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Potential Reincorporation _____, 2016

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Executive summary

Summary

You asked us for information about the process for reincorporating Client from a California to a New York nonprofit corporation.

Reincorporation is not a simple file-a-form action. Instead, it involves a straightforward, but multi-step process:

- create a new New York entity
- merge the existing California corporation into the new entity
- seek approval of the merger by both California and New York regulators
- submit new application to the IRS for tax exemption of the continuing New York entity

The merger process may also require consents from third parties under loan, grant and other material agreements.

California and New York nonprofit corporation laws, including those relating to director duties, are comparable in nature. There does not appear to be material operating or regulatory burden benefit provided by reincorporation.

There is some indication that the IRS is considering relaxing its requirement that the continuing entity obtain a new tax exemption.

What we cover here

This document covers:

- factors in deciding where to incorporate a nonprofit generally
- comparison of New York and California nonprofit corporation law
- process for carrying out a reincorporation transaction under California and New York law
- IRS filing requirements and related developments
- post-transaction compliance and implementation activities
- some questions for your consideration

We look forward to discussing this matter with you.

Background

Facts

Incorporation considerations

California vs. New York corporate law

Facts

California incorporation

[_____] launched in 19__ as a California nonprofit public benefit corporation.

NY headquarters; leadership

Under the leadership of its current CEO, Client expanded to several other cities and moved the national headquarters to New York.

There are currently [__] directors. Several directors are based in New York City. Others are based in [____], [____], and other cities.

Expansion

Client has expanded from a local, direct services program to a national organization that serves clients across the country:

- **Office locations:** It operates offices in the San Francisco Bay Area, New York City, [____], and [____].
- **Employees:** There are currently [__] employees in [__] states.
- **Fundraising:** Client is licensed to fundraise in all 50 states, and primarily fundraises through events in cities where it has physical offices. It also receives donations made through mailings and its website.

National growth and impact

Strategic planning efforts center on scaling Client's impact on a national level.

Incorporation considerations

No requirements

There are no rules dictating where a nonprofit should be incorporated. Most nonprofits incorporate under the laws of their “home state,” which can reflect a variety of practical factors: location of founders, directors, executives, offices, activities, fundraising focus, and so on.

There are multiple examples of well-known nonprofits who are headquartered in one state and incorporated in another. They include:

- Room to Read
- Goodwill Industries International
- Boys & Girls Clubs of America
- Gordon and Betty Moore Foundation
- SPCA International
- United Way Worldwide

Applicable laws

The state of incorporation does not affect where Board meetings are held.

It also does not affect employment, real estate, or other laws covering the organization. The application of these laws depends on activity in the state, such as operating an office, not on where the relevant entity is incorporated.

For example, the fact that Client is incorporated in California does not affect the application of New York employment law to the organization’s operations in New York.

Regulatory intensity

Some nonprofits may consider incorporating in a state that does not heavily regulate nonprofits. States such as Nevada, Arizona, Delaware, and Wisconsin are reputed to have relatively lighter regulatory regimes.

California and New York have comparatively more intensive regulation and disclosure requirements. According to a 2007 study on incorporation choice, both California and New York enforce their respective regulations more aggressively compared to other states.

The tables on the following page compare key requirements under California’s Nonprofit Public Benefit Corporation Law and Nonprofit Integrity Act, and New York’s Not-For-Profit Corporation Law and Non-Profit Revitalization Act.

No favored state

There is no one state for nonprofits that is comparable to Delaware’s status as the favored jurisdiction for incorporation of for-profit business corporations.

