

## **HOW TO FORM A TAX-EXEMPT ORGANIZATION**

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### **Brief Note**

All references in this outline to the “Code” are to the Internal Revenue Code of 1986, as amended, and references to the “IRS” are to the Internal Revenue Service. References to the “Act” are to the Pennsylvania Nonprofit Corporation Act of 1988, 15 Pa.C.S. §5101 et. seq. All references to the “Commonwealth” are to the Commonwealth of Pennsylvania.

#### **I. Do Your Purposes Qualify as “Lawful” Nonprofit, Exempt Purposes?**

##### **A. Purposes Under the Pennsylvania Nonprofit Corporation Act of 1988 - 15 Pa.C.S. § 5101 et. seq (the “Act”)**

The Act provides that a nonprofit corporation (the “Corporation”) may be incorporated for any lawful purpose or purposes, including, but not limited to, any one or more of the following or similar purposes: athletic; any lawful business purpose to be conducted on a not-for-profit basis; beneficial; benevolent; cemetery; charitable; civic; control of fire; cultural; educational; encouragement of agriculture or horticulture; fraternal; health; literary; missionary; musical; mutual improvement; patriotic; political; prevention of cruelty to persons or animals; professional, commercial, industrial, trade, service or business associations; promotion of the arts; protection of natural resources; religious; research; scientific; and social. 15 Pa.C.S. §5301.

##### **B. Purposes Under Section 501(c) of the Internal Revenue Code of 1986, as amended (the “Code”)**

- 1. Section 501(c)(3).** Corporations, and any community chest, fund, or foundation, 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, no part of the net earnings of which inures to the benefit of

any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, any political campaign on behalf of any candidate for public office.

2. **Section 501(c)(4).** Civic leagues or organizations not organized for-profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.
3. **Section 501(c)(6).** Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for-profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.
4. **Section 501(c)(7).** Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.
5. **Other 501(c) Tax-Exempt Organizations.** Section 501(c) of the Code lists a total of 28 types of organizations exempt from some federal income taxes.

## II. Fiscal Sponsorship.

### A. What is Fiscal Sponsorship?

A fiscal sponsor is an organization determined exempt by the IRS as described in Section 501(c)(3) of the Code that receives grants and donations for a charitable project (a person or group) that does not have a 501(c)(3) tax-exemption determination, and holds and distributes such grants and donations to or for the benefit of the project. The fiscal sponsor must have complete discretion and control over all funds donated in support of the project, and is legally responsible to see that its payments to the project are made in furtherance of its own charitable purposes. The fiscal sponsor also provides appropriate charitable gift receipts to donors for their grants and gifts in support of the project and includes all revenues on its IRS Form 990. Fiscal sponsorship arrangements should be documented with a written agreement which addresses fund disbursement, administrative fees, intellectual property issues, termination, etc.

## **B. Levels of Control by Fiscal Sponsor**

- 1. In-House Management Model.** Project belongs to fiscal sponsor, which manages and controls the project “in-house;” project has no separate legal existence.
- 2. External Management Model.** Project belongs to fiscal sponsor; operation of project managed by a separate entity (i.e. an individual or organization); project has a separate legal existence.
- 3. External Operation Model.** Project does not belong to fiscal sponsor; fiscal sponsor disburses funds directly to project or vendors but retains discretion over disbursements; project has a separate legal existence.

## **C. Advantages**

Using a fiscal sponsor allows a charitable project to begin fundraising and conducting activities prior to entity formation or an exemption determination by the IRS. Fiscal sponsorship gives the project an opportunity to test its viability and ability to attract funders, without incurring the start-up costs associated with entity formation and/or an IRS exemption application.

## **D. Disadvantages**

Using a fiscal sponsor takes a measure of control away from the project, particularly if the fiscal sponsor pays project vendors directly. In this instance, the project may be subject to procedural delays and other timing issues which can affect its programs and activities. Fiscal sponsors often charge an administrative fee, which is typically between two and ten percent of all grants and donations it receives on behalf of the project. In addition, some donors may be resistant to donating funds to a fiscal sponsor, instead of directly to the project.

