

## Chapter 3

# Incorporation and Basic Structural Considerations

This chapter reviews the structural issues to be addressed in establishing a CLT as an independent not-for-profit corporation. For the most part, these are issues that must be addressed whether the organization is to have the structure of a “classic” CLT or one of the variations described in the previous chapter on “initial choices” – though we will note some concerns that are specific to the classic model. For a full treatment of all relevant issues, this chapter should be read in combination with the chapters dealing with bylaws and tax-exemption as well as the chapter on initial choices.

### The Basic Structure

**The nature of not-for-profit corporations.** Like the for-profit corporation, the not-for-profit (often called “nonprofit”) corporation is a legal entity, chartered under state law, with the power to act as though it were, in some respects, an individual. It can enter into contracts, own property, borrow and lend money, bring suit in a court of law (and be sued). The not-for-profit corporation is also like the for-profit corporation in the ways that liability is limited for those associated with the corporation. The staff, the board, and the members of the corporation are not protected from liability for their own actions, but in most circumstances they need not worry about being held liable for the acts of others merely because they are associated with the corporation.

However, for-profit and not-for-profit corporations differ fundamentally in the ways they are owned and controlled. A for-profit corporation is owned and controlled by those who own shares of stock issued by the corporation, with the degree of control usually apportioned according to the number of shares owned by each. Any profit generated by the for-profit corporation belongs ultimately to the stockholders, and it, too, is apportioned on a per-share basis. In the event of dissolution, the net assets of the for-profit corporation are distributed to the stockholders, again on a per-share basis.

Not-for-profit corporations are controlled ultimately not by stockholders but by *members*. The membership may be large and open to any who wish to join, or it may be limited in various ways. Sometimes it is limited to just the members of the board of directors. Those nonprofits whose membership is not limited to the board of directors are commonly called “membership organizations.” The classic CLT model calls for a not-for-profit corporation structured as a membership organization, with membership open both to those who lease land from the CLT and to other members of the community.

CLT corporations are normally structured in such a way that earnings and assets cannot be distributed to the members. State laws restrict a not-for-profit corporation’s right to distribute assets to members, and any such corporation may, in its articles of incorporation, prohibit such distributions absolutely. If an organization is to qualify for federal 501(c)(3) tax-exempt status, its articles must stipulate that “no part of the net earnings of the Corporation shall inure to the benefit of any individual” (except as compensation for services rendered or in furtherance of its charitable purposes), and that, in the event of dissolution, the corporation’s net assets can be distributed only to another exempt organization or only in accordance with the exempt purposes of the dissolving corporation. Even if a CLT does not intend to qualify for 501(c)(3) tax-exemption (though most do), its articles should still prohibit the inurement

of earnings to individuals and should require that, in the event of dissolution, the corporate net assets be distributed only in accordance with the CLT's corporate purposes.

**Basic organizational documents.** In establishing a CLT as a not-for-profit corporation with appropriate tax-exempt status, there are three basic steps. The formal actions involved in these steps must be taken in the order in which they are listed below. However the issues that will be confronted in drafting the several documents are closely related in a number of ways, so it is important to address the entire set of issues before taking any formal action.

1. *Draft and file articles of incorporation.* The legal identity of the corporation under the laws of your state is established by filing “articles of incorporation” (known by other names in certain states) with the Secretary of State – which in practice usually means filing with the corporations office within the Department of State.
2. *Draft and adopt bylaws.* The bylaws, establishing working rules for the corporation, are adopted by the membership and/or board of directors once the corporation has been established through the filing of articles. The bylaws are a binding legal document, but they are established internally and do not need to be filed with a government agency in the process of creating the corporation (though various agencies, including the IRS, may require that they be submitted in connection with subsequent processes).
3. (In most cases) *prepare and submit application for federal tax-exemption.* This application is submitted to the Internal Revenue Service, which normally takes several months to determine whether the organization qualifies for exemption. Separate applications for exemption from state taxes – including possible exemption from sales taxes – may then be filed. The new corporation may also need to register with certain state agencies as a charitable organization, depending on state law.

Articles and bylaws must be consistent with each other. Most of what is stipulated in the articles is more general than what is stipulated in the bylaws, which are concerned with the details of governance. However there will be a certain amount of overlap between the two documents. It is wise to work out the detailed provisions of the bylaws before preparing a final draft of the articles for filing.

Both the articles and the bylaws must be submitted to the IRS with the application for tax-exemption. In reviewing the application, the IRS will look carefully at the articles to determine whether the corporation's purposes qualify as “exempt purposes” and whether the corporation's powers are limited in the ways required for exemption. The bylaws will be examined to determine whether they are consistent both with the articles and with the requirements for exemption. For these reasons, it is important to address the questions relating to tax-exemption before filing articles of incorporation and adopting bylaws. See Chapter 6, “Tax Exemption,” for a detailed discussion of federal tax-exemption issues.

