be reported to the local police or district attorney for possible criminal prosecution.

"We learned our charitable organization was assessed penalties by the Franchise Tax Board. As members of the board, do we have an obligation to pay the penalties or can we pay the penalties by using the organization's revenue?"

Avoidable penalties generally constitute a waste of charitable assets and damage to the charity. If the charitable organization did not have processes in place to protect the organization, one can argue the penalties were assessed because of a lack of oversight and management by the directors, and that the payment should be made by the directors and not the charitable organization.[5]

The best course of action is to report the penalties to the Attorney General's Registry of Charitable Trusts on the charitable organization's Form RRF-1, and indicate the name and title of the person responsible

[5] (Corp. Code, §§ 5210, 5231, 5239.)

and explain why the payment was made with the organization's funds. Also report the name of the government agency that issued the fine, penalty or judgment; the date of payment; and the amount of the fine, penalty, or judgment. Provide copies of communications with any governmental agency regarding the fine, penalty, or judgment. And importantly, describe procedures the organization implemented to prevent a reoccurrence of the fine, penalty, or judgment. Note that Registry staff reviews any such Form RRF-1 filing to determine whether payment of the penalty from the charity's revenue is appropriate given all of the explanations provided.

CHAPTER 6 REPORTING REQUIREMENTS

In This Chapter

- Overview
- IRS
- Franchise Tax Board
- Board of Equalization, Department of Tax and Fee Administration, and Local Agencies
- Secretary of State
- Attorney General
- Other States
- Frequently Asked Questions

OVERVIEW

Charitable organizations have annual reporting obligations with various federal and state government agencies. For instance, even though nonprofit organizations do not pay taxes, they are required to file what are called "informational returns" with taxing authorities each year. State property tax and sales tax reporting obligations may also apply. Moreover, California nonprofit corporations file reports with the California Secretary of State to keep their corporate information current.

Charitable organizations, including trustees, subject to the Attorney General's supervision also must register and annually report to the Attorney General. If a charitable organization operates or fundraises in other states, those states may have similar or additional reporting requirements.

IRS

Form 990 and Its Alternative Informational Returns

Most tax-exempt organizations must file an annual informational return with the IRS.[1] The most common informational return is Form 990, which is comprised of a 12-page core form and various "schedules" to be completed as needed. However, organizations can file a shorter version of Form 990 instead, called Form 990-EZ, if it has gross receipts and total assets below a certain threshold for the relevant tax year (currently, gross receipts less than $200,000 and total assets less then $500,000). For smaller organizations that do not normally receive more than $50,000 in annual gross receipts, they can choose to file an electronic notice, Form 990-N. This notice, also called an e-Postcard, reports only basic

[1] (Int.Rev. Code, § 6033.)

organizational information. Form 990-PF is the appropriate annual informational return for tax-exempt private foundations.[2]

Churches and certain religious organizations affiliated with a church are not required to file these returns or notices with the IRS.

Failure to file an informational return for three consecutive years results in the organization losing tax-exempt status. The informational return must also be filed on or before the 15th day of the fifth month following the close of an organization's annual tax accounting period (i.e., May 15 for a calendar-year organization). Failure to file in a timely manner may result in penalties of $20 per day, with a cap the lesser of $10,500 or 5% of the organization's gross receipts for the year. However, for larger organizations (currently those with gross receipts exceeding $1,028,500 for any year), the penalty is $105 per day, with a cap of $53,000.[3] The penalty may be abated if reasonable cause can be shown. An incomplete informational return may be treated as a failure to file, with penalties assessed.

Form 990-T and Unrelated Business Income

As previewed in Chapter 3, a tax-exempt organization with more than $1,000 of "unrelated business income" in a taxable year must report such income to the IRS on Form 990-T. This is filed in addition to the Form 990 informational return or its alternatives. Exempt organizations are also required to make quarterly estimated unrelated business income tax payments, calculated at corporate rates. Penalties apply for late filing, late payment, or underpayments of taxes on income reportable on Form 990-T.

Public Disclosure of Exemption Application and Informational Returns

A charitable organization must furnish a copy of its federal tax exemption application, IRS Form 1023 or Form 1023-EZ (also see Chapter 3), to any person who requests a copy. Also, an organization tax-exempt under Internal Revenue Code section 501(c)(3) and classified as a public charity must furnish copies of its annual informational returns (e.g., Form 990 and Form 990-T if applicable) for its three most recent tax years upon request.[4]

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[2] (26 C.F.R. § 1.6033-2(a)(2)(i) (2019).)

[3] (IRS, *Instructions for Form 990 Return of Organization Exempt From Income Tax* <https://www.irs.gov/pub/irs-pdf/i990.pdf> [last updated Jan. 2021]; see also Int.Rev. Code, § 6652(c)(1)(A).)

[4] (Int.Rev. Code, § 6104(d).)

If a request for an exemption application and/or informational return is made in person, the organization must provide a copy on the day the request is made. However, in unusual circumstances where this would be unreasonably burdensome, the organization may provide a copy the next business day. If the request is made in writing, the organization must provide a copy within 30 days. An organization may charge a reasonable fee for providing copies and actual postage costs, which can be collected before providing copies.

An organization may avoid the requirement of providing copies of its exemption application and informational return when they are made "widely available," such as by positing them on the organization's website, or on another organization's website as part of a database of similar materials.

Returns and Reports for Organizations with Employees

As mentioned in Chapter 4, there are additional requirements for organizations that have employees. From an IRS perspective, this involves the following:

- Federal income tax withholding: most tax-exempt organizations are required to withhold and pay federal income tax with respect to wages of their employees in the same manner as for-profit organizations.
- Social Security and Medicare taxes: most tax-exempt organizations are required to withhold and pay these taxes, also known as Federal Insurance Contributions Act taxes, in the same manner as for-profit organizations. Generally, employers deposit these tax payments (and the withheld income mentioned above), and file IRS Form 941 on a quarterly basis.
- Federal unemployment taxes: tax-exempt organizations under Internal Revenue Code section 501(c)(3) are not required to pay federal unemployment taxes, but may elect to participate in a state program. If applicable, employers file IRS Form 940 to make these payments.
- Wage and Tax Statements for Payees: tax-exempt organizations are required to prepare and annually file certain forms to report amounts paid to employees and others, in the same manner as for-profit organizations. These include Form W-2 and Form 1099. See Chapter 4 for information on classification of a worker as an independent contractor or employee.

The IRS' Publication 15 (Circular E), *Employer's Tax Guide*, also contains helpful information on these employer obligations.

FRANCHISE TAX BOARD

Form 199 and Form 199N Annual Information Returns

In addition to complying with the IRS' reporting requirements, most tax-exempt organizations in California must file an annual informational return with the California Franchise Tax Board (FTB). Most charitable organizations, including those tax-exempt under Internal Revenue Code section 501(c)(3) and classified as a public charity, file FTB Form 199. Churches and certain religious organizations affiliated with a church are not required to file.

Small organizations (i.e., those that do not normally receive more than $50,000 in annual gross receipts) are not required to file Form 199. Instead, they may file an annual electronic notice reporting basic organizational information on FTB Form 199N, also called the 199N California e-Postcard. Private foundations are not eligible to use Form 199N, and must file Form 199.

Form 199 or Form 199N must be filed on or before the 15th day of the fifth month following the close of an organization's annual tax accounting period (i.e., May 15 for a calendar-year organization). Failure to file either form for three consecutive years results in loss of tax exemption. Also, late filings, or filing with incomplete information, may result in penalties.

Form 109 and Unrelated Business Income

A tax-exempt organization with more than $1,000 of unrelated business income in a taxable year must report such income on FTB Form 109. This is filed in addition to Form 199. California and federal laws are generally the same with regards to unrelated business income. For form instructions, search by form number on the FTB's Forms and Publications Search website.

MyFTB

Available on the FTB's website, MyFTB provides tax account information and online services to organizations, their representatives, and tax preparers. Once a nonprofit organization is registered, it can access account information, such as tax returns, and update contact information through MyFTB. MyFTB includes the option to chat with FTB representatives about confidential matters

BOARD OF EQUALIZATION, DEPARTMENT OF TAX AND FEE ADMINISTRATION, AND LOCAL AGENCIES

The California State Board of Equalization (BOE), in coordination with local government agencies, administers property taxes that apply to nonprofit organizations, unless exempt. Meanwhile, the California Department of Tax and Fee Administration (DTFA) administers sales

taxes, which vary locally. The following provides an overview of these taxes, applicable exemptions, and reporting requirements.

Property Taxes

California imposes a tax on real property and certain kinds of personal/moveable property.[5] Nonetheless, the California Constitution exempts certain kinds of property from this form of taxation (e.g., property used for libraries and museums that are free and open to the public,[6] property used for higher education,[7] and property used for religious worship[8]). The California Constitution also authorizes the Legislature to exempt property used exclusively for religious, hospital, or charitable purposes, which are owned by entities that are organized and operating for such purposes.[9] This is known as the "welfare exemption" from property taxes. The Legislature has also adopted a series of more specific exemptions, such as the religious,[10] church,[11] and college[12] exemptions.

Organizations that wish to claim the welfare exemption should consult BOE's Publication 149, *Property Tax Welfare Exemption*, and its Welfare Exemption website. The process involves filing forms with both BOE and the county assessor in the county in which a given property is located. BOE's Exemptions website also has information on other property tax exemptions, such as those for museums, public schools, and religious organizations.

After an organization has demonstrated its entitlement to exemption from property taxes on a given piece of property, it needs to demonstrate its continued entitlement on an annual basis. Organizations do this through filing Form BOE-267-A or its equivalent with the county assessor where the property is located.

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[5] (See generally Cal. Const. art. XIII, §§ 1-25.5; Cal. Const. art. XIIIA; Rev. & Tax. Code, §§ 50-5911.)
[6] (Cal. Const. art. XIII, § 3, subd. (d); Rev. & Tax. Code, §§ 202, subd. (a)(2), 202.2.)
[7] (Cal. Const. art. XIII, § 3, subd. (e); Rev. & Tax. Code, §§ 203, 203.1.)
[8] (Cal. Const. art. XIII, § 3, subd. (f); Rev. & Tax. Code, §§ 206, 206.1.)
[9] (Cal. Const. art. XIII, § 4, subd. (b); Rev. & Tax. Code, § 214.)
[10] (Rev. & Tax. Code, § 207.)
[11] (Rev. & Tax. Code, § 206.)
[12] (Rev. & Tax. Code, § 203.)

Sales Taxes

California imposes taxes on the sale of tangible personal property.[13] What people often informally refer to as the "sales tax" is actually three taxes:

1. The tax on in-state retail sales;
2. The transactions and use tax, which are add-on taxes approved by local voters; and
3. The "use tax" which applies to retail purchases made from vendors outside of California.

The second kind of tax explains why sales tax rates vary from county to county. DTFA's California City and County Sales and Use Tax Rates website lists tax rates by city and county. Review DTFA's Sales and Use Tax in California website for general information on sales taxes.

If charitable organizations are involved in the sale of tangible personal property, they will likely need to obtain a "seller's permit" from DTFA. See DTFA's Obtaining a Seller's Permit website for more information, and visit the Registrations section of DTFA's Online Services website to apply for this permit.

To report taxable sales, DTFA assigns a filing schedule based on anticipated taxable sales at the time of registration. For information on filing dates, see DTFA's Filing Dates for Sales and Use Tax Returns website.

Although there is no general exemption from the obligation to charge and remit sales taxes for charitable organizations, there are some exceptions that may be of special interest to charitable organizations. Review DTFA's Publication 61, *Sales and Use Taxes: Exemptions and Exclusions* to learn more.

SECRETARY OF STATE

Tax-exempt organizations formed as California nonprofit corporations (including public benefit corporations) have reporting requirements with the California Secretary of State (SOS) as well. California nonprofit corporations must file a Statement of Information, Form SI-100, which asks for the names and addresses of the corporation's officers and its agent for service of process.

Form SI-100 is filed within 90 days of incorporation and every other year after incorporation, by the last day of the month of incorporation. It can also be filed more frequently in order to update the SOS on changes of

[13] (See generally Rev. & Tax. Code, §§ 6001-7176.)

officers, agent for service of process, or other contact information. Such updates, however, are not automatically shared with other California state agencies or the federal government.

Form SI-100 can be filed electronically on the SOS' website. Penalties apply for late filings or failure to file.

Foreign corporations, be it out-of-state or out-of-country, also have reporting requirements with the SOS. Pursuant to California Corporations Code section 2105, a foreign corporation may not conduct intrastate business in California (defined in Corporations Code section 191 as "entering into repeated and successive transactions of its business in this state") without first obtaining a Certificate of Qualification from the SOS. To qualify a foreign nonprofit corporation to transact business in California and receive a Certificate of Qualification, the corporation must file with the SOS a Statement and Designation by Foreign Corporation, Form S&DC-S/N. Attach to this form a certificate from an authorized public official in the corporation's home jurisdiction indicating the corporation is in good standing; the attached certificate must also indicate the corporation is a non-stock, nonprofit corporation. Then, foreign nonprofit corporations are required to file a Statement of Information, but on Form SI-550. The first filing is due within 90 days after qualification, and then annually with the SOS. For more information on these requirements, visit the SOS' Business Entities Frequently Asked Questions website.

ATTORNEY GENERAL

The Attorney General's Registry of Charitable Trusts (Registry) regulates charities and other nonprofit organizations by administering the registration and reporting requirements in the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code, § 12580 et seq.), and its regulations. The Registry does this through its various programs: Initial Registration, Registration Renewals, Delinquency, Dissolution, Commercial Fundraising, Raffles, Complaints, and Administrative. The Registry also maintains a searchable database for the public to research registered charitable organizations and fundraising professionals.

The following information discusses the registration and reporting requirements for charitable organizations. For information on fundraising professionals, refer to Chapter 9.

Form CT-1 and Initial Registration

Government Code section 12585 requires charitable organizations, including trustees, to register with the Attorney General's Registry of Charitable Trusts within 30 days of first receiving property (i.e., a cash donation, property donation, or other assets with financial value received for charitable purposes). The initial registration fee is $25. Charitable

organizations are required to file the Registry's Initial Registration Form (Form CT-1), a copy of the organization's tax exemption application IRS Form 1023 or Form 1023-EZ (if submitted to the IRS), a copy of the organization's IRS determination letter (if received from the IRS), and copies of the organization's founding documents as follows:

- Corporations: endorsed articles of incorporation stamped with the corporate number assigned by the SOS (including all endorsed amendments), current bylaws;
- Associations: instrument creating the organization (bylaws, constitution, and/or articles of association); or
- Trusts: trust instrument, or will and decree of final distribution.

Entities organized primarily as a hospital, educational institution, or religious organization are exempt from the registration and reporting requirements. Mutual benefit organizations are exempt if they are operated and funded by their membership, and do not hold assets in trust for charitable purposes. If exemption is claimed, complete substantiating documents are required to be submitted to the Registry. Exemption requests are reviewed on a case-by-case basis by Registry staff.

Also review Chapter 12 for information on the registration obligations of charitable trustees, religious organizations, and non-California entities.

Form RRF-1 and Annual Reporting

In addition to the initial registration requirement, there are annual registration renewal requirements.[14] Every charitable organization, such as charitable trustees and unincorporated charitable associations, must file an Annual Registration Renewal Fee Report (Form RRF-1). This form's filing fee depends on the organization's gross annual revenue for the preceding year. Charitable organizations in good standing with the Registry may file the Form RRF-1 electronically with the Registry. For information on filing electronically, visit the Online Renewal System on the Attorney General's Charities website.