## **E. Resources**

- 1. Gregory L. Colvin, Esq.** Mr. Colvin is the author of *Fiscal Sponsorship: 6 Ways To Do It Right* (Study Center Press, 1993, 2005), and maintains a website devoted to fiscal sponsorship at <http://www.fiscalsponsorship.com>.
- 2. Fiscal Sponsor Directory.** This Directory is a tool created by the San Francisco Study Center to help connect community projects with fiscal sponsors; it is also a forum for fostering understanding of that relationship and its impact on the nonprofit sector. The website is located at <http://www.fiscalsponsordirectory.org>.
- 3. Foundation Center Fiscal Sponsor FAQ page.** This website is located at [http://foundationcenter.org/getstarted/faqs/html/fiscal\\_agent.html](http://foundationcenter.org/getstarted/faqs/html/fiscal_agent.html).

4. **Tides Center.** The Tides Center provides back-office services, a legal framework, and capacity-building support to hundreds of nonprofit projects nationwide that share its vision of a just, healthy, and sustainable world. The website is located at <http://www.tidescenter.org>.

### **III. Choice of Entity**

#### **A. Nonprofit Corporation**

The nonprofit corporation is the organizational form most commonly used to establish a tax-exempt organization in the Commonwealth. Nonprofit corporations in the Commonwealth are subject to the requirements of the Act, and may be incorporated for any lawful purpose or purposes, including, but not limited to, any one or more of the following or similar purposes: athletic; any lawful business purpose to be conducted on a not-for-profit basis; beneficial; benevolent; cemetery; charitable; civic; control of fire; cultural; educational; encouragement of agriculture or horticulture; fraternal; health; literary; missionary; musical; mutual improvement; patriotic; political; prevention of cruelty to persons or animals; professional, commercial, industrial, trade, service or business associations; promotion of the arts; protection of natural resources; religious; research; scientific; and social. 15 Pa.C.S. §5301.

Further discussion regarding incorporation and corporate structure and requirements follows later in this outline.

#### **B. Unincorporated Association**

Unincorporated associations are generally defined as groups whose members share a common purpose, and who function under a common name under circumstances where fairness requires the group be recognized as a legal entity. Unincorporated associations may or may not be governed by a written agreement and/or a governing body.

Unincorporated associations may apply for name registration by filing the “Application for Registration of Unincorporated Association Name” with the Pennsylvania Corporation Bureau. 54 Pa.C.S. § 502.

#### **C. Charitable Trust**

Charitable trusts are subject to Chapter 77 of the Pennsylvania Probate, Estates and Fiduciaries Code, also known as the “Uniform Trust Act.” 20 Pa.C.S. §7701 et.seq. A charitable trust may be created for the following purposes: relief of poverty; the advancement of education or religion; the promotion of health; governmental or municipal purposes; or other purposes the achievement of which is beneficial to the community. 20 Pa.C.S. §7735.

#### **D. Limited Liability Company (LLC)**

The LLC is the least common organizational form used to establish a tax-exempt organization in the Commonwealth. LLCs are typically used when all members of the organization are nonprofit corporations, for example, a nonprofit health system.

### **IV. Incorporating in Pennsylvania**

#### **A. Forms**

Form Articles of Incorporation (“Articles”) as well as the required Docketing Statement are available on the Corporation Bureau’s website at [www.dos.state.pa.us/corps](http://www.dos.state.pa.us/corps).

#### **B. Choosing a Registered Address**

The Corporation must have and continuously maintain a registered office in the Commonwealth. The registered office must be located at a street address, not a post office box. The Corporation may have any number of other offices at such places as it may determine. 15 Pa.C.S. §5507.

#### **C. Selecting a Name**

- 1. General.** The name of the Corporation may be in any language, but must be expressed in Roman letters or characters or Arabic or Roman numerals. 15 Pa.C.S. §5503(a).
- 2. Duplicate use of names prohibited.** The name of the Corporation must be distinguishable upon the records of the Department of State from the following:
  - i. the existing name of any other domestic for-profit or nonprofit corporation which is either in existence or for which articles of incorporation have been filed but have not yet become effective, or of any foreign for profit or nonprofit corporation which is either authorized to do business in the Commonwealth or for which an application for a certificate of authority has been filed but which has not yet become effective, or the name of any association registered at any time under 54 Pa.C.S. Ch. 5 (relating to corporate and other association names); and
  - ii. a name the exclusive right to which is reserved by any other person whatsoever in the manner provided by statute. A name must also be rendered unavailable for corporate use if it is an assumed or fictitious name filed in the Department of State as required by 54 Pa.C.S. Ch. 3 (relating to fictitious names. 15 Pa.C.S. §5503(b).

