



Date: November 14, 2024

To: Board of Directors

Submitted by: David Aranda, Interim General Manager

Subject: Discussion and Possible Direction In Forming A Non-Profit To Benefit the District
In Taking Tax Deductible Donations for District Operations

Recommendation

This is a discussion item with possible direction from the Board of Directors.

Background

The subject of taking donations from residents in Kensington has been brought up a number of times over the past few years. At the October board meeting it was brought up again, and so it was suggested that it be an actual agenda item for discussion.

You will find a memo from Isabel Safie, an attorney for BB&K who specializes in forming non-profit organizations. She was responsible for forming a non-profit for Stallion Springs a number of years ago. You will also find some brief comments from General Counsel Ann Siprelle.

The issues at hand involve the following:

1. Does the Board of Directors feel that a non-profit would be of benefit to KPPCSD?
2. If so, does the Board of Directors feel that it would be best to have a non-profit formed that is part of the KPPCSD or that is a separate entity?

Based on the two questions above, the IGM can take direction from the board on how to move forward.

Exhibit(s)

- Memorandum dated October 31, 2024 from Isabel C. Safie, Partner regarding Consideration in the Formation of a Nonprofit Tax-Exempt Entity



MEMORANDUM

To: Kensington Police Protection and Community Services District
From: Isabel C. Safie, Partner
Date: October 31, 2024
Re: Consideration in the Formation of a Nonprofit Tax-Exempt Entity

The following is a broad overview of exempt organizations, as applicable to public entities, in order to assist the District in making the determination as to whether it is in the District's best interest to form an exempt organization.

ANALYSIS

The District could take the initiative to form a nonprofit corporation so long as the purposes for which it creates the nonprofit are within the scope of powers of the District. Therefore, the question is not whether the District has the authority to create an exempt organization but whether the advantages of establishing an exempt organization outweigh its disadvantages.

A. ADVANTAGES TO THE DISTRICT OF CREATING AN EXEMPT ORGANIZATION

The primary advantages to the District of forming an exempt organization would be: (i) operational, (ii) the generation of goodwill from community members and others who are more likely to make contributions to an exempt organization than to a public District, (iii) greater flexibility on investments.

The advantages derived from the operational benefits of creating an exempt organization depend on the level of control that the District wishes to maintain over the exempt organization. If the District wishes to remain involved in the operation of the exempt organization, then the benefits are with respect to the centralization of the operations of the various activities that will be shifted into one separate entity so that the burden on District staff will theoretically be lessened (this all depends on the level of involvement by District staff in the nonprofit). If the District is comfortable with the idea of establishing an exempt organization which is wholly independent from the District (i.e., the District would not have a role in the operation of the exempt organization, including the appointment of members of the board of directors), then the District could also potentially shield itself from liability with respect to the activities wholly operated by the nonprofit. Further, irrespective of the level of control maintained by the District, the creation of an exempt organization will also permit the concentration of resources, both financial and human, on the activities sponsored by the exempt organization.

The second advantage to the District of forming an exempt organization is the ability of the exempt organization to generate additional funding or other resources for activities that are currently sponsored by the District. For example, individuals are much more likely to make monetary and in-kind contributions to 501(c)(3) exempt organizations than they are to public agencies. Additionally, irrespective of the basis of its exemption, an exempt organization can stimulate community involvement in its activities from committed volunteers and therefore free up District resources. Further, an exempt organization may conduct fundraising campaigns (including raffles which the District cannot conduct) for the purpose of raising funds to be used in furtherance of its activities. In addition, an exempt organization will have access to additional funds that the District may not be eligible for, such as grants from governmental agencies or other nonprofit organizations which are available only to qualifying exempt organizations and not to public agencies.

A third advantage to the District of forming an exempt organization is while contributions to the District will be subject to the same limitations on investment options as are applicable to the District's funds, such limitations are not applicable to an exempt organization.

B. DISADVANTAGES TO THE DISTRICT OF CREATING AN EXEMPT ORGANIZATION

Any disadvantages are with respect to the requirements imposed by law of an exempt organization incorporated as a public benefit corporation which is the preferred method of organization for exempt organizations. Potential disadvantages of incorporation include certain built-in costs of formation, the need to observe corporate formalities and the burden imposed on directors by statutory standards of conduct. However, these disadvantages are usually outweighed by the substantial advantages of the corporate form.