When filing a Form RRF-1, charitable organizations are required to file a copy of their annual IRS Form 990, Form 990-EZ, or Form 990-PF informational return. All schedules to these forms filed with the IRS must also be filed with the Registry, including Schedule B. If a charitable organization's total revenue for the fiscal year is under $50,000, Form CT-TR-1 must be filed along with Form RRF-1. Private foundations are not required to file Form CT-TR-1 and instead must file IRS Form 990-PF with Form RRF-1. For more information please review the Attorney

[14] (Gov. Code, § 12586.)

General's Charities website which contains information and webinars on Annual Registration Renewals and Form CT-TR-1.

Form RRF-1 must be filed within four months and fifteen days after the end of the organization's fiscal or calendar year. This generally coincides with the organization's reporting requirements with the IRS and FTB. If the organization obtains an extension to file with the IRS, the Registry honors that extension.

Form RRF-1 specifically asks whether the registered charitable organization has audited financial statements. This is particularly relevant for charitable organizations with gross revenue of $2,000,000 or more (excluding grants from and contracts for services with government entities), as Government Code section 12586, subdivision (e), requires such organizations to have audited financial statements (and an audit committee if a corporation). The failure to have audited financial statements when required may result in the Form RRF-1 being rejected by the Registry. While the audited financial statements do not need to be filed with the Registry, they must be available for inspection by the Attorney General, and made available to the public if requested.

A charitable organization's registration must be current to operate; delinquent or suspended organizations may not solicit or disburse charitable funds.

If an organization fails to annually renew its registration, it is listed as delinquent in the Registry's publicly available database. Late fees of $25 per month may be assessed, and if the delinquency is not remedied, it may result in a permanent suspension.[15] A charitable organization's registration must be current to operate; delinquent or suspended organizations may not solicit or disburse charitable funds.[16]

For more information on registration and reporting requirements, visit the Attorney General's Charities website for the registration guide and webinar, the annual registration renewal guide and webinars, and required forms. Registry staff also provide information on these topics to persons seeking assistance. Visit the Attorney General's Contacts website to submit an inquiry to the Registry of Charitable Trusts.

Additional Reporting Requirements

California's Charitable Solicitation Law contains additional reporting requirements for charitable organizations (and fundraising professionals); see Chapter 9. Also, charitable organizations have reporting requirements for certain corporate transactions such as voluntary dissolution, mergers, or a sale or transfer of all or substantially all of the corporation's assets. See Chapter 11.

[15] (Gov. Code, § 12586.1.)
[16] (Cal. Code Regs., tit. 11, § 999.9.4.)

OTHER STATES

If a charitable organization conducts activities or fundraising in other states, the organization should confirm what registration or reporting requirements may be necessary in those states. For more state-specific information, visit the National Association of State Charity Officials' State Government website.

FREQUENTLY ASKED QUESTIONS

"Should we keep copies of our filings? If so, for how long?"

Charitable organizations must keep records for federal tax purposes for as long as may be needed to document evidence of compliance with provisions of the Internal Revenue Code. Keep copies of all filings permanently.

While there may be statutes of limitations for audits and other inquiries from some agencies, there is often no statute of limitations applicable for allegations of fraud or criminal activity.

"What are the consequences of making misrepresentations on any of the forms we have to file with public entities?"

In most cases, these forms are signed under penalty of perjury. Perjury, which is knowingly making a false statement, is a serious criminal offense.[17] Any director, officer, or agent of a public benefit corporation who knowingly makes false statements in filings may face potential imprisonment in a county jail for up to a year and fines.[18]

In addition, officers, directors, and employees may be liable to both the corporation and any person injured by such misstatements.[19] The Attorney General may also seek redress. If so, the potential consequences include financial penalties, appointment of a receiver to protect the corporation, removal of the directors, and dissolution of the corporation.[20]

"Our charity has no money. Does this relieve us of the obligation to register with the Attorney General and file annual reports?"

Every charitable corporation, unincorporated association, and trustee must register with the Attorney General's Registry of Charitable Trusts within 30 days after it initially receives property. Property includes more than just money, such as supplies, food, clothing, real property, stocks and bonds, and other tangible gifts. Thus, even if the charity has no

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[17] (Pen. Code, §§ 118, 129.)
[18] (Corp. Code, §§ 6812-6814; Pen. Code, § 1170, subd. (h).)
[19] (Corp. Code, § 6215.)
[20] (Corp. Code, § 6216; Gov. Code, § 12591.1.)

money, if it has charitable "property," it must file a Form CT-1 to register with the Registry, and do so within 30 days of the property's receipt. Thereafter, it must annually file a Form RRF-1 with the Registry. For charities with less than $25,000 in gross annual revenue, there is no filing fee for the Form RRF-1. Also, charities with less than $50,000 annual revenue must file an Annual Treasurer's Report (Form CT-TR-1).

"What is a mutual benefit corporation and when does it have to register with the Attorney General's Registry of Charitable Trusts?"

Many mutual benefit corporations are often organized for the benefit of their members. Examples of mutual benefit corporations include civic leagues, social welfare organizations, local employee associations, veterans of foreign wars organizations, homeowners' associations, business leagues, and chambers of commerce. Yet, if a mutual benefit corporation holds any of its assets for charitable purposes, it must register and report on these charitable assets to the Attorney General.

For instance, mutual benefit corporations that benefit law enforcement, firefighters, or other public safety personnel that solicit and/or hold charitable assets are required to register and report annually. However, if such public safety mutual benefit corporations make clear that the purpose of all of their solicitations is for the sole benefit of their actual active membership, and they do not otherwise hold charitable assets, they would not be required to register and report.[21]

"We don't solicit directly from the public, but we receive donations at events we hold. Are we required to register and report?"

Yes, all organizations that hold assets in trust for public and charitable purposes are required to register and report annually. However, if there is empirical proof the sole purpose of the solicitation is to benefit members, then the organization would be exempt.

"We don't solicit directly from the public, but we hold events that are open to the public and we charge a fee for attendance (i.e., ticket sales, concessions). Are we required to register and report?"

Yes, all organizations that hold assets in trust for public and charitable purposes are required to register and report annually. However, if there is empirical proof the sole purpose of the solicitation is to benefit members, then the organization would be exempt.

Exemptions are reviewed on a case-by-case basis to determine the registration requirements pursuant to Government Code sections 12585 and 12586. If exemption is claimed, complete substantiating documents are required such as the organization's founding documents, a

[21] (Gov. Code, § 12581.2, subd. (d).)

determination letter from the IRS, and a description of the organization's funding activities.

"We use a fiscal sponsor to receive donations. Are we required to register and report?"

Generally, a fiscal sponsor is a charity with tax-exempt status under Internal Revenue Code section 501(c)(3) that agrees to sponsor another nonprofit, sometimes called a project of the fiscal sponsor. Many nonprofits that are not yet financially able to form their own charity pay a fee for administrative costs, marketing, and personnel to a fiscal sponsor. In this scenario, the fiscal sponsor generally receives charitable donations designated for the sponsored project, and then spends or grants the funds for that project using restricted fund accounting. Also, the fiscal sponsor retains discretion and control over the donations, and donors can receive tax deductions for their contributions. These donations would be reported as revenue on the fiscal sponsor's annual information return (e.g., IRS Form 990) and the Registry's Form RRF-1 (assuming the fiscal sponsor is registered with the Attorney General's Registry of Charitable Trusts).

When a nonprofit is a program of a fiscal sponsor as described above, and the fiscal sponsor is registered with the Attorney General, the nonprofit does not need to register and report as well.

However, if the sponsored nonprofit becomes its own standalone charity, it is required to register and report to the Attorney General. Once the organization files articles of incorporation with the SOS and receives a corporate number (if the charity is formed as a nonprofit corporation in California), obtains its own federal Employer Identification Number and tax-exempt status with the IRS, or obtains its own Entity Identification Number and tax-exempt status with the FTB, the organization needs to register with the Attorney General within 30 days of receiving charitable assets.

Until registration is required, the Registry requests the fiscal sponsorship agreement, which is added to the Registry's database for public viewing.

CHAPTER 7 DIRECTORS & OFFICERS OF PUBLIC BENEFIT CORPORATIONS

In This Chapter

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INTRODUCTION

Every California nonprofit corporation must have a board of directors.[1] Also known as board members, directors serve many important roles: they oversee the work of officers and other senior management, they make policy decisions for the charity, and they ensure the organization is faithfully carrying out its charitable mission. The powers, duties, and limitations of what is expected and required from directors and officers are governed by California statutes and common law.[2] For instance, Corporations Code section 5210 provides that "the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board."

This chapter explains some of the powers, duties, and limitations of directors and officers for public benefit corporations, including discussions on compensating directors and officers, and their fiduciary duties. Liability issues are also explained, such as when directors and officers may be held personally liable, and options for indemnification and insurance.

[1] (Corp. Code, §§ 5210 [nonprofit public benefit corporations], 7210 [nonprofit mutual benefit corporations], 9210 [nonprofit religious corporations].)

[2] (E.g., Corp. Code, §§ 5210-5215.)

SELECTING DIRECTORS

Legally, a public benefit corporation may operate with only one director.[3] However, most charities operate with three or more directors. This allows the charity to avoid potential conflict of interest problems, and gives the board members the ability to share in oversight responsibility.

As for the method of selecting directors, this varies. For instance, directors may be elected, either by voting members of the corporation (if any) or by the existing board of directors. Directors may also be designated by specified persons or entities given such right in the organization's governing documents. Additionally, depending on the bylaws, a corporation may have ex officio directors. Ex officio directors are individuals who are automatically directors of the corporation because they hold a particular position within or outside the corporation.[4]

Whatever the selection method, the method should be specified in the corporation's bylaws, as well as other provisions that govern the board of directors. This includes specifying the directors' powers and responsibilities, and provisions on resignation, removal, terms of office, and term limits of directors.

In selecting directors for board appointment, consider nominating and appointing candidates who have the appropriate levels of competency, experience, integrity, enthusiasm, and commitment to be fully engaged. Also, ensure the candidates fully realize the expectations and legal requirements that come with serving as directors, including the need to attend board meetings, as directors often accept their appointments without this awareness. Directors should understand they may be called upon to make difficult decisions to address critical situations on short notice. To inspire active engagement and responsible performance, directors should be provided with and encouraged to attend continuing education opportunities.

The board might also consider adopting bylaws that rotate leadership positions and limit the terms of the directors. For instance, directors may sometimes become entrenched in their ideas and positions, or may not devote enough time and energy needed to support the charity.

SELECTING OFFICERS

Every public benefit corporation must have at least three officer positions: a president (or chair of the board), a secretary, and a treasurer (or chief financial officer). Additional officers may be appointed if the corporation's bylaws provide for such officers. No person serving as the secretary or

[3] (Corp. Code, § 5151, subd. (a).)
[4] (Corp. Code, § 5047.)

treasurer/chief financial officer may serve concurrently as the president or chair of the board of a public benefit corporation. Also, there can be separate positions for president and chair of the board. The president is the chief executive officer of the corporation, unless otherwise specified in the corporation's governance documents. If there is no separate president, however, then the chair of the board often serves as the chief executive officer.[5] Generally, the president or chief executive officer is responsible for the day-to-day operations of the corporation. The treasurer or chief financial officer is responsible for the financial affairs of the corporation. Meanwhile, the secretary is responsible for maintaining corporate records, including board minutes.

Before agreeing to serve as an officer, the candidate should carefully read the description of duties to determine the requirements of the officer position.

Officers are usually appointed by the board of directors. The duties of officers and methods of their appointment should be clearly stated in the corporate governance documents, or in position descriptions adopted by the board. Charities may also have paid officers, who are employees of the charity. It may be appropriate to exclude employee-officers from also being members of the board because employee-officers depend on the corporation for their livelihoods – and as directors may be called to make decisions in the best interests of the corporation that might not align with their personal interests as employees. Also, because the board is required to exercise oversight over officers who are employees, it may be wise to exclude these officers/employees from also being members of the board.

COMPENSATING DIRECTORS AND OFFICERS

Most directors serve as volunteers and are not paid for their service as directors, other than reimbursement for actual expenses incurred in attending meetings (e.g., mileage, parking fees, meal costs). While directors may be paid for their services as directors (or as an officer should the director also be an officer of the organization), these payments must be fair and reasonable to the public benefit corporation in light of the services provided.[6] California law does not suggest what level of compensation is reasonable. This is determined on a case-by-case basis according to the particular facts and circumstances.

In California, there is also a limit on how many directors can be compensated for their professional or employment services; public benefit

[5] (Corp. Code, § 5213, subd. (a).)
[6] (Corp. Code, § 5235.)

corporations must be composed of at least 51 percent of directors who are "disinterested" persons.[7] Disinterested means that neither the director nor any member of the director's family is paid by the corporation to do anything other than act as a director. For example, a director who is a paid employee or whose spouse is a paid employee of the corporation is not a "disinterested person" for the purposes of this limitation.

In addition, the compensation including benefits paid to officers such as the president or chief executive officer, the treasurer or chief financial officer, or those with comparable responsibilities, must be reviewed by the board or an authorized committee, at the time of hiring, whenever the term of employment is renewed or extended, and whenever such compensation is modified.[8] In evaluating compensation, the board should analyze whether the proposed amount to be paid is in the best interest of the nonprofit. For instance, does the officer bring a lot of experience to the organization, and has he or she effectively and successfully improved or promoted the charity's programs? (Additional factors are listed below.) Note that if the charitable organization has declining revenue, is experiencing staff or donor dissatisfaction, or is subject to multiple lawsuits (which may reflect mismanagement), it may not be in the corporation's best interest to give the chief executive officer or chief financial officer a raise.

Furthermore, compensation paid to officers and directors cannot be concealed from donors or the public at large. Nonprofits that file IRS Form 990, Form 990-EZ, or Form 990-PF, must list compensation paid to directors, officers, trustees, and key employees (as defined by the IRS). In addition, these forms must list the compensation of its five highest-paid employees who are not directors, officers, trustees, and key employees, and earn more than $100,000 annually. The failure to provide this information may result in IRS fines. Form 990 also requires the charitable organization to provide explanations about the methods used to establish and approve executive compensation levels.

Both the IRS and Attorney General audit allegations of excessive compensation.

Both the IRS and Attorney General audit allegations of excessive compensation. The Attorney General may recover excessive compensation from the directors and officers who received the overpayment, and from the directors who approved the compensation if they failed to exercise due care. Likewise, the IRS may levy penalties for excessive compensation ranging from fines to revocation of an organization's tax-exempt status. IRS fines may be levied against both the person who received the overpayment and the directors who

[7] (Corp. Code, § 5227.)

[8] (Gov. Code, § 12586, subd. (g); Cal. Code Regs., tit. 11, § 312.1.)

approved or knew about the excessive compensation, but did nothing to prevent it.

In evaluating whether compensation is fair and reasonable to the nonprofit corporation, the board or its authorized committee tasked to review compensation should consider taking the following steps:

- Get the facts on the proposed compensation amount, including all "fringe benefits."
- Have a clear understanding of the job description, duties, and functions of the employee.
- Find out what other organizations with similar size, location, comparable programs, assets, and revenue pay their executives who have functionally comparable positions.
- Exclude the employee, director, or officer whose compensation is being evaluated from participating in the decision and ensure they have no role in researching or preparing the comparability data, or hiring a consultant to research and prepare a comparability study.
- Before attending any meeting scheduled to approve compensation packages, be prepared by reviewing the comparability study and data, review job descriptions, and evaluate past performance.
- Document the decision-making process at the time the board approves or the committee recommends the proposed compensation.
- The board minutes should include detailed discussions of the deliberative process, including all comparability studies relied upon, the date of approvals and compensation approved, list all board members who were present, and those who voted to approve or disapprove the proposed compensation. The minutes should also identify any board members who were present and had a conflict of interest, and what actions, if any, they took at the meeting.