3. **Reservation of Corporate Name.** The exclusive right to the use of a corporate name may be reserved by any person. The reservation must be made by delivering to the Department of State an application to reserve a specified corporate name, executed by the applicant. If the department finds that the name is available for corporate use, it must reserve the name for the exclusive use of the applicant for a period of 120 days. 15 Pa.C.S. §5505(a).
4. **Restrictions and Prohibitions.** The Corporation's name may not imply that it is a governmental agency of the Commonwealth or of the United States, a bank or trust company, an insurance company, a public utility, or a credit union. 15 Pa.C.S. §5503(c).

In addition, the Corporation's name cannot contain the following:

- i. the word "college," "university" or "seminary" when used in such a way as to imply that it is an educational institution conforming to the standards and qualifications prescribed by the State Board of Education, unless there is submitted a certificate from the Department of Education certifying that the corporation or proposed corporation is entitled to use that designation;
- ii. words that constitute blasphemy, profane cursing or swearing, or that profane the Lord's name;
- iii. the words "engineer" or "engineering" or "surveyor" or "surveying" or any other word implying that any form of the practice of engineering or surveying is provided, unless at least one of the incorporators of a proposed corporation or the directors of the existing corporation has been properly registered with the State Registration Board for Professional Engineers in the practice of engineering or surveying, and there is submitted to the department a certificate from the board to that effect;
- iv. the words "Young Men's Christian Association" or any other words implying that the corporation is affiliated with the State Young Men's Christian Association of Pennsylvania, unless the corporation is incorporated for the purpose of the improvement of the spiritual, mental, social and physical condition of young people, by the support and maintenance of lecture rooms, libraries, reading rooms, religious and social meetings, gymnasiums, and such other means and services as may conduce to the accomplishment of that object, according to the general rules and regulations of such State association;
- v. the words "architect" or "architecture" or any other word implying that any form of the practice of architecture is provided, unless at least one of the incorporators of a proposed corporation or the directors of the existing corporation has been properly registered with the Architects Licensure

Board in the practice of architecture and there is submitted to the department a certificate from the board to that effect; and

- vi. the word "cooperative" or an abbreviation thereof unless the corporation is a cooperative corporation. 15 Pa.C.S. §5503(c).

#### **D. Membership vs. Non-Membership**

1. **General.** Membership in a Corporation must be of such classes, and must be governed by such rules of admission, retention, suspension and expulsion, as Bylaws adopted by the members must prescribe. These rules must be equally enforced as to all members of the same class. Unless otherwise provided by a Bylaw adopted by the members, there must only be one class of members. 15 Pa.C.S. §5751(a).
2. **Corporations Without Members.** Where the Articles provide that the Corporation must have no members, or where the Corporation has under its Bylaws or in fact no members entitled to vote on a matter, any provision of the Act, or any other provision of law requiring notice to, the presence of, or the vote, consent or other action by members of the Corporation in connection with such matter must be satisfied by notice to, the presence of or the vote, consent or other action by the board of directors or other governing body of the Corporation. 15 Pa.C.S. §5751(b).
3. **Control.** In general, members have the power to elect and remove directors. 15 Pa.C.S. §5725(a). In addition, the Act provides members with voting rights over many aspects of the Bylaws and other fundamental changes to the Corporation. 15 Pa.C.S. §5504(b).
4. **Advantages.** Membership can facilitate community involvement and a sense of ownership, as in the case of a civic or neighborhood association, and membership dues may be tax-deductible.
5. **Disadvantages.** Membership contributes to loss of control at the board level. With a broad community membership base, there are often difficulties in scheduling meetings and in having the required number of members in attendance for necessary votes. It can also be difficult to define the membership class.

#### **E. Articles of Incorporation**

1. **General.** Articles must be signed by one or more incorporator and must be written in the English language. 15 Pa.C.S. §§5302 and 5306. Articles must be filed with the Department of State. 15 Pa.C.S. §5308.
2. **Incorporators.** One or more for-profit or nonprofit corporations or one or more natural persons 18 years of age or older may serve as incorporators under the Act.

**3. Specific Requirements.** The Articles must set forth the following information:

- i. the name of the Corporation, unless the name is in a foreign language, in which case it must be set forth in Roman letters or characters or Arabic or Roman numerals;
- ii. the address, including street and number, if any, of the Corporation's initial registered office in the Commonwealth;
- iii. a brief statement of the purpose or purposes for which the Corporation is incorporated;
- iv. a statement that the Corporation is one which does not contemplate pecuniary gain or profit, incidental or otherwise;
- v. a statement that the Corporation is incorporated under the provisions of the Nonprofit Corporation Law of 1988;
- vi. a statement whether the Corporation is to be organized upon a nonstock basis or a stock share basis;
- vii. if the Corporation is to have no members, a statement to that effect;
- viii. the name and address, including street and number, if any, of each of the incorporators;
- ix. the term for which the Corporation is to exist, if not perpetual;
- x. if the Articles are to be effective on a specified date, the hour, if any, and the month, day and year of the effective date. 15 Pa.C.S. §5306.