**Process for Drafting articles and bylaws.** It is usually possible for a small group of people to organize a not-for-profit corporation rather quickly using conventional models for the basic organizing documents. Sometimes the organizers will simply copy the documents of a similar organization, changing names and dates but otherwise raising few questions about the appropriateness of the models. We strongly recommend that this approach *not* be taken in organizing a CLT. We also strongly recommend that the matter of incorporation not simply be turned over to an attorney to be carried out without participation from others. Though the results of such action will no doubt be legally correct, the process of thinking through the

structure of the new organization should not be short-circuited. The process should be seen as an opportunity for the organizers of the CLT to discuss and agree upon the purposes of the new organization and the ways in which the organization will be structured and controlled to achieve these purposes. The process should clarify and *internalize*, within the group, the shared principles that are set down in black and white in the organizing documents.

### **Considerations in Preparing Articles of Incorporation**

The articles of incorporation (perhaps known by another term in your state) describe and establish the basic legal identity of the corporation. Your CLT will *become* a corporation when its articles are duly filed in your state's Department of State.

The information contained in the articles normally includes the legal name of the corporation, its purposes and powers, the location of its principal office, and the names of those who will have the power to act for the corporation as directors until a permanent board of directors is duly elected. Additional specific information may be required by the law of your state. The articles may also contain a variety of stipulations relating to the membership, the board of directors, and other matters.

The preparation and filing of articles is not a difficult legal process, but this fact does not mean that it should be treated casually. The goal should not be simply to "get incorporated" as soon as possible, but to establish the legal structure that will best embody and serve the purposes of the CLT. The process should be guided by an attorney or other person who is familiar with the not-for-profit corporation law of your state and the IRS requirements for 501(c)(3) tax-exempt status, but the organizers of a CLT should participate in deciding the basic questions of purpose and structure that are involved in drafting the articles. In preparing articles of incorporation a CLT will have the following major areas of concern.

- What is required by the not-for-profit corporation law in your state (and what regulations have been established by your Secretary of State)?
- What is required by the IRS if the new corporation is to qualify for tax-exempt status?
- What is the best way to establish and preserve the essential features of the CLT model? (What will enable the new CLT to work as the CLT model is designed to work and to prevent it from working otherwise?)

**State requirements.** Though they are generally similar, laws pertaining to not-for-profit corporations do vary somewhat from state to state. If you are not already familiar with your state's not-for-profit corporation law and filing procedures, you should consult with an attorney who is familiar with these matters, and/or look for the necessary information on line. It should be possible to find your state's not-for-profit corporation law on the internet, and your Department of State should have a web site that will provide basic information about filing articles of incorporation. Some of the basic points that you should check as you review the law are discussed below.

*Corporate name.* Every corporation must have a name that distinguishes it from all other corporations in the state. If you have reason to think that the name you want may already be in use, you can ask the Department of State (or the corporations bureau within the department) to search its records to determine the availability of the name before you present your proposed articles for filing.

The law may also impose other requirements or restrictions on corporate names. You may or may not be required to use some form or abbreviation of the words *Corporation*,

*Incorporated, or Limited in the name.* Certain words may also be prohibited. In some states, the word *Trust* may be used only in the names of corporations organized and regulated as financial institutions. In other states (e.g., New York) the word *trust* may be used only with the consent of the State Banking Department. (In the case of New York, consent has generally been given, but the process has sometimes been time-consuming, and some CLT organizers have chosen to adopt names that do not include the word *trust* for this reason.) In any case, check your not-for-profit corporation law for a list of prohibited or restricted words.

*Type of corporation.* The law may define different types of not-for-profit corporation with different purposes. Where this is the case, the articles should state the type of corporation that is being established. For CLTs – at least those that will seek tax-exempt status – the appropriate type is normally that defined as having charitable purposes.

*Corporate purposes.* The statement of corporate purpose included in the articles will of course be determined first by the actual purposes of the CLT, and secondly by the definition of “exempt purposes” recognized by the IRS (as discussed below). Some states, however, restrict the way in which articles may be composed to meet the IRS requirements for tax-exemption. Some may not allow you to include as *a part of your statement of purpose* all of the restrictions that the IRS insists upon, but will allow these restrictions to be stated in separate articles. Others may not allow the inclusion of the conventional *language* suggested by the IRS. In these cases, the IRS will accept alternative ways of stating the necessary restrictions.