BOARD MEETINGS, MINUTES, AND OTHER CORPORATE RECORDS

As demonstrated by the need to review the compensation of officers and to make other important decisions, the board of directors should meet regularly. The corporation's bylaws should contain provisions on board meetings, such as the required notice for meetings, the quorum requirement for meetings, the number of votes required for board approval, actions by unanimous written consent, and actions by committee. The Corporations Code sets forth requirements for many of

these items, and default provisions that apply if the bylaws are silent on these issues.[9]

Similarly, directors and officers should ensure compliance with various recordkeeping requirements.[10] For public benefit corporations, these include the duty to keep the following records:

- Current copies of the articles of incorporation and bylaws;
- Minutes of board meetings, committee board meetings, and the proceedings of its members;
- Membership lists (name, address, and type of membership);
- Adequate and correct financial and records of account;[11]
- An annual statement on certain self-dealing transactions or indemnification payments made to any officer or director, when these occur;[12] and
- An annual financial report, unless the corporation receives less than $25,000 in gross revenue during its fiscal year.[13]

At each board meeting, the directors should be prepared to review the minutes of the prior board meeting, and discuss any necessary edits before voting to approve the minutes. Directors should make sure the minutes accurately portray the board's discussion and decisions. The board's secretary should also provide a certification that the approved minutes are true and accurate copies.

These records are important not only to provide historical background and context supporting the board's decisions, but also because they may be considered prima facie evidence that meetings were held, and matters referenced in the minutes were actually decided.[14] False entries in the books, minutes, records, or accounts of a public benefit corporation or the

[9] (Corp. Code, §§ 5151, subd. (e), 5211-5212.)
[10] (Corp. Code, §§ 6215, 6813.)
[11] (Corp. Code, § 6320.)
[12] (Corp. Code, § 6322.)
[13] (Corp. Code, § 6321. The annual report shall detail assets and liabilities, the principal changes in assets and liabilities, revenue or receipts of the corporation both unrestricted and restricted, and expenses or disbursements both general and restricted. The annual statement on certain self-dealing transactions or indemnifications shall also be incorporated. This report is in addition to any report that may be prepared by an independent accountant.)
[14] (Corp. Code, § 5215.)

alteration or removal of records may result in an enforcement action by the Attorney General or a district attorney.[15]

OFFICERS' DUTIES

As indicated above, officers sometimes are not members of the board of directors. Officers may be paid employees, and have titles such as chief executive officer, chief financial officer, secretary, chief operating officer, vice president, or executive director. Regardless of titles, officers are ultimately those who participate in the management of the corporation, and have some discretionary authority in managing the corporation's affairs.[16]

Officers stand in a fiduciary relationship with the corporation. Hence, they must scrupulously protect the interests of the corporation, exercise their powers in good faith and with best efforts, and refrain from doing anything that harms the corporation. For instance, officers cannot use their positions to further their private interests, or otherwise secure any personal advantage against the corporation.[17] In fact, officers who breach their fiduciary duty to the corporation may be liable for any damage their actions or inaction caused.

Directors are required to perform with the level of care that an ordinarily prudent person in a like position would use under similar circumstances. This includes making reasonable inquiries as needed.

DIRECTORS' DUTY OF CARE

Directors also act as fiduciaries. For instance, each director owes a duty of care to its nonprofit corporation and the corporation's charitable beneficiaries. For public benefit corporations, directors are required to perform with the level of care that an ordinarily prudent person in a like position would use under similar circumstances. This includes making reasonable inquiries as needed.[18]

To ensure the duty of care is met, a director should review the corporation's articles of incorporation and bylaws to better understand the corporation's mission, and the expected roles and responsibilities of

[15] (E.g., Corp. Code, §§ 6215-6216, 6812.)
[16] (*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 Cal.App.4th 409, 420-421, disapproved on another ground in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140.)
[17] (*Bancroft-Whitney Co. v. Glen* (1966) 64 Cal.2d 327, 345; *Pigeon Point Ranch, Inc. v. Perot* (1963) 59 Cal.2d 227, 233, overruled on another ground in *Kowis v. Howard*, (1992) 3 Cal.4th 888; *GAB Business Services, Inc., supra,* 83 Cal.App.4th at pp. 416-417, disapproved on another ground in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140; *Burt v. Irvine Co.* (1965) 237 Cal.App.2d 828, 850; *Daniel Orifice Fitting Co. v. Whalen* (1962) 198 Cal.App.2d 791, 797, 800.)
[18] (Corp. Code, § 5231, subd. (a).)

directors and officers. Directors are also obliged to be informed about the nonprofit organization's program and operations.

Directors should also regularly attend board meetings and actively engage in meetings of the board and any board committees on which they serve. Before making any decision, directors should request and obtain all necessary background information and reports to promote informed decisions. Directors should use their own judgment in voting, and not simply follow the lead of other board members, or adopt the recommendations of management or staff. A director should not be afraid to ask questions at board meetings or request that matters be decided at a later date to allow for more in-depth deliberation.

In making decisions related to compensation or the charity's finances, directors should request reasonable access to management and advisors such as auditors and compensation consultants. In exercising due care, directors should proactively demand and review financial reports and statements.

If directors do not abide by the duty of care owed to their public benefit corporation, they may be held personally liable to the corporation.[19]

DIRECTORS' DUTY OF LOYALTY

Each director also owes a duty of loyalty to its nonprofit corporation. For public benefit corporations, this means the director must make decisions he or she believes is in the best interest of the corporation, as well as act in such best interest.[20] For instance, the director is obligated to act with undivided loyalty, be fair in his or her dealings with the nonprofit, and must not seek to benefit personally from the activities or resources of the nonprofit.

Duty of loyalty issues typically arise when there is a conflict of interest between the charity's best interests and the personal interests of the director, as exemplified in the Self-Dealing Transactions section below. And like the duty of care, directors who breach their duty of loyalty may be held personally liable to the corporation.[21]

SELF-DEALING TRANSACTIONS

A self-dealing transaction involves:

[19] (Corp. Code, § 5231, subd. (c).)
[20] (Corp. Code, § 5231, subd. (a).)
[21] (Corp. Code, § 5231, subd. (c).)

- A contract, agreement, or other action affecting the assets or income of a public benefit corporation;
- To which the corporation is a party; and
- In which one or more of its directors has a material financial interest.[22]

For example, a self-dealing transaction may occur when a charity pays a fee, commission, or rent, or enters into a contract with, that results in giving a material economic benefit to a director, or his or her company or partnership. Since the director's first duty of loyalty is to the corporation, it may be difficult for a director to carry out that duty if he or she is also looking to make a profit from transacting business with the corporation.

Self-dealing transactions between a director and a public benefit corporation are inherently suspect. Yet, there are situations when it may be advantageous for the corporation to enter into such a transaction, such as when the corporation is treated fairly and the director is not unduly compensated. This might occur when a corporation has the opportunity to rent office space from a director at a lower rate than would be available on the open market.

The board must follow the procedures set forth in Corporations Code section 5233 to validate a self-dealing transaction and before consummating it. These procedures require a determination by the board of directors that the corporation entered into the transaction for its own benefit, the transaction is fair and reasonable at the time it entered into the transaction, and that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances. In reaching these conclusions, the board must act in good faith and there must be a full disclosure of all material facts. Further, the board must approve the transaction by a majority of directors then in office without counting the director subject to the conflict of interest.

When a self-dealing transaction is not fair to the corporation and results in unreasonable charges or excessive profit to the interested director, the corporation suffers damage. The Attorney General and certain other persons may sue the directors to recover the actual damage suffered by the corporation, plus interest, and in some cases punitive damages. Any damages recovered are returned to the corporation. The Attorney General typically also seeks the permanent removal of the interested directors and other directors responsible for the damage.

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[22] (Corp. Code, § 5233. See also, Corp. Code, § 6322, subd. (b) [officers and holders of more than 10% of the voting power of a corporation, or its parent or subsidiary, can also engage in these kinds of transactions].)

If the "disinterested" directors fail to review a self-dealing transaction in good faith as provided in Corporations Code section 5233, and instead simply rubber stamp the transaction or approve the transaction to protect the interested director, the self-dealing transaction is not deemed validated and all directors may be held liable for any damages incurred by the charity.[23]

For added protection, the board may consider submitting a notice of the proposed self-dealing transaction to the Attorney General.[24] This protects the board against claims of improper transactions and potential damages. The Attorney General seeks to evaluate these transactions in 60 days.[25] See Chapter 11 for more information.

LOANS OF CORPORATE FUNDS

With narrow exceptions, a public benefit corporation may not grant loans to its directors or officers without Attorney General approval. One exception involves advancing money for an expense reasonably anticipated to be incurred in the performance of a director's duties, provided the director would otherwise be entitled to reimbursement for the expense.[26] The other exceptions involve purchasing a life insurance policy on the life of a director or officer, or the financing of a principal residence in California to attract a talented officer.[27] Directors may be held personally liable for authorizing prohibited loans and guarantees.[28]

Unless the loan is specifically exempt by statute, the board of directors should seek the Attorney General's approval of a prospective loan.[29] The Attorney General evaluates all material facts supporting the board's proposed decision to grant the loan, including whether the loan is in the best interest of the charity, whether the loan terms are fair to the corporation, and whether the loan is secured. The Attorney General also reviews the corporation's financial statements, founding records, and board minutes to evaluate whether the charity is authorized by its bylaws to grant loans and whether the loan would be a suitable investment given its financial statements.[30] The Attorney General seeks to respond to

[23] (Corp. Code, §§ 5231, 5233, subd. (h).)
[24] (Cal. Code Regs., tit. 11, §§ 999.1, 999.2, subd. (b).)
[25] (Corp. Code, § 5233, subd. (d); Cal. Code Regs., tit. 11, § 999.1, subd. (d).)
[26] (Corp. Code, § 5236, subd. (a).)
[27] (Corp. Code, § 5236, subds. (b)-(e).)
[28] (Corp. Code, § 5237, subd. (a).)
[29] (Corp. Code, § 5236.)
[30] (Cal. Code Regs., tit. 11, § 999.2, subd. (c).)

requests for approval of loan and guarantee agreements within 60 days after receipt of all material facts related to the proposed action.[31]

DISTRIBUTION OF CORPORATE ASSETS

Directors may also be personally liable for authorizing or receiving a prohibited distribution of the public benefit corporation's assets.[32] Examples of prohibited distributions include:

- Transfers of corporate funds or assets to directors, officers, or members without fair consideration;
- Payment of excessive or unauthorized salaries, non-contractual benefits or bonuses;
- Improper gifts of the corporation's assets to individuals; and
- Other uses of corporate assets that violate the charitable trust under which they are held.

OTHER LIABILITY ISSUES

Although situations where personal liability may be incurred are discussed above and other scenarios may apply,[33] directors and officers of nonprofit corporations are generally not personally liable for the debts, liabilities, or obligations of the corporation.

Volunteer Directors and Officers

Along those lines, volunteer directors and officers of public benefit corporations can avail themselves of statutory liability protections when certain criteria are met. Under Corporations Code sections 5047.5 and 5239, volunteer directors and officers are protected from liability in legal actions for claims of negligence involving conduct within the scope of their duties and performed in good faith. Also, the statutory protections are expressly conditioned on the corporation maintaining general liability insurance of certain amounts (based on the corporation's annual budget).[34]

However, these statutes do not protect a volunteer director's or officer's acts or omissions that are intentional, reckless, grossly negligent, outside the scope of their duties, or not made in good faith. Also, volunteer directors and officers are not protected from liability in lawsuits brought by

[31] (Cal. Code Regs., tit. 11, § 999.1, subd. (d).)
[32] (Corp. Code, § 5237, subd. (a).)
[33] (E.g., Corp. Code, §§ 6215, 6811.)
[34] (Corp. Code, §§ 5047.5, subd. (e), 5239, subd. (a)(4).)

Volunteer directors and officers are not protected from liability in lawsuits brought by the Attorney General or from lawsuits brought against them for self-dealing transactions or improper distributions.

the Attorney General or from lawsuits brought against them for self-dealing transactions or improper distributions.

Who May File Lawsuits

When a fiduciary, such as a director or officer, violates his or her duty of loyalty or care towards the charitable organization, and it results in lost income, assets and other damages, a breach of charitable trust action may be filed. Likewise, if a charitable organization departs from its charitable purpose or if funds solicited for specific purposes are diverted for other unrelated purposes, this type of conduct could result in a breach of charitable trust action to recover the lost donations. A breach of charitable trust action seeks to recover the loss of charitable assets, for the benefit of the charitable organization. Various persons have standing to file a lawsuit to remedy a breach of charitable trust action, such as:

- The Attorney General;
- Members of the corporation, if the corporation's bylaws provide for membership;
- The corporation's directors or officers;
- A person with a reversionary, contractual, or property interest in the assets subject to such charitable trust, and
- The corporation itself.[35]

The Attorney General files these types of lawsuits as part of his oversight power to protect charitable assets, and to ensure compliance with trusts, and a corporation's articles of incorporation and bylaws.[36] This oversight is an important function as charitable organizations exist to benefit the public in general. The Attorney General may intervene in an action brought by others.[37]

A corporation's members and others can bring a lawsuit in the name of the corporation. These are called "derivative actions" because they are filed on behalf of the corporation, and not the person or entity filing suit.[38] Derivative actions against directors and officers usually seek money damages from the responsible party. Such damages are paid to the corporation or, when circumstances make it more appropriate, to a charity with the same or similar charitable purpose. The Attorney General must be given notice of any derivative action.[39]

[35] (Corp. Code, § 5142, subd. (a).)
[36] (Gov. Code, § 12598, subd. (a).)
[37] (Corp. Code, §§ 5142, subd. (a), 5250.)
[38] (Corp. Code, § 5710.)
[39] (Corp. Code, § 5142, subd. (a).)

Indemnification and Insurance

California law allows a public benefit corporation to indemnify directors, officers, and agents of the corporation for costs and expenses of civil litigation under certain circumstances.[40] The corporation's articles of incorporation and bylaws may also contain provisions on indemnification. Note that any indemnification of directors and officers must be consistent with California law and the corporation's governing documents.

Many nonprofit corporations also purchase "directors and officers" insurance to provide a source of payment for litigation costs, in addition to the corporation's own funds. Public benefit corporations may purchase indemnification insurance to protect directors and officers from liability for most claims, but not for self-dealing.[41]

FREQUENTLY ASKED QUESTIONS

"Our charity has a $200,000 surplus for the current year. How should the directors invest this surplus?"

Directors are required to make prudent investments of charitable assets under their control in accordance with applicable law (including the Uniform Prudent Management of Institutional Funds Act[42]), and are permitted to rely on the advice of investment experts if it is reasonable to do so under the circumstances. Directors may be held personally liable if they fail to act in this way and loss results to the charity. For example, directors may be liable for lost earnings on surplus funds left in a non-interest-bearing account, if doing so would not be in accordance with their duties.

"Our charity is considering paying our chief executive officer a percentage of the charity's net proceeds as a bonus. Can we do this?"

While bonuses can be paid to an officer, if the bonus is tied to revenue, it may be considered excessive compensation and an improper distribution of charitable assets.

"The board recently became aware that one of the directors was engaging in a self-dealing transaction. This interested director planned our charity event. We thought he was organizing the event for free. We were not aware, and we did not authorize the payment of his services from donations he received from ticket sales. What are our obligations now?"

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[40] (Corp. Code, § 5238.)
[41] (Corp. Code, § 5238, subd. (i).)
[42] (Prob. Code, § 18501 et seq.)

Assuming this was not a theft or embezzlement, but an honest misunderstanding or miscommunication, the board should demand a full accounting of all profits and payments received by the interested director. The board should review the bylaws to consider steps in removing the interested director. The board of directors should have been told all of the material facts by the interested director, including payments he anticipated receiving, before the board gave him authority to plan, organize, and solicit donations for a charity event. If the accounting provided by the interested director reveals the payments amounted to a material financial interest, the board should demand the funds be returned. If the interested director refuses to return the funds, the board should consider filing an action against the interested director to recover the funds and remove the director from the board; the Attorney General must be joined as an indispensable party.