**F. IRS Required Language for 501(c)(3) Organizations**

The Articles must contain the following language in order for the Corporation to obtain tax-exempt status under Section 501(c)(3) of the Code:

- 1. Purposes Clause.** “The corporation is incorporated under the Pennsylvania Nonprofit Corporation Law of 1988 (as amended) exclusively for: charitable, literary, scientific, religious, and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986; or the corresponding provisions of any future United States Internal Revenue Law (the “Code”); particularly, to **[INSERT PURPOSES]**.”

No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to, its directors, officers, or other private persons, except that the

corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of its exempt purposes. Except as otherwise provided by Section 501(h) of the Code, no substantial part of the activities of the corporation shall consist of carrying on propaganda or otherwise attempting to influence legislation. The corporation shall not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. Notwithstanding any other provision of these Articles, the corporation shall not carry on any activities not permitted to be carried on (a) by a corporation exempt from Federal income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) of the Code, or (b) by a corporation contributions to which are deductible under Section 170(a) of the Code as being to an organization referred to in Section 170(c)(2) of the Code.”

2. **Dissolution Clause.** “Upon the dissolution of the corporation, the Board of Directors shall, after paying or making provisions for the payment of all of the liabilities of the corporation, dispose of all of the assets of the corporation exclusively for the exempt purposes of the corporation in such manner, or to such organization or organizations organized and operated exclusively for charitable, literary, scientific, religious, and educational purposes which at the time qualify as an exempt organization or organizations under Section 501(c)(3) of the Code as the Board of Directors shall determine. Any assets not so distributed by the Board of Directors shall be distributed by the Court of Common Pleas of the county in which the corporation’s principal office is then located, exclusively for the corporation’s exempt purposes.”

#### **G. Advertise Filing of Articles**

The incorporators or the Corporation must officially publish a notice of intention to file or the filing of the Articles. The notice may appear prior to or after the day the Articles are filed in the Department of State, and must set forth briefly the name of the proposed Corporation, a statement that the Corporation is to be or has been incorporated under the provisions of the Act, a brief summary of the purpose or purposes of the Corporation, and a date on or before which the Articles will be filed in the Department of State or the date the Articles were filed. 15 Pa.C.S. §5307.

The notice must be filed in two newspapers published in the English language, one of which must be a newspaper of general circulation, and the other the legal newspaper, if any, designated by the rules of the court for the publication of legal notices, otherwise, in two newspapers of general circulation, published in the county in which the initial registered office of the Corporation is to be located. If there is only one newspaper of general circulation published in a county, advertisement in that newspaper is sufficient. 19 Pa. Code §41.11. A listing of legal newspapers may be found at: <http://www.dos.state.pa.us/corps/cwp/view.asp?a=1093&q=431224>.

## **V. Organization Meeting**

After the filing of the Articles, the Act provides that the initial directors of the Corporation are required to hold an organization meeting to adopt Bylaws, elect directors and officers, and conduct other business. If the directors are not named in the Articles, then the incorporator must hold the organization meeting or take action by Written Consent. 15 Pa.C.S. §5310.

## **VI. Bylaws**

Bylaws are an internal governance document used to guide the directors, officers, and members of the Corporation; however, the Corporation's Bylaws may also be relied upon by third parties to evidence compliance with certain nonprofit governance standards or to confirm that corporate actions were properly taken.

Bylaws must be drafted to be consistent with Federal, state, or local regulations and to minimize liability to the Corporation and its directors and officers. In cases where the Bylaws are silent, the Act provides default provisions. When drafting and adopting Bylaws, the Corporation should consider the following:

### **A. Adoption, Amendments, and Repeals**

The members entitled to vote may adopt, amend, and repeal the Bylaws of the Corporation, or the authority to adopt, amend, and repeal the Bylaws may be expressly vested by the Bylaws in the board of directors, subject to the power of the members to change such action. 15 Pa.C.S. §5504.

### **B. Charitable Purposes**

The Bylaws may simply refer to "the purposes as set forth in the Corporation's Articles" so that there is no need to amend the Bylaws every time the Articles are amended.