California vs. New York corporate law

Subject	California	New York
Minimum no. of directors	2	3
Board composition	No more than 49% of the Board may be compensated as employee or contractor or may be a family member.	No requirement
Fiduciary duties	Duties of care and loyalty; comparable liability and indemnity rules	Duties of care and loyalty; comparable liability and indemnity rules
Board committee composition	Committees must have at least 2 members, and only directors may serve	Committees must have at least 3 members, and only directors may serve
Board committee authority	May exercise as much authority as the Board delegates, with certain limitations	May exercise as much authority as the Board delegates, with certain limitations
Advisory committees	May include non-directors, but may not act with full Board authority	May include non-directors, but has no authority to bind the Board
Required officers	Chair or president Secretary Treasurer or chief financial officer	None
Board Chair	No requirement	Must not be an employee

Subject	California	New York
Executive compensation review	Board must review and approve compensation of CEO/President and CFO/Treasurer to assure that pay is "just and reasonable"	Compensation of Board members, officers, and employees must be "commensurate with services performed"
Required written policies	None	Conflict of interest; Whistleblower (required if nonprofit has more than 20 employees and over \$1,000,000 in revenues)
Mandatory audits	Required for nonprofits with more than \$2,000,000 in non-governmental revenues	Required for nonprofits of Client's size
Audit committee	Required for nonprofits with more than \$2,000,000 in non-governmental revenues	Required for nonprofits of Client's size
Audit committee composition	May not include staff members; chair may not serve on finance committee; finance committee may not comprise 50%	Restricted to independent directors
Annual financial reports	IRS Form 990 must be filed with Registry of Charitable Trusts of the California Attorney General's office	IRS Form 990 and audited financials must be filed with NY Charities Bureau for nonprofits of Client's size

Process

Overview

State corporate law

Federal tax exemption

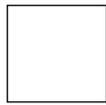
Post-transaction implementation

Putting it together

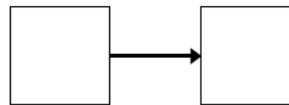
Overview



CA

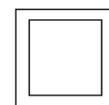


NY



CA

NY



NY

Due diligence

Client checks for consents required under grants, loans, or other other material contracts. Client also determines whether technical change in state of incorporation affects insurance policies, employer registrations with relevant states, and so on.

Form new entity

Client establishes new entity in New York.

Merger agreement

Board approves merger agreement. Client files for regulatory approval with the California Attorney General and New York Attorney General or supreme court.

IRS tax exemptions

Client files application for federal tax exemption for new entity. Client also makes exemption filings as required under state laws.

Merger consummation

Client merges California entity into New York entity by filing documents in California and New York.

New York entity continues as "surviving corporation" in merger. By operation of law, it assumes all assets and liabilities of California entity. New entity adopts new articles of incorporation and bylaws reflecting New York law.

Implementation

Client revises governance, template, and other documents to reflect New York law and practice. Client makes employer and other filings as needed.

State corporate law

California

entity formation	Board approval	merger agreement	regulatory approval	filing with state
N/A	Board of CA entity approves CA agreement of merger and NY plan of merger.	CA agreement of merger must state: terms and conditions of merger, identity of surviving corporation (NY entity), and amendments to articles and bylaws of surviving corporation.	Provide copy of proposed CA agreement of merger to CA Attorney General at least 20 days in advance of consummation date.	CA agreement of merger must be signed by each corporation by its chair, president, or vice president and its secretary; filed with CA Secretary of State.

New York

entity formation	Board approval	merger agreement	regulatory approval	filing with state
File a Certificate of Incorporation with NY Department of State. Hold organizational meeting with at least three Board members.	Board of NY entity approves bylaws, appoints officers, CA agreement of merger, and NY plan of merger.	NY plan of merger must state: terms and conditions of merger, name of constituent corporations and surviving corporation (NY entity), and amendments to articles and bylaws of surviving corporation.	Submit petition and relevant supporting documents to NY Attorney General or supreme court. May not proceed with merger until either or both authorities approve. No time frame in law for obtaining approval.	Prepare, sign, and file certificate of merger with NY Department of State. Certificate includes declarations and key details regarding merger, including effective date.

Federal tax exemption

New tax exemption needed

Even though the New York entity assumes all the assets and liabilities of the California entity and continues its mission and operations unchanged, the IRS views the new entity as a new nonprofit required to submit its own application for tax exemption under Form 1023.

Application process

The Form 1023 application is 26 pages long. It asks a series of questions about mission, related parties, and financial condition. Client's experience in preparing Form 990 tax returns and its original Form 1023 should be useful in completing the application.