The self-dealing transaction must also be disclosed on the charity's Form RRF-1 filed with the Attorney General's Registry of Charitable Trusts,[43] and in IRS filings. The board should also file a complaint with the Attorney General.

If this transaction was not the result of a miscommunication or misunderstanding, and instead was embezzlement or theft, the board should file a complaint with the local police department, and must report the crime in the Form RRF-1 and in IRS filings.

"Our charity has not had board meetings in many months and we are having problems scheduling meetings in-person. What are our options for meeting by phone or video conferencing?"

The board should consult its bylaws to determine if meetings must be in person. If the bylaws are silent on this issue, Corporations Code section 5211, subdivision (a)(6), allows directors to meet by phone or video conferencing.

[43] (Corp. Code, § 5233.)

CHAPTER 8 MEMBERS OF PUBLIC BENEFIT CORPORATIONS

In This Chapter

- Members Overview
- Frequently Asked Questions

MEMBERS OVERVIEW

A California public benefit corporation may offer membership or create classes of members to individuals or corporate entities. Such memberships would be established and defined in the corporation's articles of incorporation or bylaws. California law does not require a public benefit corporation to have members.[1]

If a public benefit corporation has members, the members are typically vested with voting and other rights pertaining to the corporation's affairs. And, when the corporation's articles of incorporation or bylaws give members certain voting rights, they are called statutory or voting members. Statutory members have the right to vote for the corporation's directors (also known as board members, not to be confused with the corporation's membership), to vote on the manner in which the corporation's assets will be disposed upon dissolution or merger, or to vote on changes to the articles of incorporation or bylaws.[2] If members are deemed statutory members, California law also gives them other rights, including the rights to:

- Inspect certain corporate records;[3]
- Receive notice of member meetings;[4]
- Remove directors;[5] and
- Sue directors in derivative actions, or third parties on behalf of the corporation, under certain circumstances.[6]

[1] (Corp. Code, § 5310, subd. (a).)
[2] (Corp. Code, § 5056, subd. (a).)
[3] (Corp. Code, §§ 6330, 6333.)
[4] (Corp. Code, § 5511.)
[5] (Corp. Code, § 5222.)
[6] (Corp. Code, § 5710.)

Statutory members cannot be abolished by the directors without the members' consent.[7] They are also not personally liable for the debts, liabilities, or obligations of the public benefit corporation.[8]

Many public benefit corporations have "honorary members" who receive a form of "membership" recognition in return for their donations or services. However, honorary members do not have statutory or voting rights, and should not be confused with statutory members.

FREQUENTLY ASKED QUESTIONS

"Are public benefit corporations subject to the open meeting requirements under California law?"

No. Legislative bodies, school districts, and governmental entities are subject to open meeting law requirements. Most public benefit corporations do not fall into these categories. Yet, some public benefit corporations may be considered government entities because of substantial government funding or government agency affiliation. If a member believes a public benefit corporation is closely affiliated with a government agency, contact that government agency to ask about the public's rights to attend the corporation's meetings under open meeting law requirements.

"I am a member of a public benefit corporation. My request to attend meetings of the board of directors and inspect the corporation's financial records has been denied by the directors. What are my rights? Can I sue?"

A statutory member has certain rights under California law, including the right to receive annual reports,[9] to inspect copies of corporation records (but only for purposes reasonably related to the person's interest as a member),[10] and to exercise the member's voting rights set forth in the corporation's articles of incorporation or bylaws. Statutory members are also entitled to notice and have rights to attend membership meetings, among other rights.[11] These rights can be enforced in court actions. Generally, members do not have statutory rights to notice of or attendance at board of directors' meetings.[12]

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[7] (Corp. Code, § 5342.)
[8] (Corp. Code, § 5350, subd. (a).)
[9] (Corp. Code, § 6321.)
[10] (Corp. Code, §§ 6330, 6333.)
[11] (Corp. Code, § 5510 et seq.)
[12] (Corp. Code, §§ 5211, 6333.)

"I am a statutory member of a public benefit corporation and would like to use the corporation's mailing list to send out information. Am I entitled to use the mailing list?"

Yes, with limitations. A statutory member's right to obtain a copy of the corporation's member list is limited to purposes reasonably related to the person's interest as a member.[13] The corporation cannot refuse a member's mailing request based on the message's content, so long as the message is reasonably related to the member's rights as a member. Note that the corporation or other members may petition a court to limit or restrict the disclosure of the membership list.[14]

"The directors of a public benefit corporation wish to abolish the class of statutory members because the members are threatening to sue the directors. Is this possible?"

It will be very difficult. Classes of statutory members cannot be abolished without their consent, and their member rights may not be adversely affected without proper notice and due process.[15]

"Management has informed me my membership is being terminated because of my criticism of the board and management. Can they do this?"

Any expulsion, suspension, or termination of a statutory member must be done in good faith, and in a fair and reasonable manner. The expulsion procedures must be set forth in the corporation's articles of incorporation or bylaws, or copies of such procedures must be sent annually to all the members. The member must receive 15-days' prior notice of the proposed expulsion, suspension, or termination, and must be provided an opportunity to be heard. Members can legally challenge their expulsion, suspension, or termination by filing an action within one year after the date of their removal.[16]

"I want to resign as member of a public benefit corporation. What steps do I need to take?"

A member can resign from membership at any time. It is best to resign by submitting a written request. Note that resigning a membership does not relieve the member from outstanding obligations for charges incurred, such as assessments or membership fees.[17]

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[13] (Corp. Code, §§ 6330, 6338.)
[14] (Corp. Code, §§ 6331-6332.)
[15] (Corp. Code, § 5342.)
[16] (Corp. Code, § 5341.)
[17] (Corp. Code, § 5340.)

"Our public benefit corporation has not been able to schedule a membership meeting in the last few months. Can we have our meeting by video conferencing?"

Unless prohibited by the bylaws, membership meetings can take place through electronic video screen communications provided they comply with Corporations Code section 5510, subdivision (f).

CHAPTER 9 CHARITABLE FUNDRAISING

In This Chapter

- Introduction
- Who Can Fundraise and Attorney General Registration
- Tips for Selecting Fundraising Professionals
- Regulatory Requirements for Fundraising Professionals
- General Fundraising Requirements
- Fundraising Through Bingo and Raffles
- Fundraising Through Telephone and Federal Law
- Fundraising Through Online Giving Platforms
- Frequently Asked Questions

INTRODUCTION

This chapter discusses the legal issues and requirements under California and federal law governing charitable solicitations, also known as fundraising, charitable fundraising, and the soliciting of donations. Popular fundraising methods include:

- In-person requests for donations;
- Mail solicitations, including e-mails;
- Telephone solicitations;
- Solicitations through websites, online giving platforms, and mobile applications;
- Newspaper and magazine advertisements;
- Ticket sales for special events, such as annual dinners, auctions, bingo, and raffles;
- Use of collection bins;
- Vehicle donation programs; and
- Sales of products.

Every year in California, individuals donate billions of dollars in response to charitable fundraising appeals.

WHO CAN FUNDRAISE AND ATTORNEY GENERAL REGISTRATION

Most charitable organizations (including others deemed charitable trusts or trustees) fundraise using their own employees or volunteers. When doing so, the charity and its employees or volunteers are not required to register as fundraising professionals (as defined below) with the Attorney General's Registry of Charitable Trusts (Registry) pursuant to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code, § 12580 et seq.). However, charitable organizations are required to register with the Registry within 30 days of first receiving

property, as discussed in Chapter 6.[1] Additionally, when a charity's fundraising involves a raffle, additional raffle registration with the Registry is required, as discussed below.

Some charities also hire outside for-profit businesses to fundraise. Depending on the services provided, these businesses are referred to as "commercial fundraisers" or "fundraising counsel," and are also called "fundraising professionals or" "professional fundraisers." Commercial fundraisers are generally individuals or entities paid to solicit donations for a charity, and/or to receive or control funds as a result of a charitable solicitation.[2] On the other hand, fundraising counsel are typically individuals or entities paid to advise on, plan, manage, or prepare fundraising materials, but do not actually solicit donations, or directly or indirectly control or receive solicited charitable funds.[3] Attorneys, investment counselors, and bankers who give professional legal, investment, or financial advice are not deemed fundraising counsel.[4] As discussed below, commercial fundraisers and fundraising counsel are regulated and must register with the Registry. Also, charities that solicit funds in California may only contract with commercial fundraisers and fundraising counsel registered with the Registry.[5]

Charitable organizations can also partner with "commercial coventurers." Commercial coventurers are individuals or entities engaged in trade or commerce, and represent to the public that the purchase of a product or service they sell will benefit a charitable organization or will be used for a charitable purpose.[6] For example, a commercial coventurer may sell food products as a trade, and represent that 10 percent of the sale proceeds will benefit a charitable organization. A commercial coventurer must register with the Registry prior to soliciting any funds in California unless exempt by Government Code section 12599.2, subdivision (b). To qualify for exemption, the commercial coventurer must enter into a signed written contract with the applicable charitable organization before the charitable representations are made, as well as transfer and provide an accounting of all funds received from such representations to the charitable organization as specified in the statute.[7]

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[1] (Gov. Code, § 12585.)
[2] (Gov. Code, § 12599, subd. (a).)
[3] (Gov. Code, § 12599.1, subd. (a).)
[4] (Gov. Code, § 12599.1, subd. (b)(1).)
[5] (Gov. Code, § 12599.6, subd. (c).)
[6] (Gov. Code, § 12599.2, subd. (a).)
[7] (Gov. Code, § 12599.2, subds. (b)-(c).)

TIPS FOR SELECTING FUNDRAISING PROFESSIONALS

Fundraising campaigns are not always profitable. That is, many charities end up owing more money to their fundraising professionals than they gained from the solicitation campaigns.

When charitable organizations use commercial fundraisers or fundraising counsel, the fundraising campaigns are not always profitable. That is, many charities end up owing more money to their fundraising professionals than they gained from the solicitation campaigns. These losses may be due to multiple circumstances, including hidden or unexpected costs of their fundraising appeals, the lack of core donors committed to donating, or because charity officials were swayed by a fundraising professional's unrealistic projections.

If charities choose to use fundraising professionals, best practices to protect charities from these possible adverse consequences include the following:

- Perform online research to uncover possible negative reviews or complaints.
- Contact other trusted charities, local community funds, or a fundraising professional trade association for recommendations and reviews.
- Ask for references and check them carefully.
- Ask for proof of registration with the Registry, and confirm the fundraiser is registered in all states the charity seeks solicitations from.
- Avoid long-term contracts with the fundraising professional.
- Ensure the contract covers all key requirements mandated by law.[8]
- Verify the commercial fundraiser is bonded[9] and insured.
- Ensure fundraising is done honestly and with integrity by regularly reviewing fundraising materials for accuracy.[10]
- Learn how frequently potential donors are contacted and what practices the fundraising professional implements to prevent solicitations from being deceptive or coercive.[11] Frequent mailers and phone drives may lead to donor fatigue and the loss of goodwill towards the charity.
- Determine who owns the donor list, and its terms of use. For example, is the donor list shared with other charities? Donors who might otherwise be sympathetic to one charity may become

[8] (Gov. Code, §§ 12599, subd. (i), 12599.1, subd. (f), 12599.3.)
[9] (Gov. Code, § 12599.5.)
[10] (E.g., Gov. Code, § 12599.6, subds. (a), (f)(2).)
[11] (E.g., Gov. Code, § 12599.6, subds. (a)-(b) & (f)(2).)

frustrated with constant appeals for donations from other charities that use the same donor lists.

- Find out what practices the fundraising professional implements to protect donor privacy, and who is responsible for performing security data breach notification as required by law.
- Clarify the fundraising professional's rights to fees and payment of campaign expenses. Ask questions and demand answers about all costs associated with the campaign, and expected financial results. Follow up and ask for periodic financial updates to ensure the campaign is benefitting the charity.

Charity officials who oversee the charity's fundraising should also research fundraising professionals in the Attorney General's Professional Fundraisers Report, which is published yearly and available on the Attorney General's Charities website. The Report details the amounts commercial fundraisers raised and percentages paid to a charity, among other information. By providing these details, charities can learn how effective particular commercial fundraisers have been with other charities, and what those charities are paying their fundraisers and getting in return. The report also promotes transparency and provides a way for the public to evaluate the charities they support. The Attorney General's Charities website also offers a Professional Fundraising Webinar.

REGULATORY REQUIREMENTS FOR FUNDRAISING PROFESSIONALS

Registration

Commercial fundraisers must register with the Attorney General's Registry of Charitable Trusts and pay a registration fee before soliciting, and/or receiving and controlling any funds, assets, or property as a result of charitable solicitations in California. Registration, which involves filing the Registry's Annual Registration Form (CT-1CF Form) along with a cash deposit or bond,[12] must be renewed annually.[13]

Fundraising counsel also must register and pay a registration fee prior to planning, managing, advising, counseling, consulting, or preparing material for, or with respect to, the solicitation of charitable funds, assets, or property in California.[14] Fundraising counsel register and renew their registration annually through filing the Registry's Annual Registration Form (CT-3CF Form).

[12] (Gov. Code, § 12599.5.)
[13] (Gov. Code, § 12599, subd. (b).)
[14] (Gov. Code, § 12599.1, subd. (c).)

Contract

As previously mentioned, charities must have a written contract with their fundraising professionals for each solicitation campaign. The contract must clearly state the fees and compensation to be paid to the fundraising professional, and other terms including the campaign's charitable purpose, each party's respective obligations, the effective and termination dates for service, and cancellation rights.[15] View the Registry's Basic Components of a Fundraising Representation Agreement for a model contract.

Notice

Fundraising professionals must file with the Registry a Notice of Intent to Solicit for Charitable Purposes – either the CT-10CF Form for commercial fundraisers or the CT-11CF Form for fundraising counsel – at least 10 working days prior to starting each solicitation campaign. However, notices of solicitations to aid victims of emergency hardship or disasters must be filed no later than when the campaign begins.[16]

Reporting

Commercial fundraisers must also file an Annual Financial Report, on the Registry's CT-2CF Form, accounting for all funds collected during the preceding calendar year. The report requires a detailed, itemized accounting of solicited charitable funds, assets, or property, including the following:

- Total revenue;
- The commercial fundraiser's fee or commission;
- Salaries paid to the commercial fundraiser's officers and employees;
- Fundraising expenses;
- Distributions to the charity or charitable purpose; and
- The names and addresses of any director, officer, or employee of the commercial fundraiser who is a director, officer, or employee of any charity listed in the report.[17]

Filed reports are used to publish the Attorney General's Professional Fundraisers Report, available on the Attorney General's Charities website. As previously discussed, this report summarizes the results of charitable solicitation campaigns conducted in California by for-profit

[15] (Gov. Code, §§ 12599, subd. (i), 12599.1, subd. (f), 12599.3.)
[16] (Gov. Code, §§ 12599, subd. (h), 12599.1, subd. (e).)
[17] (Gov. Code, § 12599, subds. (c)-(d).)

fundraisers. The report also covers thrift store operations and vehicle donation programs.

Recordkeeping

Commercial fundraisers must keep detailed records for each solicitation campaign they participate in for at least 10 years and are subject to inspection upon demand by the Attorney General. They are required to retain the following:

- The date and amount of each contribution received from a solicitation campaign, and for non-cash contributions, the name and address of each donor;
- The names and addresses of all solicitation personnel; and
- Records of all revenue received and expenses incurred in the course of the solicitation campaign.[18]

GENERAL FUNDRAISING REQUIREMENTS

Charitable solicitations must disclose all material facts, and unfair or deceptive practices that may create confusion or misunderstanding are prohibited....Once funds have been donated for a specific purpose, charities have a fiduciary duty to spend those funds only on that purpose.