### **C. Membership**

- 1. Classification.** If the Corporation has members, the Bylaws may provide a description of the classes of membership and the rules of admission, retention, suspension, and expulsion of members. If the Bylaws do not provide for classes of membership, the Act provides that there must be one class of members whose voting and other rights and interests must be equal. 15 Pa.C.S. §5751(a).
- 2. No Members.** If the Corporation has no members, any provision of the Act requiring notice to, the presence of, or the vote, consent, or other action by members of the Corporation in connection with such matter would be satisfied by notice to, the presence of or the vote, consent, or other action by the board. 15 Pa.C.S. §5751(b).

3. **Voting.** The Bylaws may provide for the voting rights of the members. Unless otherwise provided in the Bylaws, the Act provides that every member of the Corporation must be entitled to one vote, which may be by ballot, mail, or any reasonable means as provided in the Bylaws. 15 Pa.C.S. §5758.
4. **Other Issues.** The Bylaws may also address how members are determined, what issues members may vote on, how membership meetings are called, and what constitutes a quorum for membership meetings. 15 Pa.C.S. §5751-5767.

#### **D. Board of Directors**

1. **Authority.** Unless otherwise provided by statute or in the Bylaws, the Act provides that all powers of the Corporation must be exercised by or under the authority of, and the business and affairs of the Corporation must be managed under, the direction of a board of directors. 15 Pa.C.S. §5721.
2. **Qualification.** The Bylaws may prescribe certain qualifications for directors. For example, a neighborhood civic association may require that directors be residents, property owners, or business owners of the neighborhood. The Act only requires that directors be a natural person of “full age.”<sup>1</sup> The Act also provides that directors do not have to be residents of the Commonwealth. 15 Pa.C.S. §5722.
3. **Minimum/Maximum Number of Directors.** The Bylaws may stipulate the minimum or maximum number of directors that may be elected to its board. The Act provides that the Corporation must have at least one director on its board; however, if the number is not specified in the Bylaws, the Act requires at least three directors. 15 Pa.C.S. §5723.
4. **Election of Directors; Terms and Term Limits.** Unless otherwise provided in the Bylaws, the Act provides that directors must be elected by the members and must hold office until (a) the later of the expiration of the term for which he or she was elected or until his or her successor has been elected and qualified, or (b) his or her earlier death, resignation, or removal. 15 Pa.C.S. §5725. The Bylaws should provide the term of office each director is elected to serve. In the absence of a provision in the Bylaws fixing the term, the Act provides that the term would be one year. 15 Pa.C.S. §5724.
5. **Nominating Directors.** Unless the Bylaws provide otherwise, directors must be nominated by a nominating committee or from the floor. 15 Pa.C.S. §5725(e).
6. **Vacancies.** Unless otherwise provided in the Bylaws, vacancies in the board, including vacancies resulting from an increase in the number of directors, must be filled by a majority of the remaining members of the board though less than a

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<sup>1</sup> “Full age” is defined under the Act as eighteen years of age or older. 15 Pa.C.S. §5103.

quorum, and each person so elected must be a director to serve for the balance of the unexpired term unless otherwise restricted in the Bylaws. 15 Pa.C.S. §5725(c).

7. **Removal.** Unless otherwise provided in the Bylaws, a director may be removed from office by the: (1) members without cause; (2) the board if the director is declared of unsound mind by an order of court, is convicted of a felony, does not accept his or her term of office either in writing or by attending a meeting, or for any other proper cause which the Bylaws may specify; or (3) the courts in the case of fraudulent or dishonest acts, or gross abuse of authority or discretion with reference to the Corporation, or for any other proper cause. 15 Pa.C.S. §5726.
8. **Regular and Special Meetings.** The Bylaws may provide where and when the board must hold regular and special meetings. The Act provides that regular meetings may be held within or without the Commonwealth and upon such notice, if any, as the Bylaws may prescribe. The Act further provides that a special meeting may be held upon five days written notice to each director, unless otherwise provided in the Bylaws. 15 Pa.C.S. §5730.
9. **Compensation.** The Bylaws may permit or restrict the compensation of directors. The Act provides that directors may receive compensation for their services and may also serve as a salaried officer of the Corporation. 15 Pa.C.S. §5730.

#### **E. Conference Calls and Electronic Meetings**

The Bylaws may permit or restrict the ability of members, directors, officers, and committee members to participate in meetings by conference call. The Act provides that, unless otherwise provided in the Bylaws, one or more persons may participate in a meeting of the incorporators, the board, or the members of the Corporation by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. 15 Pa.C.S. §5708.

