LEGAL ISSUES
FOR SMALL BUSINESSES AND NONPROFIT AGENCIES
Your complete Guide to Legal Issues Confronting Small Businesses and Nonprofit Corporations

BUSINESS SOLUTIONS
Dear Business and Nonprofit Agency Customers:

Southern California Edison and Public Counsel are delighted to provide you with this guide.

Legal information is crucial for the continued growth and development of successful businesses and nonprofit agencies in our community.

We hope that you will find the information in this guide helpful and informative.

Public Counsel, the largest pro bono law office in the nation, is the Southern California affiliate of the Lawyers' Committee for Civil Rights Under Law as well as the public interest law firm of the Los Angeles County and Beverly Hills Bar Associations. Public Counsel's Community Development Project prepared this guidebook in order to help distribute basic legal information to the community at large. Public Counsel's Community Development Project provides legal assistance to community organizations and microbusinesses whose limited resources cannot support payment of legal fees without impairing their operations. The project matches qualifying nonprofits and microbusinesses with attorneys who will provide legal assistance at no cost to the client. For more information on Public Counsel, please visit www.publiccounsel.org or call (213) 385-2977.

Southern California Edison's (SCE) Economic and Business Development (E&BD) group offers business solution assistance either directly or through our strategic partners. This assistance can help your business address specific business productivity issues. In addition, E&BD also offers a variety of guidebooks, workshops, seminars, conferences, energy efficiency, and energy management resources to help businesses stay apprised of useful and timely information and resources. For more information about E&BD’s programs and services, please call us today at 1-800-3-EDISON or visit us on-line at www.sce.com.

While the information contained in this publication concerns legal issues, it is intended solely to provide general information. It is not intended as legal advice or as a substitute for obtaining the advice of an attorney. It is understood that our providing this information to you and your reviewing this information does not establish an attorney-client relationship. Anyone seeking legal advice or assistance should contact his/her own attorney.
-Contents-

Part One: How Should I Organize My New Business?

1. Introduction ................................................................................................................................ 1
2. Sole Proprietorships ........................................................................................................................ 2
3. General Partnerships .......................................................................................................................... 5
4. Limited Partnerships .......................................................................................................................... 8
5. Corporations ...................................................................................................................................... 10

Part Two: Guide to Forming a Charitable Tax-Exempt Nonprofit Organization

6. Introduction ............................................................................................................................... 15
7. Initial Considerations to Forming a Nonprofit Corporation ...................................................... 15
8. Nonprofit Incorporation Under California Law ........................................................................ 17
9. Nonprofit Public Benefit Corporations ...................................................................................... 18
10. Special Characteristics of Nonprofit Public Benefit Corporations ........................................... 19
11. Obtaining Tax Exemption ......................................................................................................... 20
12. Getting Started Step by Step ................................................................................................... 23

Part Three: Obligations and Possible Liabilities of Directors and Officers of Public Benefit Corporations

13. Introduction ............................................................................................................................... 29
14. Responsibilities and Powers of Directors .................................................................................. 30
15. Business Judgment Rule .......................................................................................................... 34
16. The Duty of Care and Particular Decisions ............................................................................. 35
17. Duty to Avoid Harm to Third Parties ....................................................................................... 37
18. Compensation of Directors ....................................................................................................... 38
Part Four: Basic Employment Issues

22 The Basic Employment Relationship................................................................. 45
23 The Hiring Process............................................................................................ 47
24 Basic Laws on Discrimination.......................................................................... 51
25 Preserving a Good Working Relationship....................................................... 52
26 Terminating the Employment Relationship.................................................. 55
27 Providing References for Former Employees................................................. 57
28 Employee Handbooks..................................................................................... 58
29 Posting Requirements..................................................................................... 63
30 Independent Contractors................................................................................ 63

Part Five: The Basics of Forming and Signing Contracts

31 Frequently Asked Questions About Contracts............................................. 66
32 Elements of An Enforceable Contract.......................................................... 67
33 Other Types of Enforceable Obligations....................................................... 69
34 The Best Contracts are Written Contracts.................................................. 70
35 Formalities of Finalizing a Contract............................................................. 74
36 Revising Contracts......................................................................................... 75
37 Unfair or Illegal Contracts............................................................................. 76
38 Additional Clauses......................................................................................... 77
Part Six: Basic Insurance Considerations

- Introduction ................................................................. 79
- What Is Insurance? .................................................. 79
- Why Purchase Insurance? ........................................ 80
- Types of Insurance Coverage .................................. 80
- Directors’ and Officers’ Liability Insurance ............... 81
- How To Shop For Insurance ....................................... 82
- Items To Consider When Purchasing Insurance ........ 83
- Your Policy of Insurance ............................................ 88
- Where To Go For Help .................................................. 89

Part Seven: Federal Tax Considerations For Small Businesses

- Introduction ................................................................. 90
- Choosing a Business Structure .................................. 90
- Basic Tasks for Tax Compliance ............................... 93
- Federal Taxes that Apply to Businesses ..................... 96
- Filing Information Returns ......................................... 97
- Federal Tax Law Penalties ......................................... 98
- Basic Recordkeeping Tips ......................................... 99
- How to Obtain Additional Information ..................... 101

Appendices:

- Glossary of types of insurance and insurance terms ........ 103
- Wage & Hour Laws - AB 60 ....................................... 110
Introduction

When you start your own business, you must choose a legal structure, or business entity, for your business. Your choice of structure affects several different aspects of your business and its operations, including tax treatment, liability, expenses and growth potential. For this reason, it is important to have a basic idea of your goals and financial outlook when choosing a business structure.

Several basic structures are available for organizing your business: a sole proprietorship, a general or limited partnership, a corporation, or a limited liability company. This booklet explores the requirements, advantages, and disadvantages of each business structure according to the laws in California. Step-by-step guidelines are provided to familiarize you with the requirements of forming each of these entities. These guidelines are not intended as instructions, but simply as a general overview. Whichever structure you choose, your initial choice of a business form is not permanent. You can start out as a sole proprietorship or partnership and convert to a corporation later as your business grows.

Remember, regardless of the business structure you choose, you should keep your business documents in a safe, convenient place. You will need them for opening business bank accounts and other business matters. Also, you are strongly encouraged to speak with a tax consultant for more specific information about your particular situation and to seek legal assistance, especially when drafting written documents and agreements.
Sole Proprietorships

What is a Sole Proprietorship?

A sole proprietorship is the simplest way to conduct your business if you are the only person involved. If you set up a sole proprietorship, it means that you are the only person who owns your business. For legal purposes, you and the business are treated as one legal entity. This structure is the simplest and cheapest way to organize your business. Only limited paperwork is necessary to start up and maintain a sole proprietorship. You can continue operating as a sole proprietor as long as you are the only owner of the business.

Be aware that keeping separate records for your business expenses and your personal expenses is important. For instance, you should keep a separate personal and business checking account and a separate business credit card. Pay for all of your business expenses from your business checking account.

A Sole Proprietor Has Unlimited Personal Liability

As a sole proprietor, you are personally responsible for paying all the debts of your business. This means that if your business does not earn enough money to pay its business debts, creditors can sue you personally. Creditors are the people to whom you or your business owe money. An example of a business creditor is a supplier. In legal terms, this personal responsibility is called “unlimited personal liability.” Unlimited personal liability means that your creditors can recover from your personal assets for repayment of your business debts. Personal assets are items such as your home, car, and personal bank accounts. If you are married, your community property might be included in your personal assets.

This unlimited personal liability (or personal responsibility) extends to any injuries to your employees or customers. For instance, if your employee is injured while on the job, you could be personally liable for the employee’s medical expenses. Similarly, if you or your employee injure someone else while performing your job, you could be personally liable for expenses that arise from that injury. You can protect against many of these risks by carrying adequate insurance.

In fact, obtaining sufficient insurance should be your first concern. It is illegal to have employees and not have workers’ compensation insurance, and it is unthinkable not to have general liability insurance. Make sure you work with a competent insurance agent and obtain coverage for premises liability, fire, theft, and loss of business. If you have proper insurance, the following example will not put you out of business or threaten your personal assets.
How Does a Sole Proprietor Pay Income Taxes?

As a sole proprietor, you do not need to file a separate business tax return. You and your business are one entity for income tax purposes. Instead, you file your own personal 1040 tax return, with an additional form called a Schedule C. On this Schedule, you add the income from your business and deduct your business expenses. Your business income and other personal income are combined and taxed at your personal income tax rate. If you are in a low personal income tax bracket, setting up a sole proprietorship is advantageous because your business income will be taxed at a low income tax bracket.

What Happens to the Business if You Die?

Remember, you are the same legal entity as your business. Therefore, if you die, your business automatically dissolves, unless you have made specific arrangements otherwise. For instance, you can write a will or establish a living trust to transfer the business assets to your family or friends to keep the business going.

The Step-By-Step Process for Establishing a Sole Proprietorship

No legal formalities are required to start a business as a sole proprietorship. However, you should do three things when you establish a sole proprietorship. First, you should file a Fictitious Business Name Statement. Second, you should request an Employer Identification Number. Third, you must obtain a Business License.

Fictitious Business Name Statement

If you plan to use a business name which does not include your own last name, you will need to file a Fictitious Business Name Statement with the County Clerk or County Recorder where the principal place of business is located, and publish a notice in the newspaper. This document is also called a “DBA Statement” because it tells the public who you are “doing business as”. For more information on how to file a “DBA Statement”, visit http://www.calgold.ca.gov, which tells you where to go to file the statement and the cost of filing one (excluding the newspaper publication fee).
Employer Identification Number

All businesses must have an Employer Identification Number, abbreviated as an EIN. With a sole proprietorship, if you are the only employee, you can use your own Social Security Number as your EIN. However, obtaining a separate EIN is strongly recommended, because your future activities may require one. For instance, if you hire other employees, you must have an EIN. The EIN is free. To request an EIN application contact the IRS by telephone, mail or fax and ask for an SS-4 Form, or visit the IRS website at www.irs.gov to obtain the form. If you pay more than $100 in wages to your employees in any calendar quarter, you must also register with the California Employment Development Department (“EDD”) using the EDD Form DE-1. This form must be filed within 15 calendar days after wages paid to employees in a calendar quarter exceed $100. The EDD will issue a separate EDD identification number.

Business License

The other legal requirement for establishing a sole proprietorship is obtaining a business license. To apply for a license, you must contact the Business License Section of the City Clerk’s Office and pay a fee for the license. Additionally, make sure to ask if you need any special licenses or permits for your particular business. More information about required business licenses is available at www.calgold.ca.gov.

EXAMPLE: Your name is Willy Fox and you plan to make your own chocolates and sell them. You file a DBA Statement because you plan to ‘do business as’ Willy’s House of Chocolates and publish your information in the newspaper. Note: If you were naming your business Willy Fox’s House of Chocolates, no DBA is needed.

EXAMPLE: Your name is Billy Ramone and you are opening a taco stand called "The Best Tacos in Town." At your stand, you plan to sell liquor. The City Clerk will tell you that you need to apply for a liquor license.
General Partnerships

What Is a General Partnership?

You can establish a general partnership if you are going to own or operate your business for profit with more than one person. Partnerships are legal entities separate from the partners themselves. Two kinds of partnerships are available: general and limited partnerships.

Formation

A general partnership is formed by an oral or written partnership agreement, but your partnership agreement should be in writing to prevent future problems. Be advised that if you are in business with someone else and you have no formal agreement, courts will imply a partnership. This is dangerous because without an agreement, if you were to continue the business and the other person left, that person could claim a partnership interest, tie you up in a lawsuit and even win something. It is very important if you go into business with another person that you spell out all rights and responsibilities in writing before starting.

Usually when a general partnership is created, each partner contributes cash, property or services in exchange for an "interest" (the legal term for some kind of ownership) in the partnership.

Responsibility

In a general partnership, each general partner has equal responsibility and authority for running the business. Each partner is involved in running the business's day-to-day activities and making management decisions. Any partner can represent the partnership in business matters without the knowledge of the other partners. In other words, the actions of one partner can bind the entire partnership. So, if one partner signs a contract on behalf of the partnership, the general partnership and each partner are responsible under the contract.

Duties to each other

According to the law, partners are required to treat each other fairly and with the highest degree of loyalty. In legal terms this requirement is called a “fiduciary duty.” This means that you as a partner cannot do things related to your business that would harm your partner or only serve to benefit you individually. For example, a partner cannot open a business which competes with the partnership business. This kind of activity is what lawyers call a “conflict of interest.” The law says that partners must avoid conflicts of interest.
Profits, losses, and salaries

Partners are treated as owners of their partnership much like a sole proprietor is treated as the owner of a sole proprietorship. Generally partners do not pay themselves salaries, but instead share in the profits and losses of the partnership. At the end of the year, partners report their share of profits and losses on their personal income tax return. This is true even if the profits are kept in the business and not distributed to the partners.

General Partners Have Unlimited Personal Liability

Like a sole proprietorship, each general partner has unlimited personal liability. This means that each partner is personally responsible for all of the partnership's debts. Each partner is also liable for the wrongful acts of the other partners, if those activities were done in the normal course of partnership business. For example, if your partners cannot pay their share of the partnership's debts, creditors can recover from your own personal assets to pay the entire partnership debts. Therefore, like a sole proprietorship, you could be held personally responsible for both the contractual debts and any injury claims against your business. You can protect against many of these risks by carrying adequate insurance.

EXAMPLE: You and three partners establish a general partnership. You discuss renting a car for the partnership, but then decide against it. However, Partner #2 doesn't like that decision, and he takes matters into his own hands. He signs a contract with ABC Car Rental to rent a car on behalf of the partnership. That contract is fully enforceable against the partnership itself and each individual partner - even if no other partner knew of, nor approved, the contract! So, you, the other partners, and the partnership itself will be responsible for paying for the car rental.

How Does a General Partnership Pay Income Taxes?