Regardless of whether a charity performs its own fundraising or retains fundraising professionals, the fundraising efforts must comply with various California charitable solicitation laws. For instance, charitable organizations are responsible for, and must control, their fundraising.[19] Along those lines, persons unaffiliated with a charitable organization cannot represent that donations solicited in California will be given to a charitable organization unless that organization provided signed written consent prior to the solicitation.[20]

Also, those responsible for a charity's operations must review the content of all fundraising materials, approve all written contracts involving fundraising, and ensure solicitations are not coercive.[21] Funds raised and fundraising costs must be accurately reported by the charity as well.

Fundraising Disclosures

Similarly, charitable solicitations must disclose all material facts, and unfair or deceptive practices that may create confusion or misunderstanding are prohibited.[22] Charities and their agents may not misrepresent how they use solicited donations. Once funds have been donated for a specific purpose, charities have a fiduciary duty to spend

[18] (Gov. Code, § 12599.7, subd. (a).)
[19] (Gov. Code, § 12599.6, subd. (b).)
[20] (Gov. Code, § 12599.6, subd. (f) (5), (11).)
[21] (Gov. Code, § 12599.6, subd. (b).)
[22] (Gov. Code, § 12599.6, subds. (a), (f); see also Bus. & Prof. Code, § 17200 et seq.)

those funds only on that purpose.[23] If a charitable organization wants flexibility to use donations for other services not mentioned in its solicitation materials, including for general program and administrative purposes, then consider adding language to the solicitation materials that includes a broader purpose.

Additionally, before engaging in face-to-face solicitations, a charitable solicitor must exhibit to the prospective donor a card, brochure, or other printed material that includes the following information:

- The name and address of each organization or fund on whose behalf the money collected will be used for charitable purposes. If there is no such organization or fund, the manner in which the money collected will be used for charitable purposes;
- If the organization or fund is not tax-exempt under both federal and state law, then disclose its non-tax-exempt status; and
- The percentage of the gift which may be deducted as a charitable contribution under both federal and state law. If no portion is deductible, then state "This contribution is not tax deductible."[24]

Also, if the face-to-face solicitation is on behalf of law enforcement, safety personnel, or veterans, additional requirements apply. For instance, if the organization's name includes the term "officer," "police," "highway patrol," "firefighter," or the like, the solicitor must disclose the total number of members in the organization, and the number of members working or living within the county where the solicitation is made; and if, the solicitation is for advertising, the statewide circulation of the publication in which the ad appears.[25] If the organization's name includes the term "veteran" or the like, the solicitor must disclose the total number of members in the organization, and the number of members working or living within the county where the solicitation is made, unless limited exceptions apply.[26]

The same disclosures for face-to-face charitable solicitations apply to charitable solicitations made by letter, radio, television, telephone, and through the Internet (with some exceptions for radio and television). If a

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[23] (Bus. & Prof. Code, § 17510.8; *Holt v. College of Osteopathic Physicians and Surgeons* (1964) 61 Cal.2d 750, 754.)
[24] (Bus. & Prof. Code, § 17510.3, subd. (a).)
[25] (Bus. & Prof. Code, § 17510.3, subd. (a)(5).)
[26] (Bus. & Prof. Code, § 17510.3, subd. (a)(6).)

donation is made, the card, brochure, or other printed material shall be mailed or otherwise delivered to the donor.[27]

Commercial Fundraiser Disclosures

Additional disclosures are required by commercial fundraisers. Before each charitable solicitation by a commercial fundraiser, the prospective donor must be told the solicitation is being conducted by a commercial fundraiser, and must provide the commercial fundraiser's name as registered with the Attorney General.[28] Also, if a prospective donor requests the percentage of total fundraising expenses of a commercial fundraiser, the commercial fundraiser must disclose this information. For instance, if this is requested during a telephone-based solicitation, the commercial fundraiser shall immediately disclose this, and follow up with written disclosure within five working days.[29]

For additional requirements for commercial fundraisers performing telephone-based solicitations, see below.

Attorney General Financial Solicitation Reporting

California's charitable solicitation laws also require charitable organizations to file annual reports on their financial solicitations with the Attorney General's Registry of Charitable Trusts when certain fundraising thresholds are met. A charity that collects more than 50 percent of its annual income and more than $1 million in charitable contributions from donors in California is required to file the Registry's Annual Financial Solicitation Report (CT-694 Form).[30] When applicable, this is in addition to filing the Registry's Form RRF-1 discussed in Chapter 6, and reporting by commercial fundraisers for solicitations on behalf of a charity as discussed above.

City and County Ordinances

Many local jurisdictions in California also require charitable organizations to obtain a license or permit before soliciting donations from residents and in public spaces. Registration and financial reporting may be another condition in allowing charitable solicitations within a jurisdiction. Comply with applicable local city and county requirements.

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[27] (Bus. & Prof. Code, § 17510.4.)
[28] (Bus. & Prof. Code, § 17510.85.)
[29] (Gov. Code, § 12599, subd. (j).)
[30] (Bus. & Prof. Code, § 17510.9.)

FUNDRAISING THROUGH BINGO AND RAFFLES

Generally, private lotteries, such as bingo and raffles, constitute illegal gambling. However, there are exceptions for tax-exempt organizations, thus enabling them to raise charitable funds through such methods.

Bingo

Organizations exempt from taxation under Revenue and Taxation Code sections 23701a, 23701b, 23701d (analogous to exemption under Internal Revenue Code section 501(c)(3)), 23701e, 23701f, 23701g, 23701k, 23701l, or 23701w, are authorized to raise money from bingo when the criteria in Penal Code section 326.5 are met. These criteria include:

- For organizations exempt under Revenue and Taxation Code section 23701d, all profits from the bingo game are used for charitable purposes (while for other exempt organizations, all proceeds are used for charitable purposes after certain bingo game expenses are paid, such as for prizes, bingo equipment, and security personnel);
- The games are played on property used by the organization as an office, or to perform its tax-exempt purpose;
- The games are open to the public, players are physically present, and are not minors;
- The games are conducted by members of the organization, whom cannot receive salaries;
- The games cannot be conducted online;
- The value of prizes for each game do not exceed $500 in cash or kind;
- There is no comingling of bingo money with other funds; and
- The organization holds an applicable license issued by the city and/or county where the bingo is played.[31]

In addition, charities must comply with any other local bingo licensing requirements before operating bingo games. Furthermore, charities must account to local licensing authorities for all bingo proceeds.

Note that charity bingo start-up costs may range from a few hundred dollars to many thousands of dollars. Proper planning is essential to ensure profitable, cost-effective, and legal games.

[31] (Pen. Code, § 326.5.)

Raffles

Charities may operate raffles if they are qualified to do business in California for at least one year before conducting a raffle. Also, they must be exempt from taxation under any of the following Revenue and Taxation Code sections: 23701a, 23701b, 23701d, 23701e, 23701f, 23701g, 23701k, 23701l, 23701t, or 23701w. Additional requirements include the following:

- Charities must register the raffle in advance with the Registry, by filing an Application for Registration (CT-NRP-1 Form). This registration is in addition to the registration discussed in Chapter 6;
- Ninety percent of the proceeds from selling the raffle tickets must be used for a charitable purpose or program;
- Raffle tickets cannot be sold online, and cannot be conducted online;
- No individual, corporation, or other legal entity may have a financial interest in the raffle except the eligible organization conducting or receiving proceeds from the raffle;
- Employees of the eligible organization are the only persons who can receive compensation in connection with the operation of a raffle; and
- Charities must annually report the results of raffles to the Registry, by filing a Nonprofit Raffle Report (CT-NRP-2 Form); this report is in addition to any reports filed, as discussed in Chapter 6 or above.[32]

Note that "50/50 raffles," where 50 percent of the proceeds from selling tickets are split between the winner and the eligible organization, are limited to organizations affiliated with certain major league professional sport teams or associations. Such organizations register and report their 50/50 raffles with the Attorney General's Bureau of Gambling Control.[33]

FUNDRAISING THROUGH TELEPHONE AND FEDERAL LAW

Commercial fundraisers that solicit charitable solicitations via telephone also need to comply with the Telemarketing Sales Rule,[34] a federal law enforced by the Federal Trade Commission, the Attorney General, and other State Attorneys General.

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[32] (Pen. Code, § 320.5; Cal. Code Regs., tit. 11, § 410 et seq.)
[33] (Pen. Code, § 320.6.)
[34] (16 C.F.R. § 310 (2019).)

Some Telemarketing Sales Rule's requirements overlap with requirements under California's charitable solicitations laws. For instance, telephone-based commercial fundraisers generally must not make misrepresentations during solicitations, including misrepresentations about the charitable organization's nature, purpose, or tax-exempt status; the tax deductibility of a donation; how donated funds will be used and the amount that goes to the charitable organization; and any false affiliation or sponsorship with any person, charities, other organizations, or government entities.[35]

Furthermore, other Telemarketing Sales Rule provisions reflect similar requirements under California charitable solicitation laws. For example, telephone-based commercial fundraisers must maintain certain records for two years, such as telemarketing scripts and employee records.[36] Yet, as discussed above, commercial fundraisers must keep certain records for 10 years under California law.[37] The Telemarketing Sales Rule also bans threatening or intimidating conduct during solicitations, while California law prohibits coercive fundraising activities.[38] Ensure compliance with all aspects of both laws.

Other key provisions of the Telemarketing Sales Rule are as follows:

- Before a charitable solicitation is made, commercial fundraisers must promptly disclose the identity of the charitable organization they are calling on behalf of, and that the purpose of the call is to solicit a charitable contribution.[39]
- Commercial fundraisers must maintain "do not call" lists for each charity they solicit charitable contributions for, and ensure they do not call those who have asked not to be called again.[40] Accordingly, they must obtain and update the do not call lists used by any prior commercial fundraisers a charity has used.
- Commercial fundraisers cannot use prerecorded messages in solicitations, unless made to the charity's prior donors or members. And when prerecorded messages are used in those

[35] (Gov. Code, §§ 12599, subd. (j), 12599.6, subds. (a), (f)(2), (5), (8) & (11); 16 C.F.R. § 310.3(a)(4), (d) (2019).)
[36] (16 C.F.R. § 310.5 (2019).)
[37] (Gov. Code, § 12599.7, subd. (a).)
[38] (Gov. Code, § 12599.6, subd. (b); 16 C.F.R. § 310.4(a)(1) (2019).)
[39] (16 C.F.R. § 310.4(e) (2019).)
[40] (16 C.F.R. § 310.4(b)(iii)(A) (2019).)

instances, commercial fundraisers must provide an automated opt-out mechanism and comply with other requirements.[41]

- Commercial fundraisers cannot call prospective donors before 8 a.m. or after 9 p.m., and perform other acts considered abusive.[42]

For more information on the Telemarketing Sales Rule, visit the Federal Trade Commission's Complying with the Telemarketing Sales Rule website.

FUNDRAISING THROUGH ONLINE GIVING PLATFORMS

Charitable giving on the Internet is no longer limited to giving directly to a charity through its website. For instance, many companies unaffiliated with a charity let the public perform the following on their websites and other Internet-based platforms:

- Select a charity to receive a donation from a list or database of charities;
- Fundraise for charities; or
- Support charities when making purchases on the platform.

For more information on soliciting through charitable fundraising platforms, review the Attorney General's Guide for Online Charitable Giving. Charities must ensure their fundraising efforts on these platforms comply with applicable charitable solicitation laws, as referenced in the General Fundraising Requirements section above.

FREQUENTLY ASKED QUESTIONS

"One of the director's friends wants to solicit for our charitable organization in California and get paid a 10 percent commission for all revenue raised in the solicitation. What steps does the charity need to take?"

If the friend is controlling the charitable funds, he or she is a commercial fundraiser and must register with the Registry in advance, through filing an Annual Registration Form (CT-1CF Form), and provide a cash deposit or bond. The charity must also enter into a written contract with the commercial fundraiser, and certain terms are required to be included in the contract.[43] Review the Registry's Basic Components of a Fundraising Representation Agreement for a model contract.

The commercial fundraiser also needs to file with the Registry a Notice of Intent To Solicit for Charitable Purposes (CT-10CF Form) before the

[41] (16 C.F.R. § 310.4(b)(v)(B) (2019).)
[42] (16 C.F.R. § 310.4(c) (2019); see generally 16 C.F.R. § 310.4 (2019).)
[43] (Gov. Code, §§ 12599, subd. (i), 12599.3.)

solicitation campaign commences. At the end of the campaign, the commercial fundraiser also files an Annual Financial Report (CT-2CF Form) for the solicitation campaign. Instructions for these forms are available on the Attorney General's Professional Fundraiser Forms website. He or she must also comply with recordkeeping, distribution, and solicitation disclosure requirements specific to commercial fundraisers.[44]

"Another friend has offered to help the charity raise funds by researching and applying for grants for a fixed payment. This friend is not an employee of the charity and she will not control the grant funds as they will be paid directly to the charity. Does this friend need to register and report as a commercial fundraiser or fundraising counsel?"

If this friend is paid a flat fee, and not a percentage, and if this friend does not control directly or indirectly the funds or assets after they are paid to the charity, he or she is a fundraising counsel unless he or she falls within one of the exceptions in Government Code section 12599.1, subdivision (b), which includes a person whose total annual gross compensation for writing grants does not exceed $25,000.

"One of our directors suggested we raise money for a raffle, and reported to the board the charity does not need to register for the raffle if tickets are also given away for free."

If participants are required to purchase a ticket in order to have a chance to win a prize, the drawing is subject to the provisions of Penal Code section 320.5 and related regulations, which require registration and reporting. However, a raffle is exempt from Penal Code section 320.5, including registration with the Registry, if all of the following are true:

- 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.[45]

"Another director suggested we raise money through a hosting a poker tournament. Is this type of gaming permitted for charity?"

Organizations that have conducted business in California for at least three years and are exempt under Revenue and Taxation Code sections 23701a, 23701b, 23701d, 23701e, 23701f, 23701g, 23701k, 23701l, or 23701w can fundraise through controlled games, such as poker. This type of fundraising may occur once annually for up to five consecutive

[44] (Gov. Code, §§ 12599, subd. (j),12599.6, subd. (e), 12599.7; Bus. & Prof. Code, § 17510.85.)
[45] (Pen. Code § 320.5, subd. (m).)

hours, and requires registration with and approval by the Attorney General's Bureau of Gambling Control. Business and Professions Code sections 19985 to 19987 must be fully complied with, such as maintaining detailed fundraising and accounting records, and at least 90 percent of the fundraiser's gross revenue going directly to the tax-exempt organization. The fundraiser may not be operated or conducted online. Local ordinances may also require registration and other requirements.

"I am the director of a mutual benefit corporation. When the organization fundraises, should our solicitations disclose that donations are not tax deductible?"

California law requires anyone, including mutual benefit corporations, who solicits assets for charitable purposes to disclose certain information as part of a solicitation, including the percentage of a donation that may be deducted as a charitable contribution under both federal and state law. If no portion is deductible, then the solicitor must state "This contribution is not tax deductible."[46] Hence, when a mutual benefit corporation solicits donations to benefit a particular charitable cause, the mutual benefit corporation must disclose the above.[47] In practice, this means the mutual benefit corporation would disclose the contribution is not tax deductible as mutual benefit corporations typically are not tax-exempt under Internal Revenue code section 501(c)(3) and Revenue and Taxation Code section 23701d, which permit tax deductions by donors.

Yet, many mutual benefit corporations are organized for the benefit of their members, and do not solicit charitable assets. This occurs when mutual benefit corporations make clear that the purpose of all of their solicitations is for the sole benefit of their actual active membership. To make this clear, the mutual benefit corporation should also state that contributions are not tax deductible. If not, donors could be confused as to whether their donations are charitable or not, and confusing solicitations are prohibited.[48]

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[46] (Bus. & Prof. Code, §§ 17510.3, subd. (a), 17510.4.)