#### **F. Notice**

Whenever written notice is required to be given to any person under the provisions of the Act or by the Articles or Bylaws, the Act provides that it may be given to the person either personally or by sending a copy thereof by first class or express mail, postage prepaid, or by telegram (with messenger service specified), or courier service, charges prepaid, or by facsimile transmission, to his or her address (or to his or her facsimile number) appearing on the books of the Corporation or, in the case of directors or members of another body, supplied by him or her to the Corporation for the purpose of notice. A notice of meeting must specify the place, day, and hour of the meeting and any other information required by any other provision of the Act. 15 Pa.C.S. §5702. In addition, the Bylaws may provide that notice may be given by email or other forms of communication.

## **G. Officers**

- 1. Authority.** Unless otherwise provided in the Bylaws, all officers of the Corporation have such authority and perform such duties in the management of the Corporation as may be provided by or pursuant to the Bylaws or, in the absence of controlling provisions in the Bylaws, as may be determined by or pursuant to resolutions of the board. 15 Pa.C.S. §5732(b).
- 2. Positions.** The Bylaws may describe the roles and responsibilities of its officers. The Act provides that the Corporation must have a president, a secretary, and a treasurer, or persons who must act as such, regardless of the name or title by which they may be designated, elected, or appointed and may have such other officers and assistant officers, such as one or more Vice Presidents or Assistant Treasurers, as it may authorize from time to time. The Act further provides that any number of offices may be held by the same person, unless the Bylaws provide otherwise; however, the IRS looks more favorably on organizations in which different people hold each office. 15 Pa.C.S. §5732(a).
- 3. Qualifications.** The Bylaws may prescribe certain qualifications for officers. The Act provides that officers must be natural persons at least 18 years of age, except that the treasurer may be a corporation. The Act further provides that officers need not be directors. 15 Pa.C.S. §5732(a).
- 4. Election and Term.** The Act provides that officers and assistant officers must be elected or appointed at such time, in such manner and for such terms as may be fixed by or pursuant to the Bylaws. Unless otherwise provided by or pursuant to the Bylaws, the Act also provides that each officer must hold office until (a) the later of the term for which he or she was elected or until his or her successor has been elected and qualified, or (b) until his or her earlier death, resignation, or removal. 15 Pa.C.S. §5732(a).
- 5. Vacancies.** Unless otherwise provided in the Bylaws, the Act provides that the board must have power to fill any vacancies in any office occurring from whatever reason. 15 Pa.C.S. §5732.
- 6. Removal.** Unless otherwise provided in the Bylaws, the Act provides that any officer may be removed by the board, but such removal must be without prejudice to the contract rights of any person so removed. 15 Pa.C.S. §5733.
- 7. Nomination of Officers.** Unless the Bylaws provide otherwise, officers must be nominated by a nominating committee or from the floor. 15 Pa.C.S. §5732(c).

## **H. Committees**

The Bylaws may provide for standing committees, such as an executive committee, nominating committee, audit committee, investment committee, or compensation committee, and may also authorize the board to establish additional committees. Unless otherwise restricted in the Bylaws, the Act provides that the board may establish one or more committees to consist of one or more directors. Each committee of the board may serve at the pleasure of the board, and, to the extent provided by resolution of the board, may exercise all of the powers and authority of the board, except that no committee may have any power or authority as to the following:

- a. the filling of vacancies in the board;
- b. the adoption, amendment, or repeal of the Bylaws;
- c. the amendment or repeal of any resolution of the board; or
- d. action on matters committed by the Bylaws or by resolution of the board to another committee. 15 Pa.C.S. §5731.

## **I. Indemnification.**

The Bylaws may include an indemnification provision that expresses the intent of the Corporation to cover the expenses that a director, officer, employee, or agent might incur in defending an action and paying settlements or judgments related to his or her service on behalf of the Corporation. The Bylaws may provide that the decision to indemnify a director, officer, employee, or agent is permissive or mandatory. The Bylaws may also describe the procedures for determining when indemnification is appropriate. If the Bylaws do not provide for indemnification or if such a provision is unclear, the Act provides default provisions regarding indemnification. 15 Pa.C.S. §5741-5742.

## **J. Limited Liability**

In addition to indemnification, the Bylaws may provide that a director cannot be personally liable, as such, for monetary damages for any action taken unless: (a) the director has breached or failed to perform his or her fiduciary duties as described in Subchapter B of Chapter 57 of the Act; and (b) the breach or failure to perform constitutes self-dealing, willful misconduct, or recklessness; provided however, that directors would be liable for criminal acts and the payment of taxes under Federal, state, or local law. 15 Pa.C.S. §5713.