The general partnership itself does not pay income taxes. Instead, each partner pays taxes on her share of the partnership income, or deducts a share of the partnership's losses, if applicable. The partnership must file an annual informational tax return with the Internal Revenue Service and the State Franchise Tax Board. This return describes how much money the partnership earned or lost and how much each partner made or lost. The partnership must also file annual tax forms for each partner, specifying the income each partner has earned, if any. Each individual partner then lists her share of partnership profits on her personal tax return and pays taxes on that income. If the partnership has lost money, each partner deducts her share of the loss on her personal tax return, thereby decreasing the amount she owes for her personal income taxes.
What Happens to the Business if a Partner Withdraws or Dies?

If any of the partners withdraw from the partnership or die, the partnership must buy out the partner’s interest in the partnership. In some situations, if one partner dies, the partnership is dissolved, unless the remaining partners agree to continue the partnership.

The Step-By-Step Process for Establishing a General Partnership

**Partnership Agreement**

First, although a written agreement is not required for a general partnership, creating a written agreement is strongly suggested. In a written agreement, you can describe the general partners and their respective shares of contributions and profits. The agreement can divide the profits and losses disproportionately, which means that the profits can be shared equally while the losses are allocated to those partners investing money. In the absence of a written agreement, profits are shared equally. Remember that all partners must sign the agreement. (Note: In drafting your partnership agreement, it may be helpful to get some legal advice from an attorney.)

**Fictitious Business Name Statement**

If the name of the General Partnership will not include all of the partners' surnames (last names), then the partnership must file a Fictitious Name Statement ("DBA"). As discussed earlier, the DBA statement must be filed with the County Clerk or County Recorder where the principal place of business is located, and a notice must be published in the newspaper. For more information on how to file a “DBA Statement”, visit http://www.calgold.ca.gov, which tells you where to go to file the statement and the cost of filing one (excluding the newspaper publication fee).

**Employer Identification Number**

A general partnership must apply for a separate Employer Identification Number (EIN). As mentioned earlier, contact the IRS by telephone, fax, or mail or go to the IRS website for your EIN.

**Business License**

A business license is also required for establishing a general partnership. As previously discussed, this license can be obtained from the City Clerk’s Office. Remember to ask if you need any other licenses (e.g. a liquor license) for your particular business.
Limited Partnerships

What Is A Limited Partnership?

Like a general partnership, a limited partnership is available if you are going to own or operate a business for profit with more than one person. A limited partnership has two types of partners: general partners and limited partners. The purpose of a limited partnership is to encourage investors (the limited partners) to invest in the business without exposing them to personal liability. This form of ownership is also fraught with dangers because it is likely that if you intend to be the general partner (you must if you run the business) and you locate investors and persuade them to become limited partners, you will probably run afoul of the securities laws if you do not get good advice. This form of ownership is usually used in large real estate management transactions and other secured transactions. The operations of a limited partnership are governed by an oral or written partnership agreement, but a written partnership agreement is always advisable.

Responsibility

The responsibilities of the general and limited partners are different. The general partners manage the partnership business and are personally liable for partnership debts. The limited partners, also called passive investors, contribute money but are not involved in running the business. The limited partners usually are not responsible for the debts of the partnership beyond the amount of money they contributed. This means that the limited partners have limited liability.

Profits and Losses

Partnership profits and losses are shared in proportion to the partners’ contributions, unless the partnership agreement provides otherwise.

General Partners Have Unlimited Personal Liability, But Limited Partners Have Limited Personal Liability

As mentioned above, the extent of personal liability is different between general partners and limited partners. General partners have unlimited personal liability, meaning that they are fully responsible for all of the partnership's debts (just like partners in a general partnership). This means that creditors can recover from the general partner’s personal assets to repay the partnership's debts. Limited partners, however, have only limited personal liability.
They are liable only up to the amount of their investment in the partnership. Thus, creditors cannot collect from the personal assets of limited partners to repay the partnership's debts. It is very important not to lose this protection of limited liability! This protection might be lost if limited partners directly participate in the control of the partnership, such as the decision making and operation, and if third parties think that the limited partner is a general partner. If a limited partner does not directly participate in running the business, that partner is protected by limited personal liability.

What Happens to the Business if a Partner Withdraws or Dies?

If the general partner dies or withdraws, the partnership dissolves unless: (1) there is another general partner and the partnership agreement allows the remaining general partner to continue the business; or (2) the limited partners agree in writing to find another general partner within six months. Death of a limited partner has no effect on the partnership.

The Step-By-Step Process for Establishing a Limited Partnership

**Partnership Agreement**

The Limited Partnership is governed by an oral or written partnership agreement. A formal written agreement is strongly recommended. Specify in the agreement such things as the names of the general and limited partners and their respective shares of contributions and profits.

**Certificate of Limited Partnership**

Under California law, a Limited Partnership is formed when it files a certificate of limited partnership (Form LP-1) with the Secretary of State with a filing fee. The certificate must be signed by the general partners and must show their names and addresses and the partnership’s principal place of business.

**Fictitious Business Name Statement**

If the name of the Limited Partnership will not be the same as the name contained in the certificate of
limited partnership filed with the Secretary of State, then the partnership must file a Fictitious Business Name Statement ("DBA"). As discussed earlier, the DBA statement must be filed with the County Clerk or County Recorder where the principal place of business is located, and a notice must be published in the newspaper. For more information on how to file a “DBA Statement”, visit http://www.calgold.ca.gov, which tells you where to go to file the statement and the cost of filing one (excluding the newspaper publication fee).

Employer Identification Number

Because a Limited Partnership has some characteristics of a separate legal entity, a separate Employer Identification Number (EIN) is necessary. Contact the IRS by telephone, fax, or mail, or visit the IRS website, as mentioned earlier.

Business License

A business license is also required. As previously discussed, you contact the City Clerk’s Office for the business license. Remember to ask if you need any other licenses (e.g. a liquor license) for your particular business.

Corporations

What is a corporation?

A corporation is a legal entity separate from the individuals who own or operate it. The shareholders (people who invest money in the company) are the owners of the corporation. These investors are given shares of corporate stock in return for the money they invest. Having shares of stock gives the investors certain rights, such as the right to vote on important business decisions, and the right to receive dividends. Dividends are profits which the corporation pays out to its shareholders. Corporate profits are taxed at the corporate level and again at the shareholder level. This tax burden and a solution are discussed later in this chapter.

Corporations that do not offer shares to the general public are called privately held corporations. If you have a privately held corporation, you may own all the stock in your corporation, or you and several other people may own the stock.
In a privately held corporation you, the owner, may be the only employee, or you may hire other workers. Generally, in a privately held corporation, the directors, officers, and shareholders are the employees of the corporation as well. They receive wages or a salary from the corporation. The corporation also may pay out dividends to the shareholders if the corporation makes a profit.

Large corporations, such as those found on the stock exchange, are publicly held. They sell stock to the general public and anyone can buy shares. There is no limit to the number of potential shareholders in a public corporation. Privately held corporations are subject to limits under securities laws regarding who and how many people may hold shares, as discussed below. For purposes of this brochure, the following information pertains to privately held corporations.

**Corporate Shareholders Have Limited Personal Liability**

As a separate legal entity, the corporation is responsible for its own debts. Normally, the shareholders, directors, and officers are not personally liable for the corporation's debts. Therefore, they have limited personal liability, meaning that they are liable only for the money they have invested in the corporation. Creditors of the corporation cannot recover from their personal assets to repay corporate debts. This limited liability is the most advantageous feature of incorporating your business.

Note, however, that exceptions to this rule exist. First, shareholders and officers are personally liable for paying the corporation's payroll taxes, which are the taxes which the corporation must withhold from its employees' wages. So make certain that your corporation's payroll taxes are paid accurately and on time.

Second, a shareholder might lose the protection of limited liability if she "commingles," or mixes together, her personal money with the corporation's money. So, always keep your corporate and personal financial accounts separate so that you keep your limited personal liability. If you commingle your funds, you could be personally liable for the corporation's debts.

**EXAMPLE:** You are a shareholder in a privately held corporation and also manage the day-to-day affairs. One day, you realize the corporation has a utility bill that is due immediately, but does not have enough money to cover the bill. So you write a check from your personal checking account. The next month, a customer writes the corporation a check in the amount you are owed, and you deposit the check into your account. Both of these acts are examples of commingling funds, and you may lose the protection of limited liability. This would make you liable for the corporation's debts.

Finally, you are personally liable for your corporation's debts if you personally guarantee them. You may decide to borrow money from a bank to finance your business. If you sign loan papers in which you "personally guarantee" repayment of the loan, the bank can come after your personal assets to repay the loan. Most banks will require you to sign such a form if you accept a business loan from them, so you probably can't avoid this situation.
How Does a Corporation Pay Income Taxes?

Because a corporation is a legal entity separate from its owners, the corporation itself pays income taxes. For federal tax purposes, corporate income and expenses are reported on IRS Form 1120. Additionally, shareholders must pay taxes on any dividends which the corporation pays out to them. This process of paying taxes twice is called "double-taxation."

In practice, however, a privately held corporation might not pay any federal income taxes at all, or at least very little, because many of the expenses are deductible. For example, the corporation can deduct salaries, rent and certain employee benefits (such as sick pay, life insurance, health insurance, disability benefits, and pension benefits) as a business expense as long as the costs are reasonable. After these expenses are deducted from the corporation's income, often very little taxable income is left over upon which the corporation must pay taxes (employees pay taxes on the wages paid to them). It is a good idea, however, to keep some profits in the corporation for future expenses. If you pay out all of your corporation’s income to employees as compensation or benefits, the IRS might suspect improper “excessive compensation.” Year end, retroactive salary bonus payments are particularly suspicious.

In addition to federal taxes, California imposes a franchise tax on corporations doing business in California, which is also generally calculated based on income. However, except for the first year of incorporation when no minimum tax is due, a California corporation must pay a minimum state franchise tax (currently $800 per year) each subsequent year, regardless of its income for the year. Even though the minimum tax is not due during the first year, the corporation may still be required to make estimated tax payments that year, based on its income.

You may decide to keep some money in the corporation as retained earnings and thus not take all of it out as salary or compensation. Although the corporation itself must still pay taxes on the retained earnings, the tax rates are favorable. Currently, corporations earning less than approximately $100,000 pay less in taxes than individuals because the tax rate for that income level is lower for corporations than individuals.

EXAMPLE: You are the President of your corporation. The corporation needs some capital (money) to buy supplies. Because you are short of money, you delay paying some of the corporation's bills, including your payroll taxes for the quarter. In the meantime, you are approved for a bank loan. The bank requires you to sign a personal guarantee for that loan. In this situation, you are personally liable for the late payroll taxes. The state can come after your personal assets to get those payroll taxes paid. Additionally, if your corporation "defaults" on its bank loan (misses payments or stops paying completely), the bank can come after you personally to make the repayments.
A Corporation's "S Election" for Tax Purposes

A corporation can make a special federal and state tax election to change its tax status. This converts a regular corporation ("C" corporation) into an "S" corporation. For income tax purposes, the "S" corporation is treated as a sole proprietorship or partnership. The "S" corporation does not pay income tax. Instead, the income and expenses are passed through to the individual shareholders and are taxed at the individual rate. There are several limitations on "S" corporations. For example, an "S" corporation may only have a maximum of 100 shareholders as of 2004. All of the shareholders must be individuals who are citizens or legal permanent residents of the United States, or certain tax-exempt organizations. Moreover, an "S" corporation may only have one class of stock.

An "S" corporation is particularly advantageous for new businesses that generate operating losses. The losses are passed through to the shareholders who can deduct them against other income. The shareholder must personally be involved in the corporation’s business activity on a regular basis to take advantage of this deduction and cannot deduct losses exceeding her actual investment.

There are two disadvantages to an "S" corporation compared to a "C" corporation. First, certain business expenses, such as employment benefits, are not deductible by the corporation. Second, there is no favorable tax rate for money kept in the business as retained earnings. Shareholders must pay income tax on their share of the corporation’s income, regardless of whether the money was paid out or kept in the corporation as retained earnings.

What Happens to the Business if a Shareholder Dies?

The death of a shareholder does not affect the business at all. A shareholder can freely transfer or sell her shares to others. These transactions have absolutely no effect on the continuation of the corporation.

Corporate Paperwork

A corporation must meet many formal legal requirements. To create a corporation, you must file Articles of Incorporation with the Secretary of State. The person(s) who incorporates the business by filing the Articles is called the "Incorporator(s)." The corporation also must prepare written Bylaws and elect a Board of Directors. Corporate Bylaws describe the details about the corporation, such as when meetings will be held, how many Director positions will be cre-
ated, and the duties of the Officers. The Board of Directors manages the corporation, makes important decisions for the business, and holds regular meetings.

The officers of the corporation act on behalf of the Board of Directors and generally are responsible for managing daily business operations. In California, corporations are required to elect certain officers: the President, who generally is the Chief Executive Officer; the Chief Financial Officer, who handles the corporate finances; and the Secretary, who manages the corporate records. You may also elect other positions, such as a Vice President.

A corporation must hold regular board meetings for the Board of Directors to meet and discuss the business. An annual meeting must also be held at which shareholders can vote on major issues. All substantial corporate actions must be approved by the Board of Directors, and then approved by the shareholders. At each meeting, the corporate Secretary must keep minutes of the meeting. Minutes describe what was discussed, what issues were voted on, and what actions were or will be taken.

The Step-By-Step Process For Establishing a Corporation

**Articles of Incorporation**

You must prepare written Articles of Incorporation, signed by the Incorporator(s) and each director named in the Articles. You do not need to name the directors in the Articles but if you do, they must sign the Articles. The Articles must include certain basic information and must be filed with the Secretary of State to legally establish the corporation. The Articles can be filed in person at the local branch offices of the Secretary of State or by mail to the Secretary of State’s Sacramento office. You must pay a filing fee when you file your Articles of Incorporation. As of 2004, the filing fee is $100.

**Corporate Bylaws**

Bylaws must be created to specify the rules for your corporation. The Board of Directors must approve them, but the bylaws do not need to be filed with any agency. The Bylaws must be kept at your principal business office.

**Initial Meeting of Board of Directors**

The Board of Directors should hold a meeting to complete the organization process, such as electing the corporate officers, authorizing opening a bank account, and issuing stock.