[47] If not already registered, this would also cause the mutual benefit corporation to register with and report to the Attorney General. See Chapter 6.

[48] (E.g., Gov. Code, § 12599.6, subd. (f)(2).)

CHAPTER 10 ATTORNEY GENERAL'S ROLE WITH CHARITIES

In This Chapter

- Overview
- Charitable Trusts Section
- Scope of Investigations
- Investigation Processes
- Frequently Asked Questions

OVERVIEW

The Attorney General has primary responsibility for supervising charities and charitable trusts in California.[1] This involves protecting charitable assets and donations, and ensuring compliance with trust documents, articles of incorporation, and other governing documents of a charitable organization. In doing so, the Attorney General investigates charities, charitable trusts, and fundraising professionals, and brings enforcement actions, as discussed below and in Chapter 11 and Chapter 12.

CHARITABLE TRUSTS SECTION

Within the Department of Justice, the Attorney General has a specialized unit, the Charitable Trusts Section, which carries out his regulatory and law enforcement program. The Charitable Trusts Section is comprised of the Registry of Charitable Trusts and a Legal and Audits Unit.

Registry of Charitable Trusts

The Registry of Charitable Trusts (Registry) is responsible for administering the registration and reporting requirements set forth in the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code, § 12580 et seq.) and its regulations. The Registry does this through its various programs: Initial Registration, Registration Renewals, Delinquency, Dissolution, Commercial Fundraising, Raffles, Complaints, and Administrative. The Registry also maintains a searchable database for the public to research registered charitable organizations and fundraising professionals.

The registration and reporting requirements the Registry administers, discussed in Chapter 6, Chapter 9, and Chapter 12, advance and promote the Attorney General's oversight over charities and fundraising professionals. For instance, Registry staff reviews forms filed by charities and fundraising professionals, and based on this review, makes referrals to the Legal and Audits Unit. The Registry also receives complaints from

[1] (Gov. Code, § 12598, subd. (a).)

the public about charity mismanagement, fraud, diversion of assets, and fundraising or reporting violations. All complaints are reviewed and researched by Registry staff and referred to the Legal and Audits Unit.

The Registry's complaint form (Form CT-9) is available on the Attorney General's Charities website or by writing to the Registry and requesting the form. The Registry of Charitable Trusts address is P.O. Box 903447, Sacramento, CA 94203-4470. A completed complaint form and any attachments should also be mailed to this address.

Legal and Audits Unit

The Legal and Audits Unit is comprised of attorneys, investigative auditors, and legal assistants. The Unit is tasked with several responsibilities, such as:

- Performing investigations, also referenced as audits, to determine if directors, officers, or trustees are carrying out their authorized charitable purposes in a lawful manner.[2] This can involve different areas of concern, as discussed below;
- Reviewing and investigating various nonprofit corporate transactions, discussed below and in Chapter 11;
- Bringing enforcement actions to stop violations of the law, recover charitable assets due to fiscal abuse, and obtain other remedies; and
- Defending and protecting gifts made to unnamed charitable beneficiaries in a will or trust (see Chapter 12).

SCOPE OF INVESTIGATIONS

The investigations of the Charitable Trusts Section's Legal and Audits Unit include the following areas of concern:

- Illegal or improper use of charitable funds;
- Diversion or loss of charitable assets;
- Losses arising out of speculative investments or the failure to diversify investments leading to insignificant gains;
- Excessive compensation, including salaries, pensions, benefits, insurance, travel, entertainment, legal and other professional fees;
- Breaches of fiduciary duties;
- Misleading, deceptive, or coercive charitable solicitations and fundraising practices;

[2] (E.g., Corp. Code, § 5250; Gov. Code, §§ 12588, 12598.)

- Improper or false statements in reports or filings, including the annual registration reports, renewal reports, and informational returns filed with the Registry;
- Self-dealing transactions;
- Improper loans of charity assets;
- Amendments to the articles of incorporation of public benefit corporations;
- Dissolutions;
- Sales of charitable assets at an unfair price;
- Mergers; and
- Conversion of a public benefit corporation to for-profit status.

The Legal and Audits Unit is also tasked to review transactions which require the Attorney General's consent or notice. For instance, a California public benefit corporation must obtain prior written consent from the Attorney General before converting into or merging with a for-profit corporation or mutual benefit corporation. Likewise, California law requires a public benefit corporation that operates or controls a "health facility" to provide written notice to and obtain the written consent of the Attorney General prior to any sale or transfer of ownership or control of a material amount of its assets to a for-profit corporation, mutual benefit corporation, or another public benefit corporation.[3] For more information, see Chapter 11.

There are also some matters the Legal and Audits Unit typically does not investigate. For instance, the Legal and Audits Unit does not become involved in disputes between charities and third parties over contracts or torts.

Moreover, the Legal and Audits Unit generally does not get involved in matters pertaining to internal board disputes, contested elections, and disagreements between directors and members over policies and procedures. However, this may not be the case if a complaint also raises concern that there has been a significant loss of charitable assets.

Also, although the Attorney General has oversight over California mutual benefit corporations,[4] the Legal and Audits Unit may decline to take action because members, directors, and officers have standing to address many corporate law violations involving mutual benefit

[3] (Corp. Code, §§ 5914-5925.)
[4] (Corp. Code, §§ 7240, 8712.)

corporations. And oftentimes, these types of complaints do not involve a loss of charitable assets.

INVESTIGATION PROCEDURES

As for what triggers a Charitable Trusts Section investigation, the Attorney General receives leads or complaints from many sources including other government agencies, directors, officers, agents, charity employees, media reports, donors, and consumers or users of services. However, even without a complaint, an investigation can occur at any time to ensure compliance with the laws the Charitable Trusts Section enforces.

When the Charitable Trusts Section receives complaints, they may be made confidentially or anonymously. To protect both the complainants and the targets of the complaints, the Attorney General does not discuss pending investigations, or confirm or deny the existence of complaints received.

The failure to respond and produce records can lead to the suspension of registration and assessment of penalties.

Frequently, the Legal and Audits Unit sends a written request to a charity or fundraising professional to investigate a complaint. It is important to fully cooperate with the investigation process. The failure to respond and produce records can lead to the suspension of registration and assessment of penalties.[5] A suspended registrant (as well as a delinquent or a revoked registrant) is not in good standing, and is prohibited from engaging in conduct for which registration is required – including solicitations for charitable purposes.[6]

During the audit process, Legal and Audits Unit auditors and attorneys may interview directors, officers, and other interested parties such as complainants, volunteers, current and past employees, bookkeepers, and accountants. Records may be subpoenaed from third parties. Donors may be contacted to confirm the complaint's allegations, or to investigate improper solicitation practices. Depending on the investigation's complexity and other work, it can take between six months to a few years to complete the audit.

In many cases, problems identified in the investigation may be resolved informally. If the parties are unable to reach a satisfactory resolution informally, or if the violations are more serious, the Attorney General may bring a formal enforcement action. Enforcement actions may seek the recovery of charitable funds including lost income and interest, the

[5] (Gov. Code, §§ 12591.1, subd. (c), 12598, subd. (e)(1); Cal. Code Regs., tit. 11, §§ 315, 999.9.)
[6] (Cal. Code Regs., tit. 11, § 999.9.4.)

assessment of penalties, injunctive relief orders removing directors and officers or prohibiting specific acts, and a charity's involuntary dissolution. The Attorney General can also recover attorney fees, audit expenses, and expert costs in successful charitable trust enforcement actions.[7]

FREQUENTLY ASKED QUESTIONS

"I have information about fiscal mismanagement of a charity by its directors. Can I submit a complaint to the Attorney General without revealing my identity?"

Yes. Many complaints about fiscal abuse of charitable assets are received by the Attorney General from directors, officers, and employees of charities who fear loss of their position or employment. Anonymous complaints are accepted and reviewed by the Attorney General's Charitable Trusts Section.

"When the Attorney General's Charitable Trusts Section conducts an audit or investigation of a charitable organization, does it make public the results of the investigation?"

No, investigations and their findings are confidential unless the Attorney General brings a formal enforcement action.

"I am a member of a homeowners' association, and am concerned about gross mismanagement of our funds. Will the Attorney General investigate this?"

Homeowners' association are typically mutual benefit corporations that do not hold charitable assets. Additionally, its directors, officers, and members have standing to file lawsuits in court. However, the Attorney General may investigate these complaints as consumer complaints. See the Attorney General's Homeowner Association/Nonprofit Mutual Benefit Corporations website.

[7] (Gov. Code, § 12598, subds. (b)-(c).)

CHAPTER 11 REVIEWING NONPROFIT TRANSACTIONS

In This Chapter

- Introduction
- Voluntary Dissolutions
- Mergers
- Sale or Transfer of Corporate Assets
- Sale or Transfer of Health Facilities
- Corporate Conversions
- Self-Dealing Transactions
- Loans of Corporate Funds
- Frequently Asked Questions

INTRODUCTION

California law requires public benefit corporations formed in California – and in certain cases mutual benefit corporations or religious corporations – to give written notice to, or obtain written consent from, the Attorney General before taking certain actions that will have a significant impact on the corporation and its assets.[1] Examples of these types of actions are voluntary dissolutions, mergers, and the sale or transfer of a corporation's assets. These are generally called index transactions. As discussed in Chapter 10, the Attorney General's Charitable Trusts Section, specifically its Legal and Audits Unit, reviews and investigates these nonprofit transactions. These transaction notification and consent requirements are described in this Chapter, as well as in the Attorney General's Nonprofit Transactions Requiring Notice or Attorney General Approval publication.

VOLUNTARY DISSOLUTIONS

The Attorney General must receive notice of the commencement of voluntary (and involuntary) proceedings to dissolve. This applies to California public benefit corporations, mutual benefit corporations (if holding charitable assets), and religious corporations.[2]

Moreover, the Attorney General must be involved in providing a written waiver of the distribution of the corporation's assets. A dissolution waiver can be obtained from the Attorney General by submitting a letter signed

[1] (See generally Corp. Code, §§ 5110 et seq. [nonprofit public benefit corporations], 7110 et seq. [nonprofit mutual benefit corporations], 9110 et seq. [nonprofit religious corporations].)

[2] (Corp. Code, §§ 6611-6612, 6615-6617, 6716 [nonprofit public benefit corporations]; 7238, 8611, 8614, 8716 [nonprofit mutual benefit corporations]; 9680 [nonprofit religious corporations].)

by an attorney or director for the nonprofit, detailing all charitable organizations, individuals, or groups who will be receiving the corporation's remaining assets. If no assets remain for distribution, that information should be provided in the letter. The letter should include the recipient's full legal name, address, telephone number, corporate number, and Federal Employer Identification Number, if any. The letter should also itemize and list all assets to be distributed (by type and value), provide the proposed date of distribution, and indicate any restriction on the use of the assets. Also attach the following records to the letter:

- A copy of the recipient's articles of incorporation;
- Endorsed filed copy of the dissolving corporation's articles of incorporation, including any amendments;
- A signed copy of the Certificate of Dissolution prepared for submission to the Secretary of State; and
- Copies of the dissolving corporation's last three annual information returns with the IRS. If the dissolving corporation does not have any informational returns (because it files an e-Postcard), it should submit financial statements showing receipts and disbursements, and balance sheets for the three most current accounting periods.

For more information on dissolutions, see the Attorney General's Charities website.

MERGERS

The Attorney General must receive 20-days' prior notice before a nonprofit corporation consummates its merger with another corporation. For instance, a merger between two public benefit corporations requires this advance notice. These notice requirements apply to California public benefit corporations, mutual benefit corporations (if holding charitable assets), and religious corporations.[3]

In addition to notice, the parties may also require the Attorney General's written consent for a proposed merger depending on the corporate forms of the merging parties. For example, if a public benefit corporation seeks to merge with a mutual benefit corporation, the proposed merger requires the Attorney General's prior consent.[4]

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[3] (Corp. Code, §§ 6010 [nonprofit public benefit corporations]; 7238, 8010 [nonprofit mutual benefit corporations]; 9640 [nonprofit religious corporations]; Cal. Code Regs., tit. 11, § 999.2, subd. (e).)
[4] (Corp. Code, §§ 6010, 8010.)

Any California nonprofit corporation providing notice of a proposed merger or seeking approval from the Attorney General of a merger should include the following information:

- A letter signed by an attorney or director for the corporation setting forth a description of the proposed action;
- Copies of the merger agreement, board minutes, and resolutions authorizing the proposed action;
- A copy of the corporation's current financial statement; and
- Copies of the current version of the corporation's articles of incorporation, and the articles of incorporation of any other corporation that is a party to the proposed action.

Also, depending on the nature of the charitable assets, the Attorney General may request an independent appraisal or other evidence that the merger's sale price and terms are fair to the corporation.

SALE OR TRANSFER OF CORPORATE ASSETS

The Attorney General must receive 20-days' notice before a nonprofit corporation in California sells, leases, conveys, exchanges, transfers, or otherwise disposes of all or substantially all of its assets. These requirements apply to California public benefit corporations, mutual benefit corporations (if holding charitable assets), and religious corporations.[5]

Information provided to the Attorney General should contain sufficient information to enable the Attorney General to review and evaluate the transaction. Any California nonprofit corporation seeking to notify the Attorney General of a sale of assets should submit the following information:

- A letter signed by an attorney or director of the corporation setting forth a description of the proposed action;
- Copies of the asset purchase agreement(s), board minutes, and resolutions authorizing the proposed action;
- A copy of the corporation's current financial statement; and
- Copies of the current version of the corporation's articles of incorporation, and the articles of incorporation of any other corporation that is a party to the proposed action.

[5] (Corp. Code, §§ 5913 [nonprofit public benefit corporations]; 7238, 7913 [nonprofit mutual benefit corporations]; 9633 [nonprofit religious corporations]; see also Cal. Code Regs., tit. 11, §§ 999.1-999.4.)

Similar to merger applications, depending on the nature of the charitable assets, the Attorney General may request an independent appraisal or other evidence that the assets' sale price and terms are fair to the corporation.

SALE OR TRANSFER OF HEALTH FACILITIES

Notice to and approval from the Attorney General is required for the sale of – or transfer of assets or corporate control by – nonprofit corporations that operate or control healthcare facilities.[6] This requirement applies to health care facilities that are licensed to provide 24-hour care, such as hospitals and skilled nursing facilities.

For transactions involving a general acute care hospital with 50 or more beds, the Attorney General hires a health care expert to prepare a health care impact statement. This statement addresses whether the agreement or transaction may create a significant effect on the availability or accessibility of health care services to the affected community. This includes an assessment of emergency services, charity care, services to Medi-Cal and county indigent patients, community benefit programs, staffing and employees, mitigation measures, and alternatives. Sometimes auditors or financial analysts are also consulted for economic evaluations.

The Healthcare Rights & Access Section reviews these transactions, and make recommendations to the Attorney General.

The Attorney General may deny the transaction, consent to the transaction, or issue conditional consent. In making the determination, the Attorney General considers all relevant factors including the following:

- Whether the terms and conditions of the agreement or transaction are fair and reasonable to the nonprofit corporation;
- Whether the agreement or transaction will result in inurement to any private person or entity;
- Whether the agreement or transaction is at fair market value;
- Whether the market value has been manipulated by the actions of the parties in a manner that causes the value of the assets to decrease;
- Whether the use of the proceeds is consistent with the charitable trust on which the assets are held by the health facility, or by the affiliated nonprofit health system;

[6] (Corp. Code, §§ 5914, 5920, 9634; Cal. Code Regs., tit. 11, § 999.5.)