## **K. Real Property**

The Bylaws may restrict the Corporation's ability to engage in certain real property transactions. The Act provides that the Corporation, unless it is an industrial development corporation, cannot purchase, sell, mortgage, lease away, or otherwise dispose of real property, unless authorized by the vote of two-thirds of the board, except that if there are twenty-one or more directors, the vote of a majority of the board would be sufficient. 15 Pa.C.S. §5546.

## **L. Negotiable Instruments/ Corporate Seal**

The Bylaws may stipulate which officers may sign on behalf of the Corporation. The Act provides that any note, mortgage, evidence of indebtedness, contract or other document executed or entered into between the Corporation and any other person, when signed by one or more officers or agents having actual or apparent authority to sign it, or by the president or vice-president and secretary or assistant secretary or treasurer or assistant treasurer of the Corporation, would be held to have been properly executed for and in behalf of the Corporation. 15 Pa.C.S. §5506(a). The Act also provides that the Corporation is not required to use a corporate seal to validate the execution, assignment, or endorsement by the Corporation of any instrument or other document; however, the Corporation may want to require that such documents are validated with a corporate seal. 15 Pa.C.S. §5506(b).

## **M. Annual Report**

The Act provides that the board must present an annual report to the members. The annual report must be verified by the president and treasurer or by a majority of the directors. 15 Pa.C.S. §5553(a).

## **VII. Corporate Policies and Best Practices**

In recent years, nonprofit corporate governance has increasingly become a concern for donors, policymakers, government regulators, the media, and the general public. For example, while the Sarbanes-Oxley Act was passed by Congress in 2002 primarily in response to the corporate and accounting scandals of Enron, Tyco, and other publicly traded companies, the following two provisions apply to nonprofit corporations: (1) provisions prohibiting retaliation against whistleblowers; and (2) provisions prohibiting the destruction, alteration, or concealment of certain documents or the impediment of investigations.

More recently, the IRS added several new questions about internal policies and procedures to both the application for tax-exempt status (2004-revised IRS Form 1023) and the annual information return (2008-revised IRS Form 990). For example, Part VI, Section B, of the revised IRS Form 990 inquires about the following specific policies: (1) conflict of interest; (2) whistleblower policy; (3) document retention and destruction policy; and (4) key employee compensation policy. The IRS noted in its guidance, *Nonprofit Governance and Related Topics-501(c)(3) Organizations* (available at [www.irs.gov/pub/irs-tege/governance\\_practices.pdf](http://www.irs.gov/pub/irs-tege/governance_practices.pdf)), that “a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance.”

Below is a description of recommended policies and best practices, which will facilitate corporate accountability and transparency.

## **A. Conflict of Interest Policy**

A director of the Corporation owes it a duty of loyalty, which requires that the director act in the interest of the Corporation rather than in his or her personal interest. The Corporation may insert conflict of interest provisions in its Bylaws or adopt a separate conflict of interest policy to address potential conflicts of interest involving its directors, trustees, officers, and other employees. Such provisions or policy should be in compliance with the Act, and consistent with the IRS Model Conflict of Interest Policy.

1. **Conflict of Interest Provisions in the Act.** The Act provides that no contract or transaction between the Corporation and one or more of its directors or officers or between the Corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, would be void or voidable solely for such reason, or solely because the director or officer is present at or participates in the meeting of the board which authorizes the contract or transaction, or solely because his, her, or their votes are counted for that purpose, if:
  - i. the material facts as to the relationship or interest and as to the contract or transaction are disclosed or are known to the board and the board in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors even though the disinterested directors are less than a quorum;
  - ii. the material facts as to the relationship or interest and as to the contract or transaction are disclosed or are known to the members and the contract or transaction is specifically approved in good faith by vote of the members; or
  - iii. the contract or transaction is fair as to the Corporation as of the time it is authorized, approved, or ratified by the board. 15 Pa.C.S. §5728.
2. **IRS Model Conflict of Interest Policy.** The current IRS Form 1023 asks whether the Corporation has adopted a written conflict of interest policy that is consistent with the model included in the Form 1023 instructions. The provisions of this model policy are more restrictive than those provided in the Act; therefore, it is recommended that a Corporation seeking tax-exempt status from the IRS adopt a policy similar to that provided in the Form 1023 instructions.