**Employer Identification Number**

As with the other business structures, an Employer Identification Number must be obtained. You can call, mail, or fax the IRS to obtain the SS-4 Form.
"S" Corporation Tax Status

If you want to become an "S" corporation, you must submit forms to the IRS and the California Franchise Tax Board to make the “S” election. The IRS form is the Form 2553 and the Franchise Tax Board form is the FTB 3560. You must file the form with the IRS before you file the FTB form.

Stock

You must prepare Stock certificates and issue them to the shareholders. It is important to comply with both state and federal securities regulations. You should contact an attorney to make sure you follow the securities rules.

Part Two: Guide to Forming a Charitable Tax Exempt Nonprofit Organization

Introduction

The purpose of this guide is to help you decide whether to form a nonprofit organization and, if so, whether it should be organized as a nonprofit corporation. It will also explain the basic steps required to form a California nonprofit corporation and to secure tax-exempt status from the state of California and the federal government.
Initial Considerations to Forming a Nonprofit Corporation

Is the organization necessary?

The first question is whether there is a need in the community for this new organization. Some of the factors to consider in answering this question are:

- What is the primary purpose to be served by your organization?
- What is the community that will be served by this organization?
- Does the community have a need?
- Are there competing organizations that are already providing the same or similar services to this community?
- Is there a strong commitment from the organizers and participants to build your organization?
- Is there an adequate source of funds to support the organization?

Should you form a nonprofit corporation?

Once you have determined that there is a need for your organization, the next question you must consider is whether to form a nonprofit corporation for your organization. If your project is for a short duration or you are uncertain as to the ability to fund your project, you may consider alternative ways to operate your organization.

Alternatives to Incorporation

Fiscal Sponsorship

Can your goals be achieved by joining with an existing organization? If you meet certain requirements, you may be able to align with an existing organization and operate under its tax exempt status. Under this alternative your organization is operating under the “umbrella” of the existing organization, also known as a “fiscal sponsor.” The advantage of following this procedure is that it provides you with the time to grow and develop your organization. When the organization has built a solid foundation it can then incorporate and operate as a separate and independent entity.
Unincorporated nonprofit association

It is possible to form and operate the organization as an unincorporated nonprofit association. The association can be organized easily and informally and without the necessity of filing with the state of California. It can operate without the mandated formalities of a corporation. A major disadvantage to the unincorporated association is that its members would not be protected from legal liability for their acts or the acts of the association. Another disadvantage is the uncertainty as to the law that applies to this type of organization and the difficulty of creating documents that solve the uncertainties and protect its members. This type of structure would only be recommended for a small or short-term project.

What is a nonprofit corporation?

A corporation is a legal entity created under state laws. A corporation is composed of a Board of Directors and officers. The Board of Directors is responsible for the oversight and supervision of the officers and employers. The officers are responsible for the day-to-day operations of the corporation and supervision of employees. An important distinction between nonprofit and for-profit corporations is that a for-profit corporation has shareholders who are the owners of the corporate property.

A corporation is treated as legally separate from the people who own, manage and operate it. The corporation is able to enter into contracts, incur debts, and pay taxes just like any person. The corporation’s rights and obligations are separate from those of the people who own or run the corporation. In other words, if the corporation were to lose a lawsuit, the people who work there, manage, or own it would not be personally financially accountable, with some exceptions.

A nonprofit corporation is one that is organized and operated for one of the nonprofit purposes recognized under state corporation law and federal and state tax statutes. What makes a corporation “nonprofit” is that (a) the mission of the corporation is to undertake activities whose goal is not primarily to earn a profit; (b) no person owns shares of the corporation or interests in its property; and (c) the property and any income of the corporation are not distributed to any “owners,” but instead are recycled into the corporation’s activities. This does not mean that the nonprofit corporation cannot make a profit.

A nonprofit corporation may earn money as long as it is organized and operated for a recognized nonprofit purpose (for example, an educational or charitable purpose) and earnings are put back into the nonprofit corporation’s charitable activities, rather than dis-
California recognizes three types of nonprofit corporations. They are public benefit, mutual benefit (benefiting members only), and religious. Since this chapter is designed to assist in the creation of organizations intended to promote public benefit purposes, we will only discuss public benefit nonprofit corporations. Examples of groups with public benefit purposes are childcare centers, shelters for the homeless, community health care clinics, museums, hospitals, schools, performing arts groups, conservation groups, and low-income housing groups, to name a few. We will discuss various definitions of public benefit purposes in Section 11 (Obtaining Tax Exemption) below.

Nonprofit Incorporation Under California Law

State law governs the powers and characteristics of corporations.

Nonprofit Public Benefit Corporations

A nonprofit public benefit corporation offers some important benefits as a result of its corporate and tax exempt status.

Some of the advantages of becoming a nonprofit public benefit corporation include:

Limited Liability

Limited liability means that the owners have limited personal liability for business debts. Creditors can only go after corporate assets to satisfy liabilities incurred by the corporation.

Exemption From Income Tax

If the corporation satisfies federal and state requirements, the corporation will not be required to pay taxes on its earned income. This will be discussed more extensively below.

A nonprofit corporation may make a profit!

Limited liability means that the owners have limited personal liability for business debts.
Contributions Are Tax Deductible

If there are private persons or entities that want to contribute to your organization, they may deduct contributions from their taxable income. This is a great tool for encouraging contributions.

Tax-Deductible Benefits for Employees and Officers

Employees and principals of the corporation may be eligible for tax-deductible fringe benefits, including: sick pay, group life insurance, accident and health insurance, payment of medical expenses, and coverage by an approved corporate employee pension or retirement income plan.
Special Characteristics of Nonprofit Public Benefit Corporations

The nonprofit corporation, in a sense, is “owned” by the public. No private person can claim ownership of the corporation. The nonprofit corporation is managed and controlled by its Board of Directors.

The assets of a nonprofit corporation are irrevocably dedicated to charitable, scientific, and educational purposes. That means the nonprofit’s cash, equipment, and other property cannot be given to anyone or used for anyone’s private benefit and, moreover, that this property is permanently to be used for exempt (charitable) purposes. When and if the corporation decides to dissolve, any assets remaining after the debts and liabilities are paid must go to another public benefit organization—not to any members of the former corporation or to a for-profit buyer.

The California Attorney General has power to oversee the operations of public benefit corporations and can commence legal actions against the corporation to make sure it complies with the law.

If any of the directors are to be compensated as officers or employees of the corporation, an independent Board of Directors must approve such compensation. An independent Board of Directors requires that not more than 49 percent (in other words, less than half) of the Board of Directors are paid or related to other persons who are paid employees or officers of the corporation. For example, if there are five directors on a board, no more than two can receive a salary as an officer or employee.
Obtaining Tax Exemption

Tax Exemption Under California Law

California corporations are subject to an annual corporate franchise tax on the net income of the corporation. California nonprofit corporations can apply to be exempt from paying this annual franchise tax.

California tax law exempts the same type of groups as are covered by Section 501(c)(3) of the Federal Internal Revenue Code -- religious, charitable, scientific, literary and educational organizations.

Tax Exemption Under Federal Law

For most groups, the preferred form of tax exemption is under Section 501(c)(3) of the Internal Revenue Code (IRC). This is reserved for groups performing public benefit activities and refraining from significant political activities. Corporations exempt under § 501(c)(3) do not pay income taxes and donors to such corporations can deduct their contributions from their taxable income. Nonprofit corporations engaging in substantial political activities can be exempt from paying tax on income, under IRC § 501(c)(4), but their donors cannot deduct contributions from their taxable income.

We will first briefly discuss the range of public benefit purposes, which may be exempt under § 501(c)(3), and then we will go into greater detail regarding possible exemption for nonprofit community development corporations.

Public Benefit Purposes

Tax exempt status under § 501(c)(3) is available to groups organized and operated for religious, charitable, scientific, educational, or literary purposes. We will briefly discuss charitable purposes, educational purposes, and literary purposes.

Charitable Purposes

Charitable purposes are broadly defined as services that are beneficial to the public interest. To meet the requirements, the group’s purpose must be beneficial to society and the group must serve an open class of people, not a limited number of group members. For instance, an organization established to provide food to the homeless in the community would be a charitable organization, but an organization established to provide food to Paul, Henry and Mary would not be. The beneficiary class needs to be open and unspecified, but does not have to be large. An organization established to feed the hungry in a certain two-block area would also qualify as a charitable organization.
**Examples of charitable purposes include:**

- Relief of the poor, distressed, or under privileged;
- Advancement of education or science;
- Erection or maintenance of public buildings or monuments;
- Lessening the burdens of government;
- Elimination of prejudice and discrimination;
- Promotion and development of the arts; and
- Defense of human and civil rights secured by law.

**Educational Purposes**

Educational purposes include instruction of the public on subjects useful to individuals for the benefit of the community and for self-development. The IRS allows a curriculum to present particular viewpoints if there “...is sufficiently full and fair exposition of pertinent facts to permit an individual or the public to form an independent opinion or conclusion.” However, mere presentation of unsupported opinion is not considered educational.

Some examples of educational purposes include:

- Publishing public interest educational materials that do not conflict with the requirement above;
- Conducting public discussion groups, forums, panels, lectures, or workshops;
- Offering a correspondence course or one that uses other media such as television or radio;
- Operating a museum, zoo, planetarium, symphony orchestra, or other performance groups;
- Serving an educational institution, such as a college bookstore, alumni association, or athletic organization;
- Publishing educational newsletters, pamphlets, books, or other material.

**Literary Purposes**

Usually nonprofit organizations fall under educational purposes when they involve books and reading. However, some organizations may want to publish books that are geared to the benefit of the public interest. As long as the organization does not target its activities to commercial markets and sells the publications at a modest price, public interest publishing groups can obtain tax exempt status. Some examples include publishing material on environmental preservation, highway safety, or drug and alcohol abuse information.

**Community Development Organizations**

An important category of charitable purposes is community development, such as job training, small business assistance, or developing affordable housing. Essentially, there are four independent bases for federal tax exemption for community development.
corporations and nonprofit housing organizations:

- Relieving the poor and distressed,
- Combating community deterioration,
- Eliminating discrimination, and
- Lessening the burdens of government.

Relieving the Poor and Distressed

The difficulty with this category is determining whether an individual or family is “poor and distressed.” The IRS defines “poor and distressed” as the inability to afford the “necessities of life” without undue hardship. Factors such as a lack of adequate housing, chronic unemployment or underemployment, and the identification of an area as economically disadvantaged by a government agency are relevant considerations in the granting of tax-exempt status.

Combating Community Deterioration and Eliminating Discrimination

Under this area of exemption, organizations can claim tax exemption on the basis of their social welfare activities, and thereby avoid the need for a determination as to whether the resident population served meets the undefined IRS standard of “low income” or “poor and distressed.” Examples include organizations which erect or rebuild housing in a deteriorated area, or sponsor efforts to promote racial integration, stabilize the neighborhood, and provide social services to area residents.

Lessening the Burdens of Government

To qualify under this category, an organization must meet a two part test: (1) the government must consider the activities to be the government’s responsibility, and (2) the activities must actually “lessen” the burden. The best way to establish an activity as a government burden or duty is to find a government rule or policy that applies to the particular activity (such as a local housing or economic development plan or policy). Other relevant factors include a governmental unit’s prior involvement in an activity on a regular basis for a significant length of time; the funding of an organization’s activities by the government; and an activity which is one that could be performed directly by a governmental unit.

The second test is whether the organization’s activities “lessen” the burden when viewed under all the circumstances. Basically, the group’s activities must directly address the burden. It will also be helpful if an organization has a favorable relationship with the government or enables the government to improve its functions without additional expenditures of government funds.

The provision of affordable housing for low income families has historically been considered a governmental function. (For example, look at the federal...
agencies dealing with housing, such as HUD, the Farmers’ Home Administration, etc.) Increasingly, encouraging job creation and growth of small business is also a goal of government, and so economic development corporations also should have a strong claim that they lessen the government’s burden.

**Social Welfare Organizations Under IRC § 501(c)(4)**

Another category of nonprofit organizations whose purposes include pursuing public benefit is a social welfare organization or civic league. These organizations receive slightly different tax treatment than IRC § 501(c)(3) nonprofits because their activities are directed more toward their members or toward influencing public opinion and the legislative process. Tax exemption is offered to such groups under IRC § 501(c)(4) if they, “. . . operate primarily to further (in some way) the common good and general welfare of the people of the community (such as by bringing about civic betterment and social improvements).” Section 501(c)(4) organizations may engage in political activities, although that may not be their primary activity.

Some examples of § 501(c)(4) social welfare organizations include volunteer fire companies, community associations, crime prevention associations, or organizations interested in promoting industrial development in a community.

A major difference between 501(c)(4) and 501(c)(3) organizations is that donations to 501(c)(4) organizations are not tax deductible. This is an important factor to consider when setting up a nonprofit organization.
Articles of Incorporation

Prepare the Articles of Incorporation that are to be filed with the Secretary of State’s office. The Articles of Incorporation establish the formation of the corporation and state its broad purposes. Articles of Incorporation must contain and meet certain statutory requirements.

Filing Articles

Once the Articles are prepared, they can be mailed to the Secretary of State’s office at 1500 11th Street, Sacramento, CA 98514, Attn: Document Filing. A $30 filing fee must accompany the Articles. Documents may be hand delivered to any Secretary of State’s office location for an additional $15 over-the-counter processing fee.

The original and at least four copies of the Articles of Incorporation should be included with your submittal. The Secretary of State will certify as true and correct two copies of the filed document without charge, provided that copies are submitted to the Secretary of State with the original Articles to be filed. Any additional copies submitted with the original filing, or at a later time, will be certified upon request and payment of the $8.00 per copy certification fee.

Minute Book

Obtain a minute book in which the corporation will keep the minutes of its Board of Directors’ meetings and other documents such as Articles of Incorporation and bylaws. This can be a minute book obtained at an office supply store, or even a three-ringed binder in which you insert signed copies of the meeting minutes.

Draft and Adopt Bylaws for the Corporation

In general, the Bylaws set out the rules and operating procedures for the activities and conduct of the corporation. They serve three purposes: (1) to provide rules for matters not covered by state law; (2) to alter specific rules that control in the absence of a contrary bylaw; and (3) to provide a ready reference to the governing laws and rules for the corporation’s attorney, directors, and officers.