- Whether the agreement or transaction involves or constitutes any breach of trust;
- Whether the Attorney General was provided sufficient information and data by the nonprofit corporation to adequately evaluate the transaction, or the effects thereof on the public;
- Whether the agreement or transaction may create a significant effect on the availability or accessibility of health care services to the affected community;
- Whether the agreement or transaction may create a significant effect on the availability or accessibility of cultural interests provided by the health facility in the affected community; and
- Whether the agreement or transaction is in the public interest.[7]

The Attorney General also conducts one or more public meetings related to the transaction to obtain public input on the transaction.[8] Confidential comments can also be provided.

The Attorney General's conditional consent often requires the continuation of existing levels of charity care, continued operation of emergency rooms and other essential services, and other conditions to mitigate or reduce any significant adverse effects on health care services to the affected community. See the Attorney General's Nonprofit Hospital Transaction Notices website for more information.

CORPORATE CONVERSIONS

A public benefit corporation that has any assets cannot convert its corporate form to a mutual benefit corporation, business corporation, social purpose corporation, or cooperative corporation unless written consent of the Attorney General has been obtained. The Attorney General requires certification that all charitable assets will be transferred to another charity as a condition to consent.[9] Likewise, if a mutual benefit corporation holds charitable assets, notice of the transaction should be submitted to the Attorney General.[10]

Any public benefit corporation or mutual benefit corporation with charitable assets applying for approval of corporate conversion should submit the following information to the Attorney General:

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[7] (Corp. Code, §§ 5917, 5923; Cal. Code Regs., tit. 11, § 999.5, subd. (f).)
[8] (Corp. Code, §§ 5916, 5922.)
[9] (Corp. Code, § 5813.5; Cal. Code Regs., tit. 11, § 999.2, subd. (d).)
[10] (Corp. Code, § 7820; Cal. Code Regs., tit 11, § 999.3, subd. (d). For religious corporation conversions, see Corp. Code, §§ 9620, 9621.)

- A letter signed by an attorney or director of the corporation setting forth a description of 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 board meeting minutes reflecting discussion of the proposed action;
- A copy of the corporation's current financial statement;
- Copies of the current version of the corporation's articles of incorporation, and copies of the proposed restated articles of incorporation;
- Any independent appraisals of the value of charitable assets (in complex conversions of a large corporation, the Attorney General usually requires independent valuation appraisals or other evidence that the transaction is fair and reasonable to the corporation); and
- A statement of the plan for distribution of the assets of the charitable assets to a qualified charitable organization.

SELF-DEALING TRANSACTIONS

As referenced in Chapter 7, self-dealing transactions are presumed to be detrimental to a public benefit corporation (and a mutual benefit corporation holding charitable assets) unless specific steps are taken by the board before consummating the transaction to ensure the transaction is both fair and reasonable to the corporation.[11] One way the corporation's board can protect itself from an unfavorable self-dealing transaction is to submit the transaction to the Attorney General for approval. The following information should be submitted:

- A letter signed on behalf of the corporation by an authorized director, officer, or agent setting forth a detailed description of the self-dealing transaction, the extent to which any director has a material financial interest in the self-dealing transaction, and all material facts concerning the self-dealing transaction;
- A copy of the corporation's current financial statement;
- A copy of the articles of incorporation of the corporation and any amendments, if not on file with the Attorney General's Registry of Charitable Trusts;
- A copy of the bylaws of the corporation and any amendments, if not on file with the Registry of Charitable Trusts;

[11] (Corp. Code, §§ 5233, 7238; Cal. Code Regs., tit. 11, §§ 999.2, subd. (b), 999.3, subd. (b).)

- Copies of all meetings minutes of the board or its committees that reflect any discussions or evaluations of the self-dealing transaction; and
- If not covered above, a letter signed by the interested director setting forth a description of the director's material financial interest in the self-dealing transaction, listing all material facts concerning the transaction, and all facts disclosed by the interested director to the board concerning the transaction.

Furthermore, the Attorney General may require submission of additional information by the corporation and its directors in order to complete analysis of the self-dealing transaction.[12]

LOANS OF CORPORATE FUNDS

As discussed in Chapter 7, except in limited circumstances, a public benefit corporation is prohibited from making any loan (of money or property) or guaranty to any director or officer, unless approved by the Attorney General. This also applies to a mutual benefit corporation holding charitable assets.[13]

It may be wise for the corporation's board to protect itself from improper loans by seeking the Attorney General's approval before agreeing to any loan made to a director or officer. In doing so, submit this information to the Attorney General:

- A letter signed on behalf of the corporation by an authorized director, officer, or agent setting forth a detailed description of the loan or guaranty, and all material facts concerning the loan or guaranty;
- A copy of the loan or guaranty agreement, note, and related security agreements;
- A copy of the corporation's current financial statement;
- A copy of the articles of incorporation of the corporation and any amendments, if not on file with the Registry of Charitable Trusts;
- A copy of the bylaws of the corporation and any amendments, if not on file with the Registry of Charitable Trusts;
- Copies of all meetings minutes of the board or its committees that reflect any discussions or evaluations of the loan or guaranty; and

[12] (Cal. Code Regs., tit. 11, §§ 999.1, subd. (a), 999.2, subd. (b), 999.3, subd. (b).)
[13] (Corp. Code, §§ 5236, 7238; Cal. Code Regs., tit. 11, §§ 999.2, subd. (c), 999.3, subd. (c).)

- If not covered above, a letter signed by the interested director setting forth a description of the director's material financial interest in the loan or guaranty, listing all material facts concerning the transaction, and all facts disclosed by the interested director to the board concerning the transaction.

Similar to self-dealing transaction applications, the Attorney General may require submission of additional information by the corporation and its directors in order to complete an analysis of the loan or guaranty.[14]

FREQUENTLY ASKED QUESTIONS

"How long does it take the Attorney General to review a transaction for approval of a self-dealing transaction or loan?"

The time required to complete a review of a corporation transaction varies from two weeks to several months, depending on the facts and complexity. As a matter of policy, the Attorney General attempts to respond to requests for approval of self-dealing transactions and loans within 60 days after receipt of all material facts related to the proposed action.

"The directors of our public benefit corporation, which operates a school, voted to convert it to a business corporation. Will the Attorney General approve this conversion?"

The Attorney General's answer depends on a thorough review of all the facts. Conversion is permitted by statute if the terms are approved by the Attorney General and all of the charitable assets of the converting public benefit corporation (which are irrevocably dedicated to charitable purposes) are distributed to another charity with a similar charitable purpose(s). The Attorney General looks at all material facts of a conversion to determine whether the transaction is fair to the charity. For instance:

- Is the value assigned to the assets of the converting public benefit corporation the true fair market value of those assets? Is an independent appraisal needed?
- Will the directors of the public benefit corporation become the directors and shareholders of the new business corporation?
- Are there self-dealing issues?
- Are the terms of payment for the school's assets fair and reasonable?

[14] (Cal. Code Regs., tit. 11, §§ 999.2, subd. (c), 999.3, subd. (c).)

- Is the organization that will receive sale proceeds from the transaction tax-exempt, and does it have a similar charitable purpose to the converting corporation?

"I am the last director of the charity. No one is interested in helping me run the charity. I would like to resign or dissolve the charity. What are my obligations?"

No director may resign where the corporation would then be left without a duly elected director in charge of its affairs.[15] If the corporation has no members, it is possible to start the dissolution process with the vote of one director. The corporation will need to file a certificate of election to dissolve with the Attorney General, and obtain a written waiver of objections to the distribution of the corporation's assets. A certificate of dissolution will also need to be prepared for filing with the Secretary of State.[16] See the Attorney General's Dissolution website. Alternatively, a petition for dissolution may be filed with a court.[17]

[15] (Corp. Code § 5226.)
[16] (Corp. Code, §§ 6610, subd. (c), 6610.5, 6611, 6615.)
[17] (Corp. Code, § 6617.)

CHAPTER 12 CHARITABLE TRUSTS, RELIGIOUS, & FOREIGN ENTITIES

In This Chapter

- Introduction
- Charitable Trusts
- Religious Corporations
- Foreign Entities
- Frequently Asked Questions

INTRODUCTION

This Chapter discusses charitable trusts, nonprofit religious corporations, non-California entities, and the jurisdictional reach the Attorney General has over them. As is the case for charities generally, the Attorney General's Charitable Trusts Section – comprised of the Registry of Charitable Trusts and the Legal and Audits Unit – is responsible for performing and advising the Attorney General on this jurisdictional oversight.

CHARITABLE TRUSTS

Understanding Charitable Trusts and Fiduciary Duties

A trust is not a separate legal entity, but rather a legal relationship by which one person or an entity, holds title to property for the benefit of another person or entity.[1] This legal obligation is traditionally created by a written instrument, such as a will when the will is probated (called a "testamentary trust"), or a trust agreement executed by a living person (called an "inter vivos trust"). A trust that holds assets for a public purpose is considered a charitable trust. Public purposes include the relief of poverty; the advancement of knowledge or education; the promotion of health; governmental or municipal purposes; and other purposes beneficial to the community.[2]

The trustee, the person with legal title to the property, has a fiduciary duty to always act in the best interests of the trust and its beneficiaries, who hold equitable title. California case law defines a fiduciary relationship wherein one party, such as a trustee, "is in duty bound to act with the

[1] (*Presta v. Tepper* (2009) 179 Cal.App.4th 909, 913-914.)

[2] (*Lynch v. Spilman*, (1967) 67 Cal.2d 251, 261; *Estate of Breeden* (1989) 208 Cal.App.3d 981, 985; Rest.3rd Trusts, § 28. A charitable trust can also be created through solicitations for charitable funds. See Chapter 1.)

utmost good faith for the benefit of the other party," such as a trust's beneficiaries.[3]

Trustees are held to a high duty of loyalty and care in managing trust assets, and fulfilling the trust's purposes; this includes reporting to beneficiaries.[4] The fiduciary duties of a trustee may be different and broader than those for directors of public benefit corporations in California.[5]

Attorney General Oversight

The Attorney General represents the public beneficiaries of charitable trusts, and not only has the right, but the duty, to protect charitable gifts and the public beneficiaries' interests in charitable trusts.

The Attorney General has oversight jurisdiction over trusts that are created or hold assets for charitable purposes. More specifically, the Attorney General represents the public beneficiaries of charitable trusts, and not only has the right, but the duty, to protect charitable gifts and the public beneficiaries' interests in charitable trusts.[6]

For example, this can occur in a court proceeding, where the parties seek approval from a probate court to modify or terminate a charitable trust.[7] Yet, the court has no jurisdiction to do so unless the Attorney General is a party to the proceeding.[8] Another example of Attorney General oversight is when a charitable trust becomes irrevocable. When this occurs, California law requires a trustee to serve notice on the Attorney General.[9] Other examples are described below.

Probate Notices

Notice must be given to the Attorney General of any probate proceeding involving a will or trust that makes a charitable bequest or creates a

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[3] (*Wolf v. Superior Court* (2003) 107 Cal.App.4th 25, 29-30; *Herbert v. Lankershim* (1937) 9 Cal.2d 409, 483.)
[4] (Prob. Code, §§ 16000-16069; see also Prob. Code, § 16102; *People v. Larkin* (N.D.Cal. 1976), 413 F.Supp. 978, 982 [self-dealing strictly prohibited].)
[5] (Compare the Trust Law [Prob. Code, § 15000 et seq.] with the Nonprofit Public Benefit Corporation Law [Corp. Code, § 5110 et seq.].)
[6] (Gov. Code, §§ 12591, 12598, subd. (a); *Estate of Ventura* (1963) 217 Cal.App.2d 50, 57; *In re Veterans' Industries, Inc.* (1970) 8 Cal.App.3d 902, 919.)
[7] (Prob. Code, § 15409.)
[8] (Gov. Code, § 12591; see also *In re Los Angeles County Pioneer Society* (1953) 40 Cal.2d 852, 861; *Estate of Zahn* (1971) Cal.App.3d 106, 114.)
[9] (Prob. Code, §§ 16061.5-16061.7.)

charitable trust.[10] See the Attorney General's Notice to the Attorney General in Probate Matters publication for more information.

These notices may result in the Attorney General becoming involved in those proceedings. For instance, the Attorney General may become involved when a will or trust provides a gift for charitable purposes (e.g., to rescue animals), but does not name a specific charitable organization to receive it (e.g., a local humane society). Also, if the intended charity listed in a will or trust is no longer in operation, the Attorney General may assist the court in identifying the appropriate charity or charities to receive a gift. The Attorney General may also challenge any probate petition which seeks to diminish the charitable gifts provided in a will or trust. This includes challenging a will or trust contest, opposing a petition that seeks to modify a charitable trust, or filing a petition to remove trustees because of their breach of a fiduciary duty.

Registration Requirements

A charitable trustee must register and report annually to the Attorney General's Registry of Charitable Trusts (Registry), unless exempt.[11] To commence the registration process, the trustee should file the Registry's Initial Registration Form (Form CT-1), along with copies of the trust instrument, IRS Form 1023 or Form 1023-EZ (if submitted to the IRS), and an IRS determination letter (if received from the IRS). Thereafter the trustee is required to file annually an Annual Registration Renewal Fee Report (Form RRF-1), an Annual Treasurer's Report (Form CT-TR-1) if revenue is below $50,000, or the applicable IRS annual informational return (Form 990, Form 990-EZ, or Form 990-PF).[12] See the Attorney General's registration guide and Annual Registration Renewal website for more information.

The registration requirement for charitable trusts commences on the date of distribution to the charitable interest. If a charitable trust is created from a trust instrument, and distribution to charity begins immediately, the date of the trust document is referenced by the Registry as the beginning date for registration. When the trust is created from a will, the date of distribution is the date of the court's final decree of distribution. If the trust is a charitable remainder trust, in which non-charitable beneficiaries receive distributions before the charitable beneficiaries, the registration date is the date the distributions to charity begin. If the distribution is a one-time gift, usually from a will, no registration is necessary.

[10] (Prob. Code, § 17203.)
[11] (Gov. Code, § 12585.)
[12] (Gov. Code, § 12586.)

The registration and reporting requirements allow the Attorney General to evaluate the financial stability of the trust, to understand whether the trust is paying excessive trustee or administrative fees, and to ensure the trust is meeting its charitable mission. As is the case for charities generally, the Attorney General may also audit the trust and hold the trustee personally liable for any breaches of a fiduciary duty that lead to the misuse or loss of charitable assets.

RELIGIOUS CORPORATIONS

The Attorney General's oversight over religious nonprofits is limited by statutes.[13] For instance, the Attorney General does not have the legal authority to file derivative actions to correct and recover damages for self-dealing transactions, improper distributions, loans, or claims of mismanagement.[14]

However, the Attorney General has the authority to engage in criminal enforcement, may challenge the classification of a corporation as religious, and may remove a director for fraudulent acts.[15] The Attorney General also has oversight over solicitation practices.[16] Furthermore, the Attorney General may seek redress against the corporation's directors, officers, employees, and agents who knowingly make, prepare, issue or publish false financial statements, books, minutes, and other corporate records.[17]

Also, the notification and consent requirements discussed in Chapter 11 for voluntary dissolutions, mergers, asset sales, and the sale or transfer of health facilities apply to religious corporations. For example, a religious corporation is required to obtain Attorney General or court approval for the distribution of its assets upon dissolution.[18] Likewise, religious nonprofit organizations operating hospitals covered by Corporations Code sections 5914 and 5920 must obtain the Attorney General's consent before selling or transferring those health facilities.[19]

Note that the primary responsibility for protecting religious corporations and their assets rests with the corporations' board of directors, officers, and members. Only the religious corporation's directors, officers, or, in

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[13] (Corp. Code, § 9230; see generally Corp. Code, § 9110 et seq.)
[14] (Corp. Code, §§ 9142, 9230, 9243, subd. (c), 9610.)
[15] (Corp. Code, §§ 9223, 9230.)
[16] (Corp. Code, § 9230, subd. (d); Gov. Code, § 12599.6; see also Bus. & Prof. Code, § 17200 et seq.)
[17] (Corp. Code, § 9660, subd. (b).)
[18] (Corp. Code, § 9680, subds. (a), (e).)
[19] (Corp. Code, § 9634.)

some cases statutory or voting members, may file a civil action to correct, obtain damages for, or otherwise remedy breaches of trust under which the corporation's assets are held.[20]

Religious corporations are not required to register or file annual reports with the Attorney General's Registry of Charitable Trusts pursuant to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code, § 12580 et seq.). Accordingly, religious corporations classified as religious by the Secretary of State are automatically exempted from registration and reporting with the Registry. However, some religious corporations may opt to register and report despite the exemption to promote transparency to their donors.