C. FORMATION PROCESS

The formation of a typical exempt organization can be divided into two separate steps. First, the organization¹ must be organized as a California nonprofit public benefit organization. Second, the exempt organization must then apply for federal and state tax exemption. These steps involve several requirements which are explained in further detail below. However, before considering the process of establishing an exempt organization it is essential to determine whether a new entity is necessary or sustainable.

1. *Whether a Separate Entity is Necessary*

An important decision that must be made by anyone seeking to establish a new entity is whether there will be sufficient commitment and funds to justify the creation of the

¹ As used in this memorandum, the term "exempt organization" refers to a nonprofit corporation which has received federal and state exemption from taxation. Therefore, in section C of this memorandum, which deals with the steps that an entity must pursue before becoming a nonprofit tax-exempt entity, the term "exempt organization" will not be used unless the context assumes that the entity has obtained nonprofit status and received federal and state tax exemption.

entity and to sustain the entity. As will be discussed further in this memorandum, the ideal form for an exempt organization to take is that of a corporation. However, a corporation necessarily requires the observation of corporate formalities such as frequent meetings and recordkeeping. In addition, and as discussed in Section D of this memorandum, an entity that is granted nonprofit and tax-exempt status is also required to submit certain reports to a number of state agencies (e.g., Secretary of State office, Attorney General's office and the Franchise Tax Board) and to the Internal Revenue Service. These requirements are not necessarily prohibitive so long as the entity is properly managed, but if they are not followed puts the exempt status and good standing of the organization in jeopardy.

2. Incorporation

An exempt organization may operate in California under any of several legal forms, including a nonprofit corporation, a trust or an unincorporated association. However, the majority of California exempt organizations are organized as nonprofit corporations primarily because of concerns with liability issues. Therefore, this overview will focus on the incorporation of a nonprofit corporation.

The three most common types of nonprofit corporations under California law are: public benefit corporations, mutual benefit corporations, and religious corporations. Of these, the majority of nonprofit corporations in California are organized as public benefit corporations which is the form that we would recommend to the District. Specifically, a public benefit corporation must be formed for public or charitable purposes and may not be organized for the private gain of any person. Therefore, a public benefit corporation could undertake purposes which parallel the services that may be provided by the District. Although there is significant paperwork involved in forming a public benefit corporation, the procedures for operation and the rights and duties of directors, officers and members are more clearly set forth for public benefit corporations (in the California Corporations Code beginning with Section 5110) than for other forms of organizations under California law. This may be very helpful during the operating life of the corporation.

The incorporation of a public benefit corporation in California is fairly simple once the appropriate documents have been drafted. After a name has been selected for the corporation, the corporation's incorporator (usually an attorney) must then file articles of incorporation with the California Secretary of State. The content of the articles is crucial since the inclusion or absence of certain language will be instrumental in determining whether the organization will be granted exemption under federal and state laws. The key provision of the articles is the purpose clause which establishes the limits under which the organization will operate. In addition to the articles, the corporation will also need to have bylaws drafted. Together with the articles, the bylaws will establish the rubric under which the corporation will be managed. Finally, several other organizational documents will need to be created for the purpose of formally transferring operational power from the incorporator to the corporation's board of directors.

Prior to the filing of the articles, several factors will need to be taken into consideration by the District. First, as mentioned above, will be the scope of the purposes to be served by the corporation. This, in turn, will assist the District in making the decision of whether to form a corporation that solely transfers funds to the District for public purposes (i.e., a supporting organization), multiple nonprofits (each one independent from the other) or a single nonprofit with various committees devoted to specific activities. The more distinct an activity is from another, the more advisable it is to create separate entities in order to not only shield one entity from the missteps of another but to also secure the most favorable tax status for which certain activities may not qualify.