Board of Directors’ Meeting

At the first meeting of the board, the directors must approve certain activities necessary to set up and run the nonprofit’s operations, and must give specified people (“officers”) the authority to do those things.
Minutes of this and all meetings of the Board of Directors should be recorded and filed in the corporation’s minute book. For example, the directors should:

- Accept their election as directors (if they did not already do so when the Articles were filed);
- Approve the Bylaws;
- Elect officers to manage the corporation’s day-to-day operations;
- Authorize officers to set up bank accounts for the corporation’s expenses;
- Set compensation amounts (wages or salary), if any, for the officers;
- Determine the exact location of the principal office;
- Authorize the officers to prepare and file the applications for tax exemption; and
- Any other items requiring approval by the Board of Directors.

Apply for a Federal Employer Identification Number (EIN)

All tax-exempt organizations (with or without employees) must obtain a Federal EIN. You will use this identification number on all your federal tax returns and reports.

To obtain an EIN you will need to complete and submit IRS Form SS 4. Call the IRS toll-free number, (800) 829-3676, or visit its Website, www.irs.gov, to obtain the form. To receive an EIN immediately, you may use the telephone or on-line registration procedures described in the instructions for Form SS-4. If you register by telephone, you will still need to submit an original signed copy of the Form SS-4 to the IRS.

Apply for Federal Tax Exemption

This means filing for 501(c)(3) or 501(c)(4) tax-exempt status. We have already discussed the IRS requirements, so here we will simply explain some requirements of the filing process.

In order to obtain federal tax-exempt status, you must complete and file Form 1023 with the IRS. Call the toll-free number, (800) 829-3676 or visit the IRS Website at www.irs.gov to obtain the form. When you have completed the form, mail it with payment of the filing fee to:

Internal Revenue Service
P. O. Box 192
Covington, KY 41012-992

If you are using express mail or a delivery service, send the application form to:

Internal Revenue Service
Attn: Extracting Stop 312
201 W. Rivercenter Blvd.
Covington, KY 41011
Signature requirements:

Form 1023 must be signed by a principal officer of the corporation, an authorized employee, or by an attorney or agent given the power of attorney to act for the corporation. If an agent with power of attorney signs the application, then the original Power of Attorney document must be attached to the form.

You must also include with Form 1023 the following:

• A certified copy (certified by the Secretary of State) of the articles of incorporation;

• A copy of the bylaws, signed by a principal officer or accompanied by a written declaration signed by an authorized officer of the corporation certifying that the document is a complete and accurate copy of the original Bylaws. If the Board of Directors has not yet approved the Bylaws, a copy of the proposed bylaws will suffice.

• The application fee for the Form 1023, which depends on the projected gross receipts of your organization. The fee is $150 if an exempt organization has had annual gross receipts averaging not more than $10,000 during the preceding four years or a new organization with anticipated gross receipts averaging not more than $10,000 during its first four years. The fee is $500 if an exempt organization has annual gross receipts averaging more than $10,000 during the preceding four years or a new organization that anticipates gross receipts averaging more than $10,000 during its first four years.

Apply for California Franchise Tax Exemption

The corporation must complete FTB Form 3500 and file it with the California Franchise Tax Board (FTB) along with a $25 application fee. The Form should be mailed to the FTB at the following address:

FTB – Exempt Organization Section
P. O. Box 942857
Sacramento, CA 94257

If you have any questions, call the California Franchise Tax Board toll-free number: (800) 852-5711 or visit its web site at www.ftb.ca.gov.

Maintaining Your Tax-Exempt Nonprofit Status

Nonprofit, tax-exempt corporations must file certain forms every year in order to remain in good standing. These forms are discussed below:

Federal Forms:

Annual Exempt Organization Returns (IRS Form 990)
Public benefit corporations exempt from federal income tax under § 501(c)(3) must annually file IRS Form 990 (Return of Organization Exempt from Income Tax) and the accompanying Schedule A within four and a half months following the close of the organization’s tax year. This form is an informational return providing the IRS with information about your finances and activities. Some organizations, such as churches, schools, and any organization whose gross receipts normally are not more than $25,000 in each taxable year, are not required to file the Form 990.

**Unrelated Business Income Tax Return (Form 990-T)**

Section 501(c)(3) organizations having annual gross incomes of $1,000 or more from unrelated trade or business activities must file an Exempt Organization Business Income Tax Return (Form 990-T). The obligation to file Form 990-T is in addition to the obligation to file the annual information return. Tax-exempt organizations must make quarterly payments of estimated tax on unrelated business income. An organization must make estimated tax payments if it expects its tax for the year to be $500 or more. The Form 990-T must be filed by the 15th day of the 5th month after the organization’s tax year ends. The organization must pay federal income tax on the unrelated business income at the same rate as the normal corporate federal income tax. If your organization has a significant amount of unrelated business income, the IRS may think that you are spending a “substantial” amount of time on nonexempt activities, which might jeopardize your tax exemption.

**California Forms:**

**Annual Exempt Organization Returns (FTB Form 199)**

Any organization that must file the IRS Form 990 must file the FTB Form 199, which is California’s version of the Form 990. The exemptions from the filing requirements for this form are similar to the IRS exemptions for filing Form 990. For example, if your organization’s gross receipts are normally not more than $25,000 in each tax year, you do not need to file the form.

**Unrelated Business Income Tax Return (Form 109)**

If your corporation’s gross income from an unrelated trade or business is $1,000 or more during one year, you must file an annual Exempt Organization Business Income Tax Return, Form 109. This return must be filed within four and a half months after the end of the organization’s tax year. Payment of the tax on the income must be estimated and paid during the year for which the tax is due.

**Statement By Domestic Nonprofit Corporation**

When the Articles have been filed and are returned to you by the Secretary of State, a Statement by
Domestic Nonprofit Corporation Form will be included. This Form must be completed and returned to the Secretary of State’s office along with a $20 filing fee within the time specified on that Form. Failure to comply with the filing deadline will subject the corporation to a penalty charge. Thereafter, the Form should be updated with any changes. The Secretary of State also requires this filing to be made every two years during the anniversary month of the incorporation.

Registration with and Annual Periodic Report to Attorney General (Forms CT-1 and RRF-1)

Generally, each nonprofit public benefit corporation must register with the Attorney General’s Registry of Charitable Trusts by filing Form CT-1 within 30 days after first receiving any assets. Thereafter, the corporation must file a Form RRF-1 with the Registry of Charitable Trusts by January 15 of each year. The registrar of Charitable Trusts should mail this form to the organization’s principal place of business each year. Nonprofit corporations that have assets or revenues of at least $100,000 during the preceding fiscal year are required to pay a $25 annual registration fee, which must be enclosed with the Form RRF-1. Failure to file the Form RRF-1 or pay the $25 registration fee (if required) may result in a loss of tax exemption and an assessment of a minimum tax of $800 plus interest. Nonprofit organizations also submit to the Attorney General all IRS Form 990, 990EZ or 990PF, and schedules filed with the IRS. These documents must be filed within four months, and fifteen days after the close of the corporation’s fiscal year unless the corporation gets an extension to file its tax returns with the IRS.

How to Find Help

Public Counsel’s Community Development Project (CDP) can assist you with the completion of your filings or we can provide qualified proposed nonprofit organizations with pro bono legal assistance. CDP can also assist with other corporate legal issues, from amending bylaws to large transactions like an affordable housing project. For more information, please call the CDP Hotline at (213) 385-2977, ext. 200.

If you decide to perform all the work required to form a nonprofit corporation yourself, we strongly recommend that you obtain a copy of The California Nonprofit Corporation Handbook, published by Nolo Press, written by Anthony Mancuso, Esq. You can find it in the reference section of your local library or at almost any bookstore. This book will take you step-by-step through the process of forming a nonprofit corporation and applying for tax-exempt status.
Part Three: Obligations and Possible Liabilities of Directors and Officers of Public Benefit Corporations

Introduction

This guide will address the duties and obligations of directors of public benefit and religious corporations, that is, those nonprofit corporations formed for public or charitable purposes, or for religious purposes. Of course, not all nonprofit corporations are charitable. Indeed there are three categories of nonprofit corporations under California law: (i) organizations established for a charitable or public purpose (“public benefit corporations”); (ii) organizations established to pursue religious purposes (“religious corporations”); and (iii) associations established to benefit their members as a group, such as trade associations or homeowners associations (“mutual benefit corporations”). (Where relevant, we will note different standards applicable to religious corporations, so that this outline may also be useful to religious organizations operating charitable programs. We will not comment on standards specific to mutual benefit corporations.)

Public Benefit and Religious Corporations

A public benefit or religious corporation differs from a for-profit corporation in that it is not “owned” by anyone. As such, its purpose is not to enrich shareholders but to promote certain charitable ends. Accordingly, directors of such a corporation are required to pursue only the corporation’s charitable purposes and not use the corporation as a vehicle to pursue their own business interests or those of the organization’s members, if any.

Supervision by California Attorney General

The Attorney General is the legal overseer of charities that do business in California. The Attorney General may investigate public benefit corporations at any time to see whether they have departed from their charitable purposes. Public benefit corporations must notify the Attorney General if all of the corporation’s assets are sold. The Attorney General may examine the corporation’s handling of assets dedicated to charitable purposes.)
Responsibilities and Powers of Directors

The board of directors of a public benefit or religious corporation is responsible for planning and directing the organization’s management and its activities. The board of directors acts as a group. Individual directors have no power to take actions that bind the corporation unless they have been authorized by the board to act on behalf of the corporation. Directors do not have to directly manage the affairs of the corporation. They may delegate such duties, but the board is still accountable to the corporation for the performance of those duties.

Perhaps the most important aspect of the directors’ obligations is to ensure that the corporation properly pursues its public, charitable or religious purposes. If the corporation undertakes activities unrelated to its public, charitable or religious purposes, or directed to someone’s individual benefit, the directors may be liable for breach of their duty of care or their duty of loyalty.

Duties and Powers of Officers

Every public benefit and religious corporation must have certain officers: a chairperson or a president (or both), a chief financial officer and a secretary. These officers are not required to be directors serving on the board. The board of directors of the corporation has supervisory authority over the officers. Officers of a public benefit and religious corporation are officers of the entire corporate entity, not just officers of the board of directors. The officers have responsibilities and liabilities directly related to the corporation’s operations.

Directors’ Duties to the Corporation

Although the board of directors can only act as a unit, directors can be liable as individuals for breaches of their duties to the corporation or to third parties. (E.g., such as the duty not to cause harm to others negligently).

Directors of public benefit corporations must make decisions in the following manner:

• In good faith, in a manner that the director believes to be in the best interests of the corporation; and
With such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. (Please note: the standard of care is slightly different for religious corporations—a director of such a corporation must act with such care as is appropriate under the circumstances.)

**Duty of Loyalty**

The first requirement, that directors, “act in good faith, in a manner that the director believes to be in the best interests of the corporation,” requires that, when acting in the capacity of a director, a director’s actions must be motivated only by concern for the best interests of the public benefit or religious corporation. Directors must pursue these interests irrespective of any personal interests (direct or indirect) that they may have.

It is best for directors and officers to avoid even the appearance of a conflict of interest between their personal interests and the interests of the corporation. The California Corporations Code specifies heavy penalties for directors that engage in “self-dealing” transactions, which are those transactions in which the corporation is a party and one or more directors have a material financial interest. Unfortunately, the California Corporations Code does not define material financial interest. To be safe, directors and officers should not use common sense as a guide, but rather should follow the rules set forth below for all transactions in which they have any financial interest.

**Transactions Involving Directors**

**“Self-Dealing”**

Directors of public benefit or religious corporations, like directors of for-profit corporations, must avoid participating in or attempting to influence any decision in which they have a financial interest distinct from the corporation’s interest (also termed “self-dealing” transactions).

Self-dealing does not include any of the following types of transactions:

- Determination of the compensation of officers or directors;
- Transactions that are part of the corporation’s public, charitable or religious programs that benefit a class of persons to which directors or their families belong;
- Transactions about which interested directors do not know and the value of which do not exceed 1 percent of the corporation’s gross annual receipts or $100,000, whichever is smaller.
If a “self-dealing” transaction is in the best interests of the corporation and also would benefit a director, that transaction is permissible, so long as the other directors who have no interest in the transaction are informed of the possible conflict of interest and approve of it. If a director does not follow the above rule, a court may hold the director liable for any losses suffered by the corporation as a result of the self-dealing transaction. To avoid penalties for self-dealing, the proposed transaction must be approved by the board, the Attorney General, or a court, in one of the following ways:

(1) Approval, before completion of the transaction, by the disinterested board members, who must find that:

• The corporation entered into the transaction for its own benefit;

• The transaction is fair and reasonable; and

• The corporation could not have found a better deal with reasonable effort;

(2) If immediate action is necessary and a full board meeting is not practical, before the transaction has been completed, approval by a committee having the authority of the board (e.g., an “executive committee”), so long as, shortly thereafter, the full board ratifies the committee’s approval based on the same findings as in #1, above; or

(3) Approval at any time by the Attorney General, or by a court in a legal action in which the Attorney General is an indispensable party.

It is common for directors to serve on the boards of other corporations, including for-profit corporations and other nonprofit corporations. A public benefit or religious corporation may engage in a transaction with another corporation with which it shares a common director, so long as (i) prior to conclusion of the transaction, the common director discloses the possible conflict and the transaction is approved by the rest of the board or by a committee of the board or (ii) after the transaction has been concluded, the board or a committee approves of the transaction upon finding that it was fair and reasonable to the corporation.

Loans or Guarantees to Directors

A public benefit corporation may not make loans to directors or guarantee their obligations unless the corporation first obtains approval of such a loan or guaranty from the Attorney General. A religious corporation, on the other hand, may do so, so long as
the directors meet the general duty of care in considering whether it is appropriate for the corporation to make such a loan or guaranty.

Directors of public benefit corporations who approve or do not vote on a loan or guaranty to a director are “jointly and severally liable” to the corporation for any losses associated with the loan or guaranty. This means both that (1) the directors are liable as a group to repay the amount distributed and (2) each individual director is separately liable for the full amount. Directors of a religious corporation who approve a loan or guaranty to a director that is not “appropriate in the circumstances” are also jointly and severally liable to the corporation.