Certain corporate purposes may require special approval or waivers from state agencies charged with the oversight of particular types of institutions, such as schools. A CLT with a stated educational purpose (even if it is as broad as “educating the community regarding affordable housing issues”) may be required to submit its proposed articles to the state Education Department and receive the Department's consent to their filing (or a statement by the Department to the effect that this not the type of institution whose articles it must approve).

*Role of incorporators and/or initial board.* The incorporators and the initial board may, or may not, be identical. All articles of incorporation must be signed by at least one “incorporator,” who certifies that the articles are accurate. In some cases the incorporators have the power to act for the new corporation until a regular board of directors is elected. In other cases, the articles may name those people who will serve as the initial directors (who may or may not include the incorporators). Whatever people are empowered to act for the corporation will retain this power until the first annual meeting, when a regular board will be elected. Obviously it is important to have a clear understanding of who will control the corporation initially, under the laws of your state, and to be sure that they are people who will carry out the intent of the organizers. In most cases their primary responsibility, following incorporation, will be simply to call the first annual meeting of the membership.

*Other required information.* Usually the articles must state the location of the principal office of the corporation. Sometimes they must identify the territory in which the corporation will principally operate. Check the law of your state to determine what specific information is required.

*Corporate powers granted by statute.* Obviously your CLT should have all of the powers necessary to carry out its purposes. You should determine what powers the new corporation

will have by virtue of being incorporated under the law of your state, and whether it is necessary to stipulate certain powers in the articles in order to assure that the corporation will have these powers. Even when powers are granted by statute, they may still be stipulated in the articles (sometimes done simply by quoting the statutory language), to ensure that anyone reading the articles will understand what powers the corporation has, without having to research the law itself.

*Rights and powers of members and board.* The law of your state may grant certain rights and powers to the members of the corporation and to the board of directors. Some of these rights and powers may be subject to the particular corporation's articles and bylaws. In other words, the statutory provision will apply unless the articles or bylaws provide otherwise. Other rights and powers may be granted absolutely by the law, and may not be overridden or modified by the articles or bylaws. This distinction can be particularly important with regard to the division of powers between members and board. For instance, for a membership organization such as a CLT, the law may give the members the power to adopt and amend bylaws, even if the articles or bylaws assign this power exclusively to the board of directors. Or the law may *allow* the articles or bylaws to assign this power exclusively to the board of directors or to require the approval of both the members and the board.

*Provisions regarding meetings and decision-making.* The law may deal with a number of specific points regarding membership and board meetings, notice of meetings, quorums, voting, etc. Most of these are points that you will address in your bylaws rather than in your articles, but some may have a bearing on both documents. In any case, it is important to know what the law allows and what it *requires* regarding these matters.

*Consents and approvals required prior to filing.* As noted above, certain corporate names and purposes may require special approval from certain state agencies. The law may also require that the State Attorney General and/ or a justice of a state court consent to the filing of your proposed articles, or approve the proposed articles before filing. If you are not sure of how to handle such requirements, ask your Department of State for instructions.

**IRS requirements.** Sometimes an organization applying for tax-exempt status is told by the IRS that it cannot be recognized as exempt unless it amends its articles of incorporation. You can save yourself a great deal of time and trouble if you have a full understanding of the requirements for tax-exemption before you file your articles in the first place.

*Exempt purposes.* If the corporation is to be recognized as exempt from federal taxes under Section 501(c)(3) of the Internal Revenue Code, the corporate purposes stated in the articles must qualify, in the view of the IRS, as “charitable, educational, or scientific.” The question of what statements of CLT purposes will qualify in these terms is discussed in Chapter 6. The sample statement of purposes included at the end of this chapter is designed to qualify for exemption as well as to provide a valid statement of the purposes of a CLT – but it must be adapted to the circumstances of the particular CLT.

*Required clauses.* In addition to a statement of purposes that will be recognized as exempt, the articles of an exempt organization must contain certain clauses that prohibit it from engaging in non-exempt activities:

- A clause stating that the corporation shall not, except to an insubstantial degree, engage in any activities or exercise any powers that are not in furtherance of its primary purposes.
- A clause stating (a) that no substantial part of the corporation's activities shall consist of

carrying on propaganda, or otherwise attempting to influence legislation, and (b) that the corporation shall not participate or intervene in any political campaign on behalf of any candidate for public office.

- A clause dedicating assets to exempt purposes, and stating that no part of the net income of the corporation shall inure to the benefit of any director, member, officer or private individual.
- A clause stating that, upon dissolution of the corporation, the remaining assets shall be disposed of exclusively for the corporation's charitable purposes or to another organization with 501(c)(3) tax-exempt status.

Language covering these points is included at the end of the chapter.

**Establishing the essential features of the CLT model.** Usually when an organization is incorporated, the assumption is that its articles should restrict its activities as little as possible, allowing as much power, latitude, and flexibility as is consistent with the corporate purposes and as is allowed by statute unless there is reason to include certain specific restrictions or stipulations. As noted above, the organizers of most CLTs do have reason to include the restrictions and stipulations required by the IRS to ensure that the corporation is legally limited to exempt activities. Some have also included certain stipulations and restrictions to ensure that the corporation's activities will remain consistent with the way the CLT model – and the classic CLT model in particular – is intended to function. Others have thought it was sufficient to deal with at least some of these matters only in the bylaws.

*Members and their roles in selecting directors.* It is usually assumed that articles of a classic CLT should stipulate that the organization is to be a membership corporation (that it is not to have a self-perpetuating board). Some CLT articles also stipulate that the membership may include both lessees and non-lessees. Detailed membership requirements are usually left to the Bylaws.

*Land stewardship.* The usual assumption is that land held in trust by a CLT is not to be treated as a marketable asset. Therefore, most CLTs have included in their bylaws strict restrictions on the sale of land. These restrictions can be further strengthened and emphasized by provisions in the articles as well.

*Resale restrictions.* The basic principles of “resale-restricted” ownership of improvements on leased land are also usually set forth in CLT bylaws. Though detailed provisions for establishing such restrictions may be left to the bylaws and to subsequent action by members and directors, the articles often do specify that the membership and Board are responsible for seeing that resale prices of housing or other improvements on land leased by the Corporation to low or moderate income people are to be restricted to preserve affordable access for such people.

### **Sample Language.**

**Corporate purposes.** *(Not all of the following statements of purposes are appropriate for all CLT programs. Be sure to read Chapter 6 on tax-exemption issues before drafting corporate purposes for your CLT.)*

The purposes for which the Corporation is formed are exclusively charitable. The specific and primary purposes are:

- (a) To provide housing for low-income [or low and moderate income] people that is safe, secure and affordable.
- (b) To provide affordable homeownership opportunities for low-income [or low and moderate income] people, while preserving the quality and affordability of the homes for future low [or low and moderate] income residents of the community.
- (c) To combat community deterioration in economically disadvantaged neighborhoods by promoting the development, rehabilitation, and maintenance of decent housing in these neighborhoods; by promoting economic opportunities for low-income residents of these neighborhoods; by making land available for projects and activities that improve the quality of life in these neighborhoods; and by assisting residents of these neighborhoods in improving the safety and well-being of their community.
- (d) To protect the natural environment and to promote the ecologically sound use of land and natural resources and the long-term health and safety of the community.
- (e) To lessen the burdens of government by entering into agreements to preserve the affordability of housing made affordable through government subsidies or government policies.

**Language specific to the Internal Revenue Code:**

Notwithstanding any other provisions of these articles, the corporation is organized exclusively for one or more of the purposes as specified in §501(c)(3) of the Internal Revenue Code of 1954, and shall not carry on any activities not permitted to be carried on by a corporation exempt from Federal income tax under IRC §501 (c)(3) or corresponding provisions of any subsequent Federal tax laws. No part of the net earnings of the corporation shall inure to the benefit of any member, trustee, director, officer of the corporation, or any private individual (except that reasonable compensation may be paid for services rendered to or for the corporation), and no member, trustee, officer of the corporation or any private individual shall be entitled to share in the distribution of any of the corporation assets on dissolution of the corporation.

No substantial part of the activities of the corporation shall be carrying on propaganda, or otherwise attempting to influence legislation [except as otherwise provided by IRC §501 (h)] or participating in, or intervening in (including the publication or distribution of statements), any political campaign on behalf of any candidates for public office.

In the event of dissolution, all of the remaining assets and property of the corporation shall, after necessary expenses thereof, be distributed to another organization exempt under IRC §501 (c)(3), or corresponding provisions of any subsequent Federal tax laws, or to the Federal government, or state or local government for a public purpose, subject to the approval of a Justice of the Supreme Court of the State of New York.

In any taxable year in which the corporation is a private foundation as described in IRC §509(a), the corporation shall distribute its income for said period at such time and manner as not to subject it to tax under IRC §4942, and the corporation shall not (a) engage in any act of self-dealing as defined in IRC §4941(d), retain any excess business holdings as defined in IRC §4943(c), (b) make any investments in such manner as to subject the corporation to tax

under IRC §4944, or (c) make any taxable expenditures as defined in IRC §4945(d) or corresponding provisions of any subsequent Federal tax laws.