## **B. Whistleblower Policy**

The Sarbanes-Oxley Act makes it a crime to knowingly take any action harmful to a person with the intent to retaliate against that person for providing a law enforcement officer with truthful information relating to the commission or possible commission of any Federal offense. In addition, the IRS Form 990 inquires whether the Corporation has adopted a whistleblower policy. A whistleblower policy should establish procedures by which individuals may report complaints or unethical conduct occurring at the Corporation without fear of retaliation, and procedures for the Corporation to follow while investigating and remedying any potential issues.

### **C. Document Retention Policy**

The Sarbanes Oxley Act makes it a crime to alter, destroy, mutilate, conceal, cover up, falsify or make a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any Federal department or agency or for use in an official proceeding. In addition, the IRS Form 990 inquires whether the Corporation has adopted a document retention policy. The Corporation should therefore adopt a written policy establishing standards for document integrity, retention, and destruction. The document-retention policy should also include guidelines for handling electronic files, and should cover backup procedures, archiving of documents, and regular system reliability check-ups. IRS Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations* (Publication), provides further instructions regarding document retention.

### **D. Fair Market Value Policy and the Rebuttable Presumption of Reasonableness**

Under Section 4958 of the Code and its accompanying Regulations, the IRS may impose sanctions on insiders who receive excess benefits from the Corporation; however, the Regulations provide procedures commonly referred to as the “rebuttable presumption of reasonableness” for insuring that the Corporation and insiders are in full compliance with Section 4958 of the Code, and thus not liable for the taxes. The “rebuttable presumption of reasonableness” procedures include the review and approval of certain transactions by independent persons that consider comparability data and document the deliberation and decision-making process. In addition, both IRS Form 1023 and IRS Form 990 request information regarding the procedures the Corporation uses to establish compensation for its officers and certain key employees and the fair market value paid for services or the use of property. The Corporation should, therefore, adopt a fair market value policy which establishes its “rebuttable presumption of reasonableness” procedures and guidelines.

The fair market value policy should provide that a compensation arrangement is presumed to be reasonable or the use of property is presumed to be at fair market value, if the following three conditions are satisfied:

- i. the compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction;
- ii. prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability; and
- iii. the authorized body adequately and timely documented the basis for its determination concurrently with making that determination.

If the Corporation fails to follow “rebuttable presumption of reasonableness” procedures, the person receiving the compensation may be subject to taxes referred to as “intermediate sanctions” and the organization may jeopardize its tax-exempt status.

#### **E. Charity Policy**

Tax-exempt hospitals are required to adopt a charity policy setting forth guidelines for providing medical care in a manner that benefits the community as a whole, including individuals who cannot afford to pay for such care. Schedule H of the new IRS Form 990 requires hospitals to provide information regarding their charity care practices. Note though, that charity policies are helpful to many other types of tax-exempt organizations. If the Corporation charges fees for its services, it should consider adopting a charity policy to establish that its charitable programs are available to everyone, without regard to ability to pay.

#### **F. Nondiscrimination Policy**

Tax-exempt schools are required to adopt a nondiscrimination policy. IRS Revenue Procedure 75-50, 1975-1 CB 152, specifically provides that a “school must show affirmatively both that it has adopted a racially nondiscriminatory policy as to students that is made known to the general public and that since the adoption of that policy it has operated in a bona fide manner in accordance therewith.” The policy should provide that the school does not discriminate against any applicant or pupil based on sex, race, color or ethnic origin in admissions, educational programs, and activities. In addition, the IRS Form 990 inquires whether the policy is included in the school’s Bylaws, brochures, or catalogues.

#### **G. Other Nonprofit Standards**

- 1. Statement of Values and Code of Ethics for Nonprofit and Philanthropic Organizations.** The Independent Sector is a national coalition of public charities, foundations, and corporate philanthropy programs. It drafted and released a Statement of Values and Code of Ethics (the “Code of Ethics”) as a model for tax-exempt organizations. The Code of Ethics is available at [www.independentsector.org](http://www.independentsector.org).
- 2. Panel on the Nonprofit Sector.** The Independent Sector’s Panel on the Nonprofit Sector published *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (the “Guide”). The Guide may be found at [www.nonprofitpanel.org](http://www.nonprofitpanel.org).
- 3. PANO Standards For Excellence.** The Pennsylvania Association of Nonprofit Organizations (“PANO”) adopted an ethics and accountability code known as the “Standards for Excellence.” The Standards for Excellence is posted on PANO’s website at [www.pano.org](http://www.pano.org).