Public benefit corporations may, however (without obtaining prior approval of the Attorney General), (i) advance funds to directors or officers for reimbursable expenses, (ii) obtain and pay premiums on a life insurance policy insuring the life of a director or officer, so long as the corporation is the beneficiary of the policy and (iii) lend money to an officer for the purchase of the officer’s principal residence if the loan is secured by that residence and the board determines that the loan is necessary in order to secure the services of the officer.

Usurping a Corporate Opportunity

A director who, through his or her position as a director, becomes aware of a business opportunity that would be beneficial to the corporation must not take advantage of that opportunity unless he or she first tells the other directors about the opportunity and the board of directors declines to act upon it.

If a director takes the opportunity without first telling the other directors and allowing the public benefit or religious corporation to consider the opportunity, that director would be guilty of inappropriately taking a “corporate opportunity.” In practice, however, it is unlikely that such a situation would arise, primarily because nonprofit corporations do not commonly have profit-making opportunities of which they can legally take advantage. In the interest of avoiding any appearance of a conflict of interest, directors should disclose any opportunities that they discover while acting in their capacity as directors.

Embezzlement and Fraud

Directors may also be liable for embezzlement, fraud or misrepresentation. Directors are liable to the corporation or to those who are harmed by false statements, reports or entries in the corporation’s records that the directors know are false or that they make to deceive. The Attorney General may investigate and file suit against directors who commit such acts. Directors who knowingly deceive the corporation, its members, or creditors, or who knowingly go along with such deception can be fined and/or imprisoned.

Duty of Care

The second requirement, that directors, “act with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use
under similar circumstances,” means that directors must take a certain level of care in making their decisions. This requirement is commonly referred to as the “duty of care.” This duty dictates that each director of a charitable corporation act as would a “prudent person,” meaning a careful person. Obviously, it would not be prudent for a director to make important decisions without first gathering enough information to make an educated or informed decision. The duty of care requires that a director do so.

Further, if a director knows of some fact that would lead a prudent person to seek more information to evaluate a situation or decision to be made, that director must take reasonable steps to obtain that information. Reasonable is always a hard concept to define. The requirement of making reasonable inquiry can usually be satisfied by reliance on information supplied by reliable officers of the corporation, legal counsel or other experts, or by advice of a committee organized under the authority of the board. Which steps are reasonable in a given situation will depend on a balancing of (i) the foreseeable harm that may result from the decision and (ii) the cost and effort required to gather facts or information about possible alternatives. (Directors of religious corporations are held to a slightly lower standard in that they are not bound to act as would ordinarily prudent people in like positions. Instead, they are required to take such care as is appropriate in the circumstances.)

Business Judgment Rule

The law recognizes that people can make honest mistakes even when giving careful consideration to a decision. Accordingly, a director who meets the standard of care by acting as would a prudent person cannot be held liable for making a poor decision, so long as the director believed the resulting action was in the best interest of the corporation. This is true even if the decision takes away from the public benefit or religious corporation’s purpose. This protection is known as the “Business Judgment Rule.” The purpose of this rule, for both profit and nonprofit corporations, is to relieve directors of the fear of being second-guessed by courts. Directors are required to give careful consideration to their decisions, but are not expected to make perfect decisions.

Requesting and Receiving Information

In order to effectively manage and control the corporation, it is essential that directors request and receive information. Directors must keep in mind that it is their responsibility, not their staff’s, to decide what policies the public benefit or religious corporation
The Duty of Care and Particular Decisions

Distribution of Corporate Assets

An asset is anything that the corporation owns that has a dollar value (including cash in the bank). The assets of public benefit and religious corporations are irrevocably dedicated to charitable or religious purposes. This means they may never be used or distributed to anyone for private benefit (unless such distribution is incidental and that person is a member of a category of people the corporation intends to help). Many corporations do not understand how tricky this rule is. For instance, corporations can get in trouble in the following (common) scenario:

Jason X Landlord (a friend of a friend of one of the corporation’s board members) agrees to lease property to the corporation at an above-market rent. By agreeing to pay such rent, the corporation is distributing assets for the private benefit of Jason X Landlord,
and to the detriment of the corporation and the category of people the corporation is supposed to be helping.

Directors who approve of such a distribution of assets may be held jointly and severally liable to the corporation.

Before a public benefit or religious corporation can be dissolved, all corporate debts must be paid. Any assets the corporation still owns after paying all debts must be given to another charitable organization. (Public benefit or religious corporations may also transfer assets to other charitable organizations while the corporation is still in existence.)

The board of directors must notify the Attorney General of the sale or distribution of all or most of the corporation’s assets at least 20 days prior to the distribution.

**Investing and Managing the Corporation’s Funds**

When investing the public benefit or religious corporation’s funds, directors must act conservatively, taking into consideration both the potential for return on the investment and long-term security of the funds. Directors must not place at risk the operating funds the corporation uses to conduct its charitable or religious activities. Management and investment decisions must also comply with (i) any special dedication by or agreement with the contributor of the funds as to how the organization must handle the funds, and (ii) any requirements stated in the corporation’s articles or bylaws.

For example, a nonprofit corporation may have agreed with a contributor that the contributor’s donation is to be used as an endowment, whereby the principal is to be preserved and the interest on the principal is to serve as the source of income for the corporation. In such a case, the corporation must not spend the principal and must avoid taking risks on the principal.
Duty to Avoid Harm to Third Parties

In addition to the duty of care and the duty of loyalty that directors owe to the corporation, directors owe third persons, meaning individual persons or other corporations, a duty to use reasonable care to ensure that the corporation’s acts do not cause them harm. The duty of care and duty of loyalty are duties to the corporation that are codified in the California Corporations Code. The duty to third parties is a personal duty that exists as a general doctrine of law and it might not be satisfied even if the director meets the requirements of the California Corporations Code.

Directors may be personally liable in tort for any of their actions that harm another person or corporation. For example, directors can be held liable for fraud or misrepresentation by the corporation, or for intentional interference with another’s contractual or business relationship, as well as for standard unintentional torts (e.g., where the corporation is responsible for some dangerous situation that results in harm to someone). A director may be personally liable to third parties for physical injuries suffered as a result of the corporation’s action (or inaction) if:

• The director expressly authorized or participated in the corporation’s harmful action;

• The director knew or should have known there was a dangerous situation under the board’s control, but did not take reasonable steps to remove the danger or prevent the injury;

• A careful person in the director’s position would have taken different action than that taken by the director in question.
Public benefit corporations may compensate their directors, officers and employees. However, no more than 49 percent of the directors of a public benefit corporation may be paid directly or have immediate family members paid for services other than serving as a director. (This 49 percent restriction does not apply to religious corporations). Directors who receive, or whose immediate family members receive, such payments are referred to as “interested directors.”

As noted above, any compensation paid to directors as directors or as officers must be “reasonable.” What is reasonable is most often measured by what is paid to other people holding similar positions within similar organizations. As a practical matter, this means that a start-up nonprofit should not align its salary structure with that of an established non-profit such as the Red Cross or the United Way. If the Internal Revenue Service finds that a director has received “excessive” compensation, the compensation will be labeled “private inurement,” which places the corporation’s tax-exempt status at risk.

Most directors of public benefit or religious organizations are not paid for serving solely as directors. Directors and officers receiving compensation are more vulnerable to liability than are volunteer directors. Volunteer directors and officers are afforded special protections by statute, some of which are described below. To be a “volunteer” under the statutes, a director or officer cannot receive payment for his or her services as a director or officer, but the director may receive reimbursement for expenses he or she incurs in carrying out his or her duties (e.g. mileage).
Three statutes provide additional protection from liability to volunteer directors and officers. However, these statutes only shield directors from personal liability for pecuniary (economic) injury to a third party. In other words, the code sections discussed below do not protect directors in the case of personal injury suits. In essence, there is no absolute protection from liability, even for volunteer directors.

One statute provides that people cannot successfully sue volunteer directors and officers if the directors’ and officers’ actions (1) meet certain standards (basically, the “duty of care”) and (2) the public benefit or religious corporation maintains at least a set minimum amount of insurance coverage at both the time of the injury and the time of the claim.

The other statutes provide that people cannot successfully sue volunteer directors and officers if the directors’ and officers’ actions meet the same standard as is required by the other statute, and either (i) the damage is covered by insurance maintained by the public benefit or religious corporation, the director, or the officer, or (ii) the public benefit or religious corporation made reasonable efforts to obtain insurance.

It is important to remember that, in addition to working to meet the duty of care, directors should (i) make all reasonable efforts to obtain both general liability and directors’ and officers’ liability insurance for the corporation, and (ii) keep records of those efforts so that if the public benefit or religious corporation cannot obtain such insurance, the directors can show that they made reasonable efforts. Remember that these statutes are not absolute defenses. Directors will be shielded only if they are able to prove the elements required by the statutes.

Note that neither provision protects directors or officers against actions brought by the Attorney General, or lawsuits for self-dealing or inappropriate distributions, loans or guaranties. Finally, neither statute protects the public benefit or religious corporation itself from liability for the directors’ or officers’ acts.

Directors will be shielded only if they are able to prove the elements required by the statutes.
In sum, the statutes are intended to shield directors and officers from personal liability for acts or omissions that occur while they act in their roles as directors or officers. The statutes will not provide protection if the directors and officers have not taken steps to ensure that the corporation obtains liability insurance. Additionally, the statutes have other elements that directors and officers must prove in order to be protected; therefore, directors and officers may be required to spend time and money to show that they are protected by the statutes.

Crimes and Other Penalties

Directors may be guilty of committing a misdemeanor for defrauding creditors or contributors, or for acquiring property through a fraudulent entry in any account or other book. Additionally, directors may be liable for penalties imposed on the corporation for failure to withhold federal and state taxes from employee salaries. Moreover, directors can also be convicted of misdemeanors if they intentionally fail to (i) withhold income tax and make workers’ compensation contributions or (ii) register as an employer. Directors of public benefit or religious corporations should consult an accountant and/or attorney regarding the corporations’ tax and other filings.
Indemnification; Directors’ and Officers’ Liability Insurance

The best intentions may not protect a director from liability. Public benefit or religious corporations must indemnify directors and officers for certain costs related to litigation and for certain other expenses. Indemnification is the payment of money to another person to compensate that person for damage, loss or injury suffered. A person who is invited to become a director of a public benefit or religious corporation, or who is already a director, must consider whether the public benefit or religious corporation has enough money and directors’ and officers’ liability insurance to indemnify its directors for liability for their actions as directors and officers. In certain cases, the amount of liability coverage may actually be more important than the amount of money the corporation has, because the corporation is itself prevented by statute from directly indemnifying directors against some types of liability.

Advancement of Defense Costs

One issue a director or officer may face is whether the public benefit or religious corporation can and will provide money to the director or officer in advance to pay for his or her defense. If it will not, the director or officer will have to spend his or her own money to establish that he or she is entitled to indemnification from the corporation. Public benefit or religious corporations are permitted, but not required (unless the bylaws provide otherwise) to advance money to a director or officer if he or she guarantees that the money will be repaid in the event he or she loses the suit or trial.

Indemnification of Directors and Officers

A public benefit or religious corporation must indemnify a director or officer who has successfully defended himself or herself against a suit for all costs the director or officer incurred in the defense. The extent to which a public benefit or religious corporation may indemnify a director or officer who loses or settles a case depends upon (1) whether a claim has been made that the director or officer breached a duty to the corporation and (2) whether he or she settled the claim.

In certain cases, the amount of liability coverage may be more important than the amount of money the corporation has.

In a suit brought by a third party in which no claims are made that the director or officer breached a duty to the charitable or religious purposes of the public
benefit or religious corporation and the director or officer loses the case, the corporation may indemnify the director or officer for expenses and judgments, fines, penalties, settlement payments and other amounts incurred by the director or officer in connection with the proceeding if (i) a majority of a quorum of the board (not including the involved director(s)), (ii) the members of the public benefit or religious corporation, if any, or (iii) the court (upon a request by the involved director or the public benefit or religious corporation) decides that the director or officer acted in the following way:

- In good faith;
- In a manner the director or officer believed to be in the best interests of the public benefit or religious corporation; and
- With no reasonable cause to believe that his or her conduct was illegal [only applies to criminal proceedings].

In an action in which a director or officer is found liable by a court for some breach of duty to the corporation or its charitable or religious purposes, the public benefit or religious organization may indemnify the director or officer only for his or her defense expenses, not for the cost of any judgment, fines or other penalties, unless otherwise decided by the court. In order to indemnify the director or officer for defense expenses, the board would have to make the same findings for the director or officer as it would for a director or officer who had not breached a duty to the public benefit or religious corporation, as listed above, and would also have to find that the director or officer had acted with due inquiry and the care a careful person would use in a similar situation. Directors and officers of religious corporations must meet these same requirements.

Further, if the matter is settled before a final judgment, with or without court approval, the public benefit or religious corporation may not indemnify the director or officer for payment of any settlement amount. In such a case, the public benefit or religious corporation may only indemnify the director for his or her defense costs if the Attorney General approves of the settlement.

Directors’ and Officers’ Liability Insurance

Directors’ and officers’ liability insurance does two things: (i) it directly reimburses the director and officer for costs he or she incurs that the corporation cannot or will not pay, and (ii) it reimburses the corporation for costs it incurs in indemnifying a director. Unless the policy expressly names the organization as an insured, directors’ and officers’ liability insurance will not insure the liability or defense costs of the corporation itself. It is important to have directors’ and officers’ liability insurance because it will:

- Enable the public benefit or religious corporation to indemnify directors and officers, or, in the case of those few public benefit or religious corporations that actually have enough assets to indemnify directors and officers out of the corporate funds, to
reimburse the public benefit or religious corporation; and

• Pay directors and officers for certain expenses that the public benefit or religious corporation may not legally pay.

If a public benefit or religious corporation is not able to offer directors’ and officers’ insurance, it may have difficulty recruiting directors and officers and runs the risk that it may become bankrupt if a situation arises where it is legally required to indemnify a director.