We are not aware of any IRS practice of treating applications in these circumstances on a different timeframe than filings by start-up nonprofits. According to the *Journal of Accountancy*, the IRS's average processing time for Form 1023 applications is about 6-7 months.

In addition to the procedural burdens of preparing a new Form 1023 application, Client would be subjecting its activities to a level of IRS review that it likely does not receive through submission of routine Form 990 filings.

Possible change in IRS requirement

In August 2014, the IRS issued a private letter ruling that suggests it may be open to rethinking its position that a reincorporation requires a new Form 1023 application. In that ruling, an organization effected a "redomestication," which involved state laws permitting reincorporation through simple filings in each state, without need for a merger or similar transaction. The IRS determined that this process did not require a new Form 1023 application.

Effecting a reincorporation through such a redomestication process is not available in New York, so the IRS's decision would not cover a reincorporation by Client. However, in June 2015, the New York City Bar submitted a formal request to the IRS for a ruling to the effect that a mere change in the state of incorporation of a tax exempt organization that requires formation of a new entity does not necessitate filing of a new Form 1023 application.

The IRS appears to be considering the request. There is no indication on whether the IRS will change its stance.

Post-transaction implementation

Register with NY Charities Bureau

Client would need to register the new entity with the New York Attorney General's Charities Bureau and submit regular reports as required by that office, as described in the chart on page 6.

Qualify in California

In light of the continued presence of offices and employees in California, Client would need to qualify to do business as a "foreign" corporation in California.

Qualification requires completing and filing forms with the Secretary of State and naming an agent for service of process within the state.

Update Documents and Filings

We recommend that Client reflect the change in its corporate documents and relevant external communications, such as contracts, financial statements, and website.

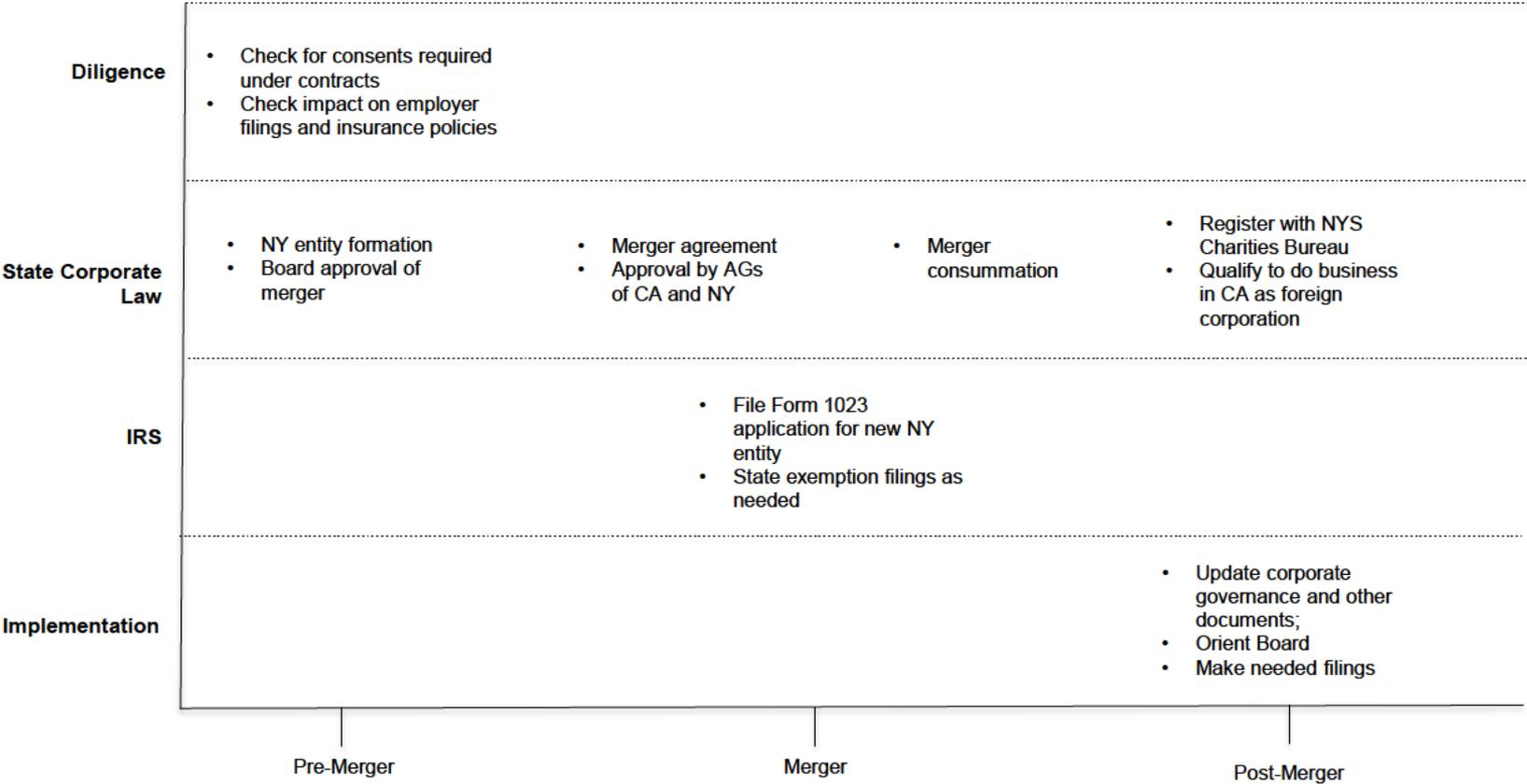
To align with New York law, Client should update, or in some cases replace, its existing corporate governance documents. These may include its orientation materials, committee documents, conflict of interest policy, whistleblower policy, and compensation review policy.

Finally, as noted earlier, Client may need to make new filings with federal and state employment agencies reflecting the technical change in employer. We encourage you to consult with your accountant and payroll provider to identify any needed actions.

Orient the Board

We recommend that Client orient and educate the Board and management about the new governance documents and requirements under New York law.

Putting it together



Other considerations

Observations

Questions for management

Limitations

Observations

Client is a national organization. Its operations and people span the country, and its strategic plan contemplates scaling impact on a national level. The scope of its operations means that, unlike many other nonprofits, no single state stands out as an obvious home state.

The choice of state of incorporation has minimal significance with respect to the law governing daily operations, such as employment, real estate, or charitable solicitation laws.

California and New York are comparable in their regulation and oversight of nonprofits. Both regulate nonprofits more intensely than other states.

Reincorporation is a multi-step, but straightforward process, involving internal diligence, Board approval, implementation, and external action by California, New York, and IRS regulators.

The current IRS requirement of a new application for tax-exemption seems burdensome, but the IRS may be rethinking its position in favor of a simpler approach.

Questions for management

In addition to the matters discussed elsewhere in this report, we encourage you to consider these questions:

Management resources

- Given how little impact reincorporation would likely have on Client's operations, is this process worthwhile?
- Does management have the bandwidth to move forward with diligence, document review, and other activities that come with a reincorporation transaction?
- Will this effort distract management from focusing on development and implementation of Client's strategic plan?

Funders and other third parties

- Is there any indication from New York funders that they would be more amenable to making grants and gifts to a New York-incorporated entity?
- Is there any indication from other key constituents that they would be more amenable to working with Client if it were a New York-incorporated entity?

History

- Would remaining a California corporation serve as a way to "honor" Client's history and origin?

IRS

- Is there anything in Client's operations or practices it should review prior to submitting a new application for tax exemption?
- Should Client wait and see if the IRS changes its view about the need for a new exemption application in reincorporation settings?

Legal support

- Does Client have access to attorneys with expertise in New York nonprofit law?

Limitations

As contemplated by our engagement letter, the scope of our review was limited. We did not undertake a full investigation of Client's governance or operating practices. We examined only the documents and information you provided to us and information on the Client website, and our conclusions are based entirely on this review.

We are not providing comprehensive advice on employment or tax matters, including Form 1023 application requirements, state tax exemption matters, payroll, or unemployment insurance.

Please note that we are licensed to practice in California. We encourage you to review our recommendations with New York counsel prior to executing any reincorporation transaction.

Thank you again for the opportunity to work with Client.