For religious organizations outside of California that claim an exemption, the Registry evaluates these claims on a case-by-case basis. The foreign religious organization should submit complete exemption documents, such as a founding document and IRS determination letter. The Registry typically exempts any foreign religious corporation that holds property for religious purposes and is operated primarily as a religious organization. Note that if a religious organization outside of California has a broad purpose statement and dissolution clause, or the purpose statement includes a non-religious purpose (e.g., to build schools internationally, feed the hungry, or shelter the homeless), the organization might not be exempt as a religious organization.

FOREIGN ENTITIES

The Attorney General has oversight over foreign entities involved in the nonprofit sector in California. Foreign entities are organizations legally formed outside of California (i.e., in another state or country), which includes foreign nonprofit corporations, charitable trustees, and for-profit fundraising professionals. This oversight covers not only the Supervision of Trustees and Fundraisers for Charitable Purposes Act, but other California laws as well.

Registration Requirements

The Supervision of Trustees and Fundraisers for Charitable Purposes Act's registration and reporting requirements apply to persons and entities that conduct business or hold charitable assets in or from California. This includes foreign corporations, trustees, and fundraising professionals. The definition of doing business in California includes:

- Actively soliciting donations from Californians through local media advertisements, mail, telephone, text messages, e-mail, websites, online social media, other Internet-based communications or

[20] (Corp. Code, §§ 9142, 9243, 9245, 9610.)

platforms, or any other direct (not passive) means from outside of California;

- Regularly receiving substantial donations from Californians;
- Conducting charitable programs or services in California, or targeting Californians with programs or services;
- Having directors, officers, employees, statutory or voting members, or authorized agents that perform work from California, such as holding meetings or assisting with operations;
- Maintaining an office or other operations in California; or
- Holding property in California, such as real estate, books and records, or other tangible property.

Actively soliciting California donors means the foreign entity is targeting or focusing on Californians for solicitations, as opposed to donors nationwide. For example, actively soliciting California donors includes the entity having a fundraising campaign purposefully directed at Californians, soliciting donations through California work campaigns, sending fundraising e-mails to those the charity knows or reasonably should know are California residents (including prior donors that move to California), targeting Californians with online solicitation ads based on location information, authorizing crowdfunding campaigns that target California donors, engaging in cause related marketing with companies that actively sell goods or services to Californians, or having website or social media content that targets donations from California and other particular states. It is important for foreign entities to comprehensively and carefully review their solicitation activities, offline and online, to learn whether the entity is targeting Californians in the aggregate, and hence required to register in California.

Yet, even if foreign entities do not actively solicit California donors, they may regularly receive substantial donations from Californians which would trigger registration. For instance, the foreign entity should review how many donations it received from Californians on an annual basis (when more than one donation comes from one donor, each donation is counted separately). The total amount of those donations should also be reviewed. If the foreign entity is receiving about 200 separate donations on an annual basis from Californians, this clearly constitutes doing business in California. However, this number can be much smaller depending on the total donation amounts, how the donations were solicited, and other contacts the foreign entity has with California.

As is the case for any charitable organization or trustee, the foreign entity is required to file the Registry's Initial Registration Form (Form CT-1) within 30 days of first receiving property (i.e., a cash donation, property donation, or other assets with financial value received for charitable

purposes) as a result of doing business in California.[21] In addition, the foreign entity should provide a copy of its tax exemption application IRS Form 1023 or Form 1023-EZ (if submitted to the IRS), a copy of its IRS determination letter (if received from the IRS), and copies of its founding documents as follows:

- Corporations: certified articles of incorporation (and any amendments) that are stamped or fully executed by an authorized public official in the corporation's home jurisdiction, current bylaws, and corporate number (if previously obtained from the California Secretary of State);
- Associations: instrument creating the organization (bylaws, constitution, and/or articles of association); or
- Trusts: trust instrument, or will and decree of final distribution.

Thereafter, the foreign entity is required to annually file an Annual Registration Renewal Fee Report (Form RRF-1), an Annual Treasurer's Report (Form CT-TR-1) if applicable, and the applicable IRS annual informational return (Form 990, Form 990-EZ, or Form 990-PF).[22] See the Attorney General's registration guide and Annual Registration Renewal website for more information.

For foreign fundraising professionals, see Chapter 9 for registration, reporting, and other regulatory requirements.

Foreign Nonprofit Corporations

Even though foreign nonprofit corporations have been formed and incorporated elsewhere, they may be subject to California corporate law enforced by the Attorney General. This is particularly the case if the corporation has little to no contact with the jurisdiction in which it was incorporated, and when vital California interests are at stake, such as protecting California residents from harmful conduct,[23] including protecting the assets meant for California beneficiaries.

Also, sections of the Corporations Code involving the California Secretary of State apply to foreign nonprofit corporations.[24] See Chapter 6 to learn about applicable filing requirements.

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[21] (Gov. Code, § 12585.)
[22] (Gov. Code, § 12586.)
[23] (*Lidow v. Superior Court* (2012) 206 Cal.App.4th 351, 362; *Friese v. Superior Court* (2005) 134 Cal.App.4th 693, 707-708, citing among other sources, Rest.2d Conf. of Laws, § 309.)
[24] (Corp. Code, § 6910.)

FREQUENTLY ASKED QUESTIONS

"How can I set up a trust?"

Consult an attorney. The terms of the trust can vary widely depending on the reasons for its creation and what one intends to accomplish with it. Creation of a trust can have significant tax and other legal implications.

"I want to leave money to charity in my will. Do I have to register?"

No, but the Attorney General must be given notice at various times in connection with the probate of a will that includes gifts to charity. For additional information on notice requirements, see the Attorney General's Notice to the Attorney General in Probate Matters publication.

"My private trust agreement includes gifts to a specific charity when I die. Do I have to register?"

Maybe. Generally, the trustee is not required to register while the charitable interest is a future or contingent interest – but must register within 30 days of any charitable interest becoming a present interest.[25]

For example, if the trust agreement provides that a gift is made to a charity upon the death of the trustor, there is no requirement to register until the trustor dies. In most cases, if it is a one-time gift, the Attorney General does not require the trustee to register as long as the trustee provides proof to the Registry the gift has been made. If the charitable gifts are payable over time, in installments, or at the discretion of the trustee, then the trustee must register and file annual reports.

If there is any question about whether a trustee must register, trustees can contact the Registry at (916) 210-6400.

"I am co-trustee with a bank of a charitable trust. Do I have to file a financial report every year?"

Yes. There is an exemption from the annual reporting requirements for banks, but it only applies if the bank is the sole trustee.[26] A trustee who is a co-trustee with the bank must register and annually file the Registry's Form RRF-1, and if applicable Form CT-TR-1 and a copy of the trust's IRS annual informational return.

"I am a trustee of a charitable trust created to provide financial assistance to needy students. I would like to change the trust purpose to fund environmental projects. Can I do this legally?"

Probably not. The law of charitable trusts requires that trusts created for specific charitable purposes be carried out for those stated purposes. A

[25] (Gov. Code, § 12585.)
[26] (Gov. Code, § 12586, subd. (a).)

rule known as the *cy près* doctrine allows a court to change the charitable purposes set forth in the trust document when it becomes illegal, impossible, or impracticable to do so.[27] The burden of proving, illegality, impossibility, or impracticability is on the trustee.

Notice of all *cy près* actions by charitable trustees must be given to the Attorney General. For more information on modifying charitable trusts, refer to Probate Code section 18506.

"I have a charitable remainder trust. The trust document has private information about my personal wishes and gifts to family members that I do not want to be made public. Do I have to provide a copy of the trust document to the Registry of Charitable Trusts?"

Yes. But in this case, the Registry would treat the document as confidential, and would not reflect it in the Registry's searchable database for the public (or otherwise make it publicly available).

When submitting the document to the Registry, clearly mark it "confidential," and include a cover letter requesting the document be treated as confidential pursuant to Government Code section 12590. This section states that "The Attorney General shall withhold from public inspection any instrument so filed whose content is not exclusively for charitable purposes."

It is also a good practice to verify the request by confirming the document was not inadvertently displayed in the Registry's database.

"I am a trustee of a split-interest trust. Do I have to register and file a financial report every year?"

Whether registration is required depends on when the charitable interest in the trust becomes a present interest. If the trust is a charitable lead trust, it would need to register right away. If it is a charitable remainder trust, it would register once the charitable interest becomes a present interest (i.e., when the charity begins receiving payments from the trust).

To request the confidentiality of the non-charitable interests, follow the procedures indicated above for a charitable remainder trust that contains private information.

For annual reporting, file the Registry's Form RRF-1, and Form CT-TR-1 if applicable. As split-interests trusts are not tax-exempt, the filing requirement for an IRS annual informational return (Form 990, Form 990-

[27] (E.g., *In re Loring's Estate* (1946) 29 Cal.2d 423, 436; *In re Veterans' Industries, Inc.* (1970) 8 Cal.App.3d 902, 918-919; *Estate of Zahn* (1971) Cal.App.3d 106, 114-115.)

EZ, or Form 990-PF) does not apply. However, one can submit IRS Form 1041 or Form 5227 instead.

"I am a member of a church and am concerned about fiscal mismanagement of church funds. Will the Attorney General investigate this?"

When religious corporations are involved, the Attorney General does not have the legal authority to correct and recover damages for self-dealing transactions, improper distributions, loans, or claims of mismanagement.[28] Statutory or voting members of a church, or members of the church with a reversionary, contractual, or property interest, may wish to contact a private attorney about possible civil action to correct such mismanagement.

If there is evidence of serious fraud, diversion of charitable assets, or concern a crime has been committed, such as theft or embezzlement, contact the local police department and IRS. A complaint can also be submitted to the Attorney General on Form CT-9. Furthermore, the Attorney General may also investigate complaints involving false reporting, false or misleading solicitation practices, and diversion of donations.[29]

"We are a foreign nonprofit corporation. We do not operate any programs directed to California, we have no board meetings in California, and we own no property in California. Do we need to register and file annual reports if all we do is solicit donations on our website without actively seeking out donors who reside in California?"

If the charity is not actively soliciting California donors and otherwise does not do business or hold property in California, then registration and reporting may not be required. By actively soliciting California donors, this means the charity is targeting or focusing on Californians for solicitations, as opposed to donors nationwide. For example, actively soliciting California donors includes a charity having a fundraising campaign purposefully directed at Californians, sending fundraising e-mails to those the charity knows or reasonably should know are California residents, or having website content that targets donations from California and other particular states. Yet simply having a "donate button" on one of the foreign charity's fundraising websites, without more, would not be enough to trigger charitable registration and reporting in California.

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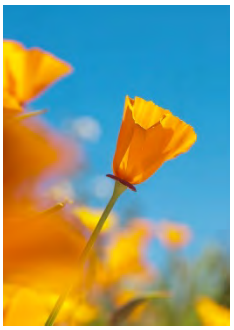
[28] (Corp. Code, §§ 9142, 9230, 9243, subd. (c), 9610.)

[29] (Corp Code, §§ 9230, subd. (d), 9660, subd. (b); Gov. Code, § 12599.6.)

Some foreign charities do not initially realize the magnitude of their online solicitations; yet upon further review, they realize they solicit much more than through a donate button on their website. For instance, many foreign charities e-mail prospective donors, have a robust social media presence, fundraise through online giving portals, and authorize crowdfunding campaigns, among other solicitation methods. Carefully review in detail all solicitation activity to assess whether Californians are actively solicited or not.

Another factor to consider is whether a foreign charity regularly receives substantial donations, even when the charity does not actively solicit California donors and otherwise does not do business or hold property in California. Should this be the case, registration and reporting in California would be required. For example, if a foreign charity receives about 200 donations annually from Californians, this clearly would trigger registration and reporting. Yet, this number can be much smaller depending on the total donation amounts, among other factors.

If there is any question about whether a foreign entity must register, contact the Registry of Charitable Trusts through its Contacts website.



APPENDICES

- Resources
- Acknowledgements

RESOURCES

This directory provides contact information for the government agencies a charity and other nonprofit sector participants in California may frequently interface with. Links to these agencies' various forms and publications are also reflected throughout this guide. Visit the Attorney General's Charities Resources website for additional links and information.

CALIFORNIA ATTORNEY GENERAL

- Charitable Trusts Section, 300 South Spring St., Room 1702, Los Angeles, CA 90013-1230
- Charitable Trusts Section, 455 Golden Gate Ave., Suite 11000, San Francisco, CA 94102-7004
- Registry of Charitable Trusts, P.O. Box 903447, Sacramento, CA 94203-4470
- Telephone for Registry of Charitable Trusts: (916) 210-6400
- Contacts website for Registry of Charitable Trusts
- oag.ca.gov website
- Charities website, which contains additional materials for charities including webinars on registration, renewals, delinquency, and dissolution
- Charities Forms website
- Charities Laws and Regulations website
- Charities Publications website
- Nonprofit Hospital Transaction Notices website
- Registry database
- Registry online renewal system

CALIFORNIA BOARD OF EQUALIZATION (regarding property taxes)

- Telephone for general questions: (800) 400-7115
- boe.ca.gov website
- Welfare Exemption website

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION (regarding sales taxes)

- Telephone for general questions: (800) 400-7115
- cdtfa.ca.gov website
- Sales and Use Tax in California website

CALIFORNIA EMPLOYMENT DEVELOPMENT DEPARTMENT (regarding state payroll taxes)

- Telephone for payroll tax assistance: (888) 745-3886
- edd.ca.gov website
- Payroll Taxes – Forms and Publications website

CALIFORNIA FRANCHISE TAX BOARD (regarding state income tax exemption)

- Telephone for the agency's Exempt Organizations Unit: (916) 845-4171
- Charities and Nonprofits website
- Forms and Publications Search website

CALIFORNIA SECRETARY OF STATE (regarding legal formation)

- Telephone for public contact information: (916) 653-6814
- Telephone for Business Entities: (916) 657-5448
- Business Programs website
- Business Entities website
- Name Availability website

IRS (regarding federal income tax exemption)

- Telephone for federal tax-exempt organizations: (877) 829-5500
- Charities and Nonprofits website
- Life Cycle of an Exempt Organization website
- Employer ID Numbers website
- Forms, Instructions and Publications website

ACKNOWLEDGEMENTS

The Attorney General's Guide for Charities was accomplished with the help of present and past members of the Charitable Trusts Section: Brian Armstrong, Steve Bauman, Sonja Berndt, Ed Gerkey, Wendi Horwitz, Tania Ibanez, Elizabeth Kim, Jonathan Miles, Elyse Rendon, James Toma, and Joseph Zimring.

The California Department of Justice also wishes to thank the following law firms and private attorneys for their past assistance in reviewing and suggesting revisions to portions of this Guide: NEO Law Group, Adler & Colvin, Law Offices of Louis E. Michelson, professor JoAnne Speers, and Alyssa Snyder. This acknowledgement does not constitute an endorsement or approval by the California Department of Justice.

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Charitable Trusts Section

June 2021

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