Advancement of Defense Costs

Be sure to read the policy carefully. In many cases, the policy does not require the insurance company to pay the insured until the insured actually suffers “loss” (a term defined in the policy), which generally does not occur until the insured corporation’s legal obligation to pay becomes fixed, usually by a judgment or settlement. Unless specifically required by the policy, the insurance company is not required to advance funds to pay for the defense. When policies include a duty to advance funds, they often include a clause requiring the insured to repay funds advanced for costs that turn out not to be covered, and perhaps to put up a bond to secure that repayment.

It is important to note that defense costs often are included within the term “loss” and so are included within the policy limit. If defense costs are not covered outside of the limit of liability, it is possible that defense costs could eat up the majority of the coverage and leave the director (or corporation) with a large judgment to pay if the director loses the case.

The bottom line is that unless the policy requires the insurance company to advance the costs of defense, or the public benefit or religious corporation is able to and agrees to advance such funds, a director may be forced to use his or her own money to defend the action until it is decided by a court or is settled. That may exert some pressure on directors to settle cases before trial.

Insurance Company’s Duty to Defend

Many policies state that the insurance company has the right, but not the duty, to defend the insured corporation. This means that the insurance company can appoint the defense counsel, if it chooses. In connection with that right to defend, many policies state that the insurance company will not pay any defense costs the insured corporation incurs without the insurance company’s prior consent.

Limitation on Claims Covered

A claim is generally defined as a legal demand, suit or court proceeding that seeks monetary or other relief. The filing of a suit against a director or officer is a claim. Directors’ and officers’ liability insurances does not cover expenses incurred as a result of actions taken due to a mere threat of a lawsuit.
Directors’ and officers’ liability insurance policies are “claims made” policies. This means the policy insures against the risk that a claim will be made against the insured corporation only within the period of the policy. Insurance companies, however, generally do not cover claims made during the policy period that are based on events that occurred before a designated cut-off date (often the beginning of the coverage term). Therefore, directors’ and officers’ liability insurance covers only those claims based on events occurring after the cut-off date and prior to the end of the term of the insurance policy.

Many policies require the insured to immediately notify the insurance company of any wrongful act that may lead to a claim. Even if a policy does not require such notice, if there are facts supporting a potential claim, the corporation should still consider notifying the insurance company. Though it may lead the insurance company to cancel the policy, the notification would lock in coverage of that potential claim.

Finally, remember that the majority of insurance companies offer joint and several liability coverage for the Board of Directors. This is extremely important because it assures all board members coverage (especially defense costs) if one board member violates the duty of care or loyalty.

**Shopping for a Policy**

When a public benefit or religious corporation shops for a policy, directors should make sure that an insurance broker or knowledgeable attorney clearly explains what the policy does and does not cover. Key items to consider include:

- Whether the policy will automatically cover directors and officers who are hired after the policy has taken effect;
- Whether the policy provides for the advancement of funds to pay defense costs as they become due, rather than only after the case ends in settlement or judgment;
- What coverage the policy gives for claims based on events occurring before the beginning of the policy period;
- Whether the policy provides coverage for employment practices liability (many policies exclude such claims);
- Whether the policy imposes a duty on the insurance company to defend; and
- What the policy limits and deductibles are.

Individuals who serve on boards of public benefit or religious corporations at the request of their employer may already be covered by their employer’s directors’ and officers’ liability insurance policy.

**Types of Claims Made**

One last note regarding directors’ and officers’ insurance: public benefit or religious corporations are exposed to legal risks in many areas. In most areas, insurance coverage exists to help mitigate these risks. The Nonprofit Insurance Alliance of California reports that of lawsuits against directors reported by its insured, sixty percent (60%) are wrongful termination suits (often involving a claim by a former Executive Director), seventeen percent (17%) involve sexual harassment, ten percent (10%) involve claims of discrimination, another ten percent (10%) involve claims of breach of fiduciary duty, and three percent (3%) involve claims of invasion of privacy.
The Basic Employment Relationship

Presumption of At-Will Employment

In California, all employment is presumed to be at-will. At-will means that you can terminate employees at any time for any non-discriminatory reason without notice. By the same token, employees can resign at any time for any reason. All employment in California is at-will unless you provide for a different relationship in a written or oral contract or engage in conduct that creates an implied contract (see below).

Exceptions To At-Will Presumption

Written Employment Contracts

In the business world, written employment contracts are usually reserved for top executives. A written employment contract will extinguish an employment-at-will relationship. However, written contracts can remain at-will by including at-will language in the contract. You should be careful though, because a written employment contract may not protect you if you have made oral promises inconsistent with the at-will presumption.

In the event that you should choose to enter into an employment contract, please contact an attorney to review the contract. An employment contract will limit your rights as an employer rather than expand them.

Implied Employment Contracts

You may form an implied contract with your employee even if you do not intend to do so. You might create an implied employment contract if you behave in a way that would lead a reasonable employee to think that you guaranteed him or her a job, such as:

- Giving the employee assurances that he or she will have a job indefinitely
- Praising the employee’s work consistently and without criticism
- Retaining the employee for many years
- Failing to inform the employee that the employment is at-will

Terminating a Contractual Employee

If you form a contract with an employee (written, oral, or implied), you may be liable for monetary damages if you terminate that employee without sufficient cause. To avoid such a situation, employers should preserve the at-will relationship as much as possible.
Preserving the At-Will Relationship

To preserve the right to terminate an employee at any time, you should include at-will language in several employee documents. At-will language should be included in:

- The employment application
- The offer letter
- The employee handbook
- On all performance evaluations

In addition, you should avoid making promises of continued employment to employees. Such promises may legally bind you to retain an employee or face monetary damages.

Sample at-will language

In all cases, employment at [Company] is at-will. This means that either you or [Company] can terminate our employment relationship at any time, for any reason, with or without cause and with or without notice. No employee of [Company] can change the nature of the at-will relationship except the President, [President]. The President can change the at-will relationship only by a written agreement signed by the President and you.

Job Applications

At-Will Language

Include at-will disclaimers in the job application. If you include at-will language in the application, then the potential employee will know from the very beginning that the position is at-will.

Truth Certification

Have the applicant certify the truth and accuracy of his or her statements in the application.

Sample language for Truth Certification

I certify that all of the information which I have provided on this Application for Employment is true, and I understand that if any of the information is determined to be false, even if that determination is made years later, it may result in my discipline, up to and including immediate discharge from employment with [Company].
The Hiring Process

Job Interviews

There are many questions that you are not permitted to ask in the job application and interview. Prohibited questions include those that seek information about the applicant regarding his or her:

- birthplace
- citizenship
- foreign languages
- foreign military service
- home (ownership or rental)
- disabilities (mental or physical)
- workers’ compensation claims
- military discharge
- arrest records
- nationality or ancestry
- sex
- sexual orientation
- gender identity
- relatives
- race or color
- pregnancy-related issues
- religion

- medical condition
- age
- height and weight
- marital status and dependents
- maiden name
- financial data

Furthermore, an employer cannot ask about prohibited subjects by requesting information in the context of an “off-the-record” or “personal” conversation. You should avoid making inappropriate or potentially offensive or harassing comments. Please review the list of prohibited topics below.

You may ask questions regarding the following:

- name changes
- residence
- proof of age
- work permits
- right to work
- references
- impediments to job performance
- ability to perform job-related functions
- availability to work schedule

If you find yourself asking or wanting to ask questions that you think might fall into one of the above categories, stand back and ask yourself why you are asking that question. Do you have a legitimate business purpose for wanting that information? Do you ask that question to all applicants or just to a particular type of applicant? If you have a legitimate business purpose for wanting the information and you ask everyone the question, it might not be discriminatory. For example, in most interviews it would be dis-
criminatory to ask the interviewee if he or she has children. For child care providers, however, such a question may help you assess the interviewee’s experience with children, a legitimate business reason for wanting the information. However, you must ask everyone that question, not just women of childbearing age.

Examples of Questions You Can’t Ask

**Protected Classes**

- What is your race, sex, gender identity, age, national origin, citizenship, sexual orientation, and/or marital status?

**Citizenship**

- Are you a naturalized or native born citizen? When did you acquire citizenship?

- Can I have a copy of your citizenship papers? [This question is prohibited prior to employment. Once you hire the employee, you must comply with immigration laws and verify the employee’s legal work status. This includes completing and retaining an I-9 Form in the employee’s personnel file. This form can be obtained from the Immigration and Naturalization Service].

- Is your spouse/are your parents citizens of the United States?

- Where were you born?

- How did you acquire your ability to read, speak and write [language] fluently?

**Disability**

- Are you disabled? What is the nature of your disability?

- Have you ever been treated for drug addiction?

- Have you ever sought mental health counseling?

- Do you consume alcohol? How much alcohol do you consume?

- Do you currently take any medication?

**Age**

- How old are you? [prohibited prior to employment]

**Criminal Record**

- Have you ever been arrested [as opposed to convicted]?

**Family**

- Are you married or single? Are you divorced?

- Do you have any dependents?

- Do you have any children, plan to have children, have child care arrangements?

- Are you pregnant? Do you plan to become pregnant any time soon?
Examples of Questions You Can Ask

**General Employment**

- Do you have the required licenses to perform this job?

**Citizenship**

- If offered employment, can you provide documentation that you have a legal right to work in the United States?
- What languages do you read, speak and write fluently?

**Disability**

If the applicant has a visible disability, or voluntarily raises the existence of a disability in the interview, you can ask:

- Are you able to perform essential job-related functions (using the written description), with or without reasonable accommodation? Please describe or demonstrate how you would perform these functions.
- Do you illegally use drugs?
- Can you meet the attendance requirements of this job? How many days of leave from employment did you take last year?

**Age**

- Are you under 18? Do you have a work permit?

Save All Applications

You are required by law to preserve all job applications for three years.

Interviews

**Documentation**

You should keep a record of all job interviews including the questions asked and the answers given. The best way to keep track of what occurs during an interview is to use a checklist. Determine what you are looking for in a successful applicant and develop a checklist of those qualities. The checklist should include all of the points you want to cover during the interview. Using a checklist will help you be consistent in your treatment of applicants and will help you document the interview.

Job Description

If you have not already given the interviewee a written job description, the interview is a good place to do that. A job description outlines the duties and expectations of the position. You should explain the job description to the employee during the interview. In addition, advise the applicant of general company policies and culture.
A job description is also valuable because it may help protect you in a discrimination lawsuit. Sometimes people who are not hired for a position assume that they were discriminated against and they sue. A written job description will help you justify why you hired one person and decided not to hire the person suing you. Also, a job description is valuable to support an assessment of the ability of an applicant or employee with a disability to perform the essential functions with or without accommodation. Consult with an attorney to make sure your job description meets these objectives. Please make sure to draft all job descriptions in sex-neutral terms.

**Hiring Decisions**

Again, do not discriminate! You cannot consider an individual’s race, sex, national origin, religion, age or any other protected characteristic when choosing between equally qualified applicants.

**Post-Offer Inquiries**

Employers are normally free to seek information after an employee is hired that may not be sought during the pre-employment process. For example, an employer may seek information regarding the age of an employee after he or she is hired, provided that it is sought and used for nondiscriminatory purposes. However, only ask questions necessary for employment purposes. Asking inappropriate questions post hire may be used against you in a discrimination lawsuit.
Basic Laws on Discrimination

Federal Laws Prohibiting Discrimination

Title VII of the Civil Rights Acts of 1964 prohibits an employer from discriminating against an employee or applicant based on race, color, sex, national origin and/or religion with respect to hiring and firing, training, and all terms, conditions, or privileges of employment. This law only applies to employers who have 15 or more employees.

Pregnancy Disability Act (PDA) prohibits employers from discriminating against an employee or applicant because she is pregnant. This law only applies to employers who have 15 or more employees.

Age Discrimination in Employment Act (ADEA) prohibits an employer from discriminating against an employee or applicant who is 40 years of age or older with respect to hiring and firing, training, and all terms, conditions and privileges of employment. This law only applies to employers who have 20 or more employees.

Americans With Disabilities Act (ADA) prohibits an employer from discriminating against any qualified individual with a disability based on that disability with respect to hiring and firing, training, and all terms and conditions of employment. This law only applies to employers who have 15 or more employees.

Immigration Reform and Control Act (IRCA) prohibits employers from discriminating against applicants based upon national origin, or protected status as a United States citizen or alien lawfully admitted for temporary or permanent employment. This law only applies to employers who have 3 or more employees.

Equal Pay Act of 1963 (EPA) prohibits employers from paying employees different wages based on the sex of the employee. This is known as “equal pay for equal work.”

State Laws Prohibiting Discrimination

California Fair Employment and Housing Act (FEHA) prohibits employers from discrimination in hiring on the basis of race, color, national origin, ancestry, sex, gender identity, physical or mental disability, age, religion, pregnancy or childbirth, medical condition, sexual orientation or marital status. The FEHA requires employers to treat all individuals equally by evaluating each person on the basis of individual skills, knowledge and abilities and not on the basis of characteristics generally attributed to a group protected by the law. This law only applies to employers who have 5 or more employees or those who have only 1 employee if there is a discrimination or harassment claim involved.
• Discrimination based on political activities is prohibited.

• Discrimination based on sexual orientation is prohibited.

Preserving a Good Working Relationship

Employee Evaluations

Review all employees at regular intervals

Even if you only have one or two employees or if an employee is only part time, you should conduct regular employment evaluations. These evaluations serve several purposes:

• They alert the employee to any areas of improvement.

• They reinforce the positive aspects of an employee’s performance.

• They provide evidence of reasons for employee discipline or termination in the event of a legal action.

Be fair! Use objective criteria in evaluating the employee. Criteria often used include: competence, judgment, demeanor and interpersonal skills, productivity, initiative, dependability, cooperation, punctual-
ity and attendance. Remember, if your case goes before a jury, the jury is likely to consist of employees rather than employers and they will expect you to have a good reason for your action.

**Document everything!**

While verbal reinforcement or suggestions may be a comfortable way to communicate with your employees, it is important to have a consistent system that allows you to have a written record of an employee’s progress and performance. Be sure to use a standard form or consistent format for employee evaluations.

The evaluation should include the following:

- A clear explanation of what (if anything) needs improvement. Be specific when addressing problems with an employee’s performance.