Another key consideration is the number and composition of the board of directors of the corporation. The board of directors of a majority of corporations created by public agencies are comprised of public officials (e.g., in the case of a public District, the corporation's board members could be members of the public District's governing board). However, in the case where the board of directors consists of public officials, the corporation itself is treated as a quasi-public District in some respects (e.g., observance of the public meeting requirements of the Brown Act). Rather than having members of the District's governing board serve on the board of the nonprofit, an alternative would be to give the governing body the authority to appoint some or all of the directors of the nonprofit. Whether the nonprofit board is comprised of public District governing board members or directors appointed by the public District, this composition allows the District the greatest amount of control over the operation of the nonprofit. If, however, the District wishes to completely divest itself of any responsibility for or oversight of the nonprofit, then the board of directors of the nonprofit could be made up of members of the community who are committed to the purposes to be served by the nonprofit. Such members would initially be identified informally and approached to serve on the board of directors by the District Board, the appointment of the initial directors would be performed by the incorporation of the entity (the attorney incorporating the entity usually serves as the incorporator), and thereafter the directors serving on the board would elect the next directors.

3. Tax Exemption

After the corporation has been incorporated as a nonprofit corporation, the next step is to prepare and submit the application for federal and state tax exemption of the nonprofit. The District's exempt status as a governmental entity does not automatically transfer to the nonprofit even if the board of directors is made up of public officials. Therefore, the nonprofit must independently seek tax-exempt status.

The federal exemption provisions are primarily found under Section 501(c) of the Internal Revenue Code which provides a number of categories under which a nonprofit can claim exemption. The 501(c)(3) designation is either for charitable organizations, including those that serve public purposes.

Once a nonprofit entity is granted exemption from federal income taxes, state exemption must be applied for separately but it is usually granted if an organization has already received federal exemption.

D. TAX FILING AND REPORTING OBLIGATIONS

Finally, it is important that the District be aware of the tax filing and reporting requirements that are imposed upon exempt organizations incorporated under California law.

1. *Reports and Returns to Internal Revenue Service and Franchise Tax Board*

Unless the gross receipts of an exempt organization are normally (using a four year average) less than a certain threshold, then it must file annual returns on long-form Form 990 with the IRS and Form 199 with the Franchise Tax Board. However, exempt organizations with gross receipts below the specified threshold will need to file short-form annual return in the form of an e-postcard. Failure to file on a timely basis could expose the exempt organization to substantial penalties, and eventually loss of exempt status after three consecutive years of failing to file the required returns. It is possible to seek exemption from the federal and state filing requirements if it can be established that the exempt organization is an instrumentality of the District.

In addition, at any time that the purposes of the exempt organization shift, the exempt organization is required to notify the IRS so that it may make a determination of whether the change affects the exempt status of the organization.

2. *Reports to Secretary of State*

Within 90 days after filing its articles of incorporation, a nonprofit corporation must file a Statement of Information with the Secretary of State containing (a) the names and addresses of its chief executive officer, secretary, and chief financial officer; (b) the street address of its principal California office, if any; and (c) a designation of an agent for service of process (and that person's address, if the agent is not a corporation). Thereafter, the Statement must be filed at least on a biennial basis. However, the Statement must be filed earlier if the officers, mailing address or agent for service for the corporation change before the biennial Statement is due. Failure to file the Statement as required could cause the nonprofit corporation to be suspended by the Secretary of State.

Further, the articles of incorporation of the nonprofit corporation cannot be revised unless the articles are amended in accordance with requirements of the Secretary of State. A nonprofit corporation's articles can be amended in two ways: (i) the corporation can file a "certificate of amendment" with the Secretary of State containing the wording of the amendment or amended articles and other information prescribed by statute; or (ii) the corporation can file a document titled "Restated Articles of Incorporation" which restates the entire text of its then current articles.

3. Attorney General

An exempt organization which is organized as a public benefit corporation which holds assets for charitable purposes is required to register with the California Attorney General's Registry of Charitable Trusts. Thereafter, the corporation must submit an annual registration renewal along with a copy of the corporation's completed Form 990. Additional reports must be filed if the organization files the e-postcard (i.e., Form 990-N) rather the full form.

There are further registration and reporting requirements if the exempt organization wishes to conduct a raffle. However, these requirements are extensive and complex and should only be considered if this is an activity that the exempt organization intends to conduct.

CONCLUSION

This overview is not exhaustive but instead generally focuses on the most salient and common issues that the District should be aware of in making its determination of whether to establish an exempt organization. Please let us know whether we can be of further assistance in providing you with additional information.