- A space for employee input. This allows the employee to have an opportunity to express the way the employee sees his or her performance and may prevent the sort of frustration that can lead to lawsuits in the future. Review the evaluation with the employee in person and provide a copy of the evaluation to the employee. Ask the employee to sign the evaluation at the conclusion. If for some reason the employee refuses to sign, you can write “refused to sign” and the reason if one is given.

**Self-evaluation**

You may find that self-evaluations work best for some employees. Self-evaluations are most appropriate for managers, supervisors or other higher ranking employees. If you choose to use self-evaluations, make sure you use a consistent format.

**Records after an employee has left**

Be sure to maintain all employee records for at least three years. Some employers choose to keep files longer, but three years is the minimum.

**Employee Discipline**

*Establish and articulate a standard for discipline and discharge*

Once again fairness is the key here. After you have set out a system of appropriate disciplinary procedures, be sure to apply them consistently and fairly to all employees. Inconsistent treatment could result in discrimination allegations.

If the punishment is anything less than termination, you should give the employee a specific time frame to correct the problem before further disciplinary action. Be sure to follow up with the employee to encourage corrected performance or behavior.
Be careful not to alter the at-will agreement!

It is important to keep the at-will arrangement (covered generally starting at page 45) in mind when you are designing and implementing your disciplinary policies. If you choose to explain the behavior that will result in disciplinary action, you must be sure that you are not guaranteeing a procedure that will unduly restrict your power to discipline or terminate as you deem appropriate for the situation. For example, if you have a policy that states an employee will receive a verbal and then a written warning prior to termination and then the employee steals a computer from the office, you do not want to have to go through the two-step warning procedure. In order to avoid a situation like this one, make it clear that certain situations will warrant a different disciplinary procedure. If you have a progressive discipline policy, make sure that you make it clear that this policy is discretionary.

Maintain the employment file

It is extremely important to maintain detailed documentation of counseling and disciplinary actions in an employee’s personnel file. Even an oral reprimand should be recorded in writing and put in the file. Make sure that discipline is supported by objective evidence and that corroborating evidence is documented as well. These files may prevent wrongful discharge judgments against you.

Employee Complaints

Your responsibilities

Complaints from your employees should be taken very seriously. Your responsibilities are to: investigate, document, and take proper remedial action.

Investigation

Employees may have complaints about anything from the behavior of another employee to general working conditions. Whatever the subject of the complaint you should gather any relevant information and keep your investigations confidential, particularly when the complaint involves another employee.

Documentation

Keep notes as you investigate and make a written record of all conversations.

Remedial action

Take responsibility for making your business a good place to work. You can’t fix every problem, but your employees will be happier and more productive if you respond to their concerns.
**A note on sexual harassment**

The number of sexual harassment complaints has increased in recent years and can be more complicated than other complaints. Sexual harassment can occur between employees and between an employee and a client or customer. It is the employer’s responsibility to keep the workplace free from sexual harassment. If you are confronted with a complaint of sexual harassment, call an attorney! A thorough investigation by a neutral party is essential.

**Never retaliate**

If an employee makes a complaint against you, do not retaliate or take any action that can be perceived as retaliation.

**Terminating the Employment Relationship**

**Steps to Avoid Wrongful Termination Lawsuits**

An employee that feels he or she has been terminated unfairly is more likely to bring what is known as a wrongful termination lawsuit against his/her employer. While there is no guaranteed means of preventing former employees from bringing a lawsuit, there are a variety of steps you can take to minimize the likelihood of legal action.

**Try to solve the problem**

Before you make a decision to terminate an employee, you should conduct an interview in which you explain the problem and give the employee the opportunity to explain as well. Determine whether you have sufficient documentation to support the decision to terminate.
Regardless of what an employee has done over the course of his/her employment, you are much more vulnerable to lawsuits when you do not have documentation to support the problems. Before you make the decision to terminate, you will be better protected if you have evidence such as negative performance evaluations or disciplinary notices in the employee’s file.

**Conduct an exit interview**

You should conduct what is known as an exit interview. This allows you an opportunity to explain to the employee why he or she is being terminated and also gives you an opportunity to close out any other business with the employee, such as the final paycheck and any required reimbursement for unused vacation time. The California Labor Code requires all wages to be paid to the employee at the time of discharge, and if the employee quits, within 72 hours.

The exit interview gives the employee an opportunity to comment as well. Many wrongful termination lawsuits arise out of an employee’s feelings of frustration because of unfair treatment. Explaining your reasons for termination to the employee and allowing the employee to respond can release tensions that might otherwise lead to wrongful termination actions.

Be honest with the employee about the reasons for termination. Don’t tell the employee he is being laid off if you are really terminating him and don’t give a false reason for the termination.

After the exit interview, document everything that was said or occurred.

**TIP:** Exit interviews can be useful when an employee has quit as well. For example, if you are having a high turnover problem, an exit interview is your opportunity to talk to an employee about what he/she didn’t like about his job and what could have been done to keep him.

**Don’t force an employee to quit**

If you want an employee out of your business and you make working conditions so bad that the employee quits, you have constructively terminated the employee and you might subject yourself to legal action. Actions that could result in a constructive termination include:

- Changing an employee’s hours unfavorably,
- Changing an employee’s duties to include responsibilities that wouldn’t normally be part of the employee’s job description,
- Treating an employee rudely, or
- Any other unreasonable changes in the working environment.

After the exit interview, document everything that was said or occurred.
Protect the employee’s dignity and privacy

Protecting the employee’s dignity and privacy will help you to avoid a defamation or invasion of privacy claim. Treat the employee with respect and do not discuss the employee’s termination or employment with other employees.

Make sure you have not altered the at-will relationship

Some employers use trial periods or probationary periods to closely monitor an employee to see if he/she can do the job. However, because an at-will relationship already grants an employer the power to terminate an employee, these sort of periods are unnecessary and may actually make the employer more vulnerable to a wrongful termination lawsuit. The employee might feel that after the probationary period ends he or she can only be fired if he or she does something really terrible. If you choose to terminate the employee after the probationary period, a court could find that you altered the at-will relationship and created an employment contract by suggesting that employment was guaranteed after the probationary period.

Providing References for Former Employees

Referrals for All Former Employees

When it comes to providing information about former employees you have several options:

You can tell the caller your honest assessment of the employee, whether it is good or bad. If your comments are negative, you are at risk for potential defamation lawsuits from employees. There is also a possibility of lawsuits from employers who hire the employee based on your positive recommendation and then find out that the employee does not live up to your strong recommendations.

You can provide the reason the person left (i.e., he/she was fired or quit), the dates that the employee worked for you, and positions held, but no other information about the employee’s performance. This may be somewhat safer than the first option, yet still provides some information to the employer that is calling for your help.
• Your third and safest option is to provide only the name, dates of employment, and last position held. If you choose this alternative, you should tell the employee as he/she leaves that this is the only information that you will release upon inquiry.

Some recent cases have suggested that the third option is the only way employers can protect themselves against possible lawsuits. You must balance this need to avoid potential legal problems against the benefit that employees get from being able to provide employers with recommendations and the helpful service that employers can provide for each other.

Regardless of which alternative you choose, you should adhere to the following policies:

• Tell all of your employees not to provide references for former employees, and to refer such inquiries to one designated person.

• Tell employees of your policy so that they will know what to expect when they leave your employ.

• Decide on a policy and apply it consistently. Inconsistencies could be perceived as discrimination.

Employee Handbooks

Introduction

Employee handbooks are a good way to establish and maintain a good working relationship with employees. The length can vary from a few pages to a thick book. You will want to design a handbook that best serves your needs, taking into consideration the size and nature of your business. Please consult an attorney once you have completed your company’s handbook. An employee handbook can serve several purposes which include:

• Educating your employees about your expectations for them,

• Providing you with support if you need to show cause for a termination, and

• Demonstrating that the rules are not merely recommended policies, but that they are something you take seriously.
**Recommended Provisions**

Your handbook should contain policies regarding:

- Introduction (right to amend, employees covered by the handbook and at-will employment)
- Recruiting and hiring
- Training and orientation
- Employee classification and categories of employment
- Compensation, meal periods & rest periods
- Benefits
- Leaves of Absence
- Standards of performance, duties and discipline
- Safety issues (workers’ compensation, horseplay and fighting, Illness and Injury Prevention Program)
- Personnel Records
- Drug and Alcohol Policies
- Employee Acknowledgement
- Miscellaneous

**Contract Disclaimer**

You want to be sure that your policy manual is not interpreted as a contract. You should make this clear at the beginning of the manual.

*Sample language:*

This handbook is available to employees only for informational purposes. It is not intended to constitute an employment contract of any kind and does not create any express or implied contractual obligations.

**Introduction and Reservation of Right to Revise Policies**

You might want to add to or change sections of your policy manual from time to time, so you should include a statement in your manual reserving this right. Any time you do alter your policies, be sure to give your employees a copy of the new rules and their effective date.

*Sample language:*

This personnel handbook is intended to provide employees with a general understanding of the Company’s personnel policies. The information in this handbook should be helpful in familiarizing employees with the Company.

This handbook, however, cannot anticipate every situation or answer every question about employment. With the sole exception of the employment-at-
will policies, the contents of this handbook do not create an employment contract. In order to retain necessary flexibility in the administration of policies and procedures, the Company reserves the right to change or revise policies, procedures and benefits described in this handbook, other than the employment-at-will provisions, without notice whenever the Company determines that such action is warranted.

**Employment Terminable At-Will**

Your employee handbook is one of the many places that you should reinforce your employment at-will policy. Remember, you should also have all employees sign the policy on a separate sheet of paper.

**Equal Opportunity Statements and Prohibition Against Discrimination**

It is also a good idea to include a statement in your handbook that sets forth your anti-discrimination policy.

*Sample language:*

[Company] is an equal opportunity employer and maintains policies and practices which prohibit discrimination against any qualified employee or applicant on the basis of race, religion, ancestry, national origin, sex, age, marital status, sexual orientation, physical or mental disability or any other characteristic to the extent protected by law. This nondiscrimination policy applies to all employment practices, including hiring, compensation, benefits, promotion, training and termination.

**Payroll Practices/Policies**

- **Paydays**

You should include the specific details of your payment system.

- **Overtime Work and Pay**

You must comply with state and federal tax withholding requirements, state workers’ compensation law, social security laws, and state disability withholding requirements, as well as state and federal wage and hour laws. Because there are so many legal regulations involved, overtime work and pay can become a very complicated issue. Please see the enclosed handout for general Wage and Hour guidelines. You should consult an attorney with your specific concerns.

**Time Off From Work**

- **Vacation**

Specify the number of paid and unpaid vacation days you will allow your employees and any restrictions that apply. Include procedural provisions such as the
amount of notice that must be given before a vacation. Remember, if you terminate someone who has paid vacation time remaining, you must pay him/her for that time when you terminate him/her. This is also true for employees that quit or are laid off. Additionally, you must determine if there is a “cap” or maximum amount of vacation days that employees may accrue.

• Sick Days

As with vacation days, you should make clear your company’s policies surrounding sick days. Be sure to include procedures for calling in sick, such as who and when to call if an employee cannot come in to work.

• Personal Time

Again, be sure to state your policy for personal time off from work. There are certain occasions when you must allow an employee to leave the workplace. For example, you must allow an employee to vote and you may be required to allow your employees to visit their children’s school for a certain number of hours each year.

NOTE: Wage and Hour laws have provisions regarding the minimum requirements for providing employees with time off from work. Consult an attorney to be sure you are in compliance with these regulations. For general guidelines, please review the Wage and Hour handout provided by Public Counsel.

• Leaves of Absence

There are times when you must allow an employee extended time off from work and situations in which you must still pay an employee or hold his/her job. Consult an attorney for clarification of these complicated issues.

• Medical Leaves of Absence
• Work Related Illness or Injury
• Pregnancy-Disability Leaves

Family laws you should be aware of:

Family and Medical Care Leaves: Family Medical Leave Act and the California Family Rights Act currently permit employees to take up to 12 weeks of unpaid leave in a 12 month period [applies to employers with 50 or more employees within a 75-mile radius]. In order for an employee to be eligible to take FMLA leave, the employee must have worked at least 1,250 hours during the 12-month period preceding the date leave would begin. Employers should be aware that, beginning in 2004, employees in California are also eligible for up to 6 weeks of paid family and medical leave. Employees can receive up to 55% of their salary through the state’s disability insurance fund.

California Parental Leave Provision permits employees to take 40 hours (no more than 8 hours per month) of leave to visit their child’s school [applies to employers with 25 or more employees].
**Workplace Safety Policies**

- Post rules/guidelines and make sure employees are familiar with them!

- Advise employees to report any unsafe conditions to the designated person immediately. Make sure to follow up on any reports.

- Make sure that employees know that they are to report any accident or injury immediately.

**Disciplinary Policies**

You might want to identify the behavior that will result in discipline and the resulting disciplinary action. However, be careful not to deprive yourself of discretion in deciding how to deal with each particular situation. (See pages 53-54 for a more complete explanation.)

Behaviors to list as appropriate for disciplinary action:

- Harassment

- Use of Drugs or Alcohol

- Theft

- Safety Violations

- Unsatisfactory Performance

- Tardiness/Absenteeism

- Falsification of Company Documents or Timekeeping Procedures

- Violations of Other Company Policies or Procedures

**Acknowledgment of Receipt of Handbook and Obligation to Read and Adhere to Policies**

In order to more effectively enforce your policies as well as protect yourself in the event of legal action, be sure that your employees read the employment manual and sign a statement that they have done so. Be sure to keep this signed statement in the employee’s file.

**Sample language:**

I acknowledge that I have received and read my copy of the [Company’s] Employee Handbook and Policy Manual. I understand and agree that my employment is governed by the guidelines set forth in this Handbook and any written revisions which may hereafter be made.

[Signature] [Date]
Posting Requirements

State and federal law require you to display informational posters telling employees about their legal rights.

You can call the California Chamber of Commerce at 1-800-331-8877 to obtain a set of these posters. The package will cost $23.00 for paper copies of the postings and $39.95 for laminated copies of the necessary postings (plus an additional $6.00 for shipping and handling).

Independent Contractors

Overview

Using independent contractors is often an attractive option for start-up businesses because the business is usually relieved from some of the costs of providing benefits and withholding payroll taxes. However, you should be aware that if you incorrectly categorize an employee as an independent contractor, you may face fines, penalties, unpaid taxes, unpaid benefits, unpaid wages, damages and legal fees and costs. You should weigh this risk against the benefits and consider whether your employee really meets the test for an independent contractor before making this decision. Beware. A signed agreement between you and the worker defining independent contractor status is not enough.

Several elements distinguish an independent contractor from an employee. An independent contractor is an independent business person who has contracted with your business to perform specific services or
achieve a specific result. The independent contractor controls how the job is performed and typically does not have the same ongoing relationship with your business as an employee. Generally, a worker is an employee if the employer has the right to decide the manner and method by which the work is performed.

Advantages to Using Independent Contractors

The most significant advantage to using an independent contractor is the cost savings to your business. You are not required to make the following contributions for the independent contractor:

- Federal Unemployment Tax (FUTA)
- Federal Insurance Contributions (FICA)
- California Unemployment Insurance or Employment Training

You also do not have to pay for employee benefits, such as medical or life insurance, vacation leave, sick time or pregnancy leave, or retirement plan participation. Workers’ compensation is optional for independent contractors and you are not required to pay overtime. Another advantage is the reduced risk of certain legal claims against you. An independent contractor is less likely to bring a lawsuit against you for a discrimination claim because most of the laws that prohibit discrimination only protect employees. You are also protected from unlawful employment termination claims. Finally, you save administrative time and costs because your payroll, record-keeping and reporting obligations are reduced.

Disadvantages to Using Independent Contractors

There are several disadvantages to using independent contractors. The most important is the liability if you misclassify a worker as an independent contractor and the worker is later determined to be an employee. You also will not have as much control over how the independent contractor performs his/her services, which could affect the quality of your services.

If you misclassify a worker as an independent contractor, you face the burden of proving that the worker is not an employee. (The test for showing a worker is an employee is discussed in the next section). If the California Employment Development Department (EDD) or the IRS reclassifies the worker as an employee, you are responsible for all payroll taxes (both the employer’s and the employee’s share) plus other financial penalties. Corporate officers and individuals within the business can also be personally liable for 100% of the total withholding tax not paid and, in serious cases, can face criminal sanctions. You also might be subject to paying minimum wages, overtime, and penalties for failure to obtain workers’ compensation coverage for employees.

Determining Independent Contractor Status

In light of these substantial penalties, you will want to make sure that your workers really qualify as independent contractors and that you treat them as independent contractors.
Generally, it is wise to consult an attorney if you aren’t sure and to look at the specific IRS and Employment Development Department (EDD) rulings and guidelines for your business and the type of work that the independent contractor will perform. Some of the guidelines are specific for the industry in question. You should also be aware of the factors that the IRS and EDD will often examine in making their determination of whether a worker is an independent contractor or an employee. The right to control the worker’s day-to-day activities is the most important factor.

**A worker looks more like an employee if:**

- The business has the right to direct or control how the worker performs the tasks.
- The business gives the worker instructions on how the work is to be done.
- The business provides training for the worker.
- There is no written contract between the parties.
- The worker receives benefits also provided to employees.
- The business has the right to unilaterally discharge or terminate the worker.
- The worker is hired to provide services that are a regular part of the business.
- The worker is paid on a hourly, weekly or monthly basis.

**A worker looks more like an independent contractor if:**

- The worker has a separate, established business of his own.
- The worker has invested in specialized training or tools.
- The worker makes his services available to others.
- The worker contracts with other employers.
- The worker has unreimbursed expenses from the project.
- There is an opportunity for the worker to make a profit or show a loss for the project.
- The worker is paid for the project as opposed to receiving a salary.

If you are using independent contractors, you should keep information about the contractor in a file to show that the worker is an independent contractor. Such information would include the background information about the contractor’s business, such as a business license, insurance, advertising, the contract for service, and a business card. Most importantly, you should make sure that you explain the result you want from the contractor, but that you do not control the process.
Part Five: The Basics of Forming and Signing Contracts

31

Frequently Asked Questions About Contracts

What is a contract?

A contract is a legally enforceable agreement. It may be verbal or written. It may involve hundreds of dollars, millions of dollars, or no money at all. Despite the variety of types of contracts, they all have some basic similarities. All contracts involve an exchange between the contracting parties, specific terms describing this exchange, and a bargain between the parties for those terms.

What makes a contract enforceable?

In its simplest form, in order to be a legally enforceable contract, an agreement must contain certain elements which meet certain legal standards. These key elements are commonly grouped together and called bargained-for exchange. If the parties have negotiated and agreed to the terms of a contract and have exchanged something of value, then it is likely there is bargained-for exchange.

Generally, the bargained-for exchange is made up of three distinct parts: an offer, an acceptance of the offer, and consideration. The basic idea is that the parties to an agreement knowingly exchange things of value with one another. The law requires certain degrees of clarity, fairness and legality. An agreement which is too vague to understand will not be enforced; an agreement which was made with one party under duress will not be enforced; an agreement to do something illegal will not be enforced. This brochure will attempt to explain some of the legal terms everyone entering into a contract should know about.

Of the three examples given above, the first is probably not a contract. Why? Basically, the husband’s agreement to pick up the laundry on his way home from work is not a contract because it is not going to be enforceable in a court of law. Only those agreements which are legally enforceable are contracts. Thus the first step in understanding the law of contracts is understanding what makes an agreement enforceable.
Elements of An Enforceable Contract

What are the basic elements of an enforceable contract?

As mentioned earlier, the basic elements of an enforceable contract are the offer, acceptance, and consideration.

Negotiating the Contract: Offer and Acceptance

An offer should be formal and made to a specific person. The terms should be as definite as possible in order to make the contract easier to enforce. The terms made in the offer, if accepted, will be the terms of the contract. More will be said about the nature of the terms later.

An acceptance must mirror the offer. This means that according to the law, the act of acceptance indicates that all of the terms of the offer have been accepted. If an offer is not accepted, it is considered rejected.

Example:

Jack offers to sell his ten speed bicycle to Maria for $150. Maria can reject or accept Jack’s price. If she accepts, they have a contract. If she rejects the offer, they have no contract.

Of course, you will likely be dealing with more complicated transactions with more terms, but the basic ideas remain the same.

Example:

Maria does not respond to Jack’s offer. The law says an offer without a stated expiration date stays open for a reasonable time, which will depend on the type of business and the facts. If Maria does not accept the offer, they have no contract.

Before Maria responds to Jack’s offer, Jack changes his mind and tells Maria that he has decided not to sell his bicycle for $150. Jack has revoked his offer and therefore Maria no longer has the option to accept it. Until an offer is accepted, the person who made it can revoke it.

Maria does not agree to buy the bicycle for $150, but says she will agree to buy it for $100. Maria has rejected the original offer and they have no contract. Instead, Maria has now made a counteroffer that Jack can choose to accept or reject. Jack and Maria are still negotiating. If Jack agrees to sell the bicycle for $100 there is a binding contract.
In addition, businesses can actually accept and form contracts without signatures. The Uniform Commercial Code provides that in a negotiation between merchants, a written memo from one of them stating the terms of the agreement is sufficient to create a binding contract, so long as the other merchant does not object within 10 days of receiving the memo. This means that you need to read your mail on a regular basis and respond to any letter or memo that purports to confirm an understanding or agreement – especially if you do not agree to the terms.

**Example:**

Wendy simply promises to take her neighbor Gabriel to Disneyland. A court will not enforce this promise as a contract unless Gabriel gives Wendy something of value in exchange.

**Example:**

Wendy is a travel agent and promises to take a group of visitors to Disneyland for a fee. A court will enforce this promise as a contract. The visitors gave a promise to pay a fee in exchange for Wendy’s promise of services.

Once a court sees that the parties have included some consideration in their agreement, it normally will not question the adequacy of the consideration. For example, if a party contracts to sell an item for a relatively low price (little monetary consideration) courts generally will not inquire into the relative value of the good sold. If, however, the consideration given by either party has no value (monetary or otherwise), a court will conclude that there was insufficient consideration and will treat the transaction as a gift from one party to the other.

It is important to remember that consideration cannot be something the party was already obliged to do. For example, a promise to serve and protect from a policeman is not consideration for a contract, because the policeman is already obligated to do so as part of his job.

---

**Consideration**

An enforceable contract must have adequate consideration, which means each party must exchange something of value. This means that each party must give and receive more than a mere gesture or symbol of a promise. Consideration may be money, services or labor, property, stock, or anything else the parties promise one another. Without an exchange of consideration, a court will conclude that there is only a gift from one party to another, not a contract.
The Need for Definite Terms

Earlier, it was discussed that a valid offer needs to contain definite terms. While the terms of each contract may vary, certain terms are almost always required. If your contract does not include certain important terms, such as the parties, price, quantity of goods or description of services, and the time goods are to be delivered or services performed, a court may not be able to enforce the agreement if a dispute arises. These required terms are referred to as material terms.

While there are many ways to draft each term of the contract, it is a good idea to include as much specific detail as possible. The more detail you include, the clearer the contract will be to each of the parties and to anyone else called on to interpret the contract. If there is a dispute, it is more likely that it can be resolved quickly if the terms are clear.

Other Types of Enforceable Obligations

Although an agreement must usually be a completed contract in order to be enforceable, there are two circumstances in which a court may enforce a contract, even if the parties have not reached a complete agreement. The first situation is called unjust enrichment, and the second is called promissory estoppel.

What is Unjust Enrichment?

Unjust enrichment occurs when only one party has benefited from the contract and it would be unfair for that party to retain the benefit without somehow compensating the other party. When this happens, the courts usually force the party to fulfill its part of the agreement or return the benefit.

Example:

Mike agrees to buy Jessica’s car. The two have not signed a contract, but they plan to do so this afternoon. Jessica lets Mike take the car in the morning. Mike refuses to pay because there is no contract. The court will make him either pay Jessica the money or return the car.
What is Promissory Estoppel?

Promissory estoppel is a legal concept which allows the courts to enforce a contract, even if it would not otherwise be enforceable. In order to claim promissory estoppel, five conditions must exist:

• One party (the defendant) makes a promise to the other party (the plaintiff) and then breaks the promise.
• Before the defendant breaks the promise, the plaintiff relied on the promise and performed some action.
• The defendant knew, or should have known, that the plaintiff would rely on the promise.
• The plaintiff took the action because of the defendant’s promise.
• The only way to avoid injustice is to enforce the contract.

Example:

Mary promises to pay Jack $50 plus the cost of tickets if he will stand in line and buy her two tickets to tonight’s football game. Jack buys the two tickets, using his own money. Mary then changes her mind, and refuses to give Jack either the $50 or the money he paid for the tickets. Jack relied on Mary’s promise, and she should have known that he would. Assuming that Jack cannot somehow use the tickets, the only way to avoid injustice would be to enforce the contract.

The Best Contracts are Written

Written contracts have many advantages over non-written (oral) contracts. It is a good idea to put all important agreements in writing. With the proper language, a written contract makes clear the terms of the agreement. Oral contracts (contracts based on spoken words or a handshake) might be legally enforceable, but if a dispute or disagreement arises it will be difficult for a court to determine whose version of the original agreement is more accurate. With a written agreement, however, there is a record that both the parties and the courts can look to for guidance.
Sometimes written contracts are required. Certain agreements must be in writing to be enforceable. The law, which is called the Statute of Frauds, requires that the following types of agreements must be in writing:

- Agreements for the sale of goods over $500.
- Agreements that will take more than one year to perform (for example, an employment contract for two years).
- An agreement to lease real property for more than one year or to sell real property.

While the written agreement does not have to be a formal contract to satisfy the Statute of Frauds, it must contain the following requirements:

- The identity of both of the parties.
- The subject of the contract (for example, the address of the property or the type of goods or services).
- The material terms of the agreement (such as the price, the length of time to perform, the quantity of goods sold, etc.).
- The signatures of both parties.

If a contract does not meet all of these requirements, it does not mean that it is invalid. It does mean, however, that if one party chooses not to go forward with the contract, the courts will not enforce the contract.

**Elements of a Good Written Contract**

A written contract should identify the parties, state that they have reached an agreement and then describe the subject and the main terms of the agreement. The more detail you include, the clearer the contract will be to each of the parties and to anyone else who must later interpret the contract. Most importantly, if the contract does not include the material terms, such as price, quantity or description of goods or services, the time the goods are to be delivered or the services performed, a court might find that the agreement is unenforceable.

In addition, if you write a contract, you should include all the terms of your agreement and fully express your intentions. If a judge has to interpret the contract, any understandings or oral agreements you have not written down will probably not get enforced.

The following list includes many of the most common terms which should be included in a contract. Not all of the terms are necessary for every contract, and there are many more that can (and often should) be included. It is important to seek legal assistance in drafting or reviewing a contract before you sign it, as each situation is different (and so are the necessary terms of each contract).
Terms to Include in a Written Contract

A simple written contract should include the following items:

**The Parties**
The names and addresses of all of the parties to the contract and the type of legal entity if the parties are businesses (such as a corporation, partnership, or sole proprietorship).

**Date**
The date the contract is signed.

**Factual background (The Preamble)**
One or two paragraphs to provide factual background for the agreement. This is often helpful in determining the intent of the parties if a dispute arises.

**Specifications**
Description of what each party promises to do (i.e. pay money, provide a service, sell something, build something, etc.)

**Deadlines**
Dates by which any work will be done, products delivered, etc. If strict compliance with contract deadlines is important, you should include the phrase “Time is of the essence.”

**Duration**
Length of time the contract will remain in effect.

**Payment Specifications**
When payment is due, whether payments will be in installments and due dates of installments, whether interest will be charged for late payments.
If you are drafting a contract for services or one which will last a fairly long time, you may want to tie the payment schedule to interim completion deadlines.

**Default or Breach**
What actions or failures to act are considered a default or breach of contract, and what will happen if one party defaults or breaches.

**Damages**
If damages will be difficult to compute in the event of a breach of the contract, you can establish in advance a fixed dollar amount (called liquidated damages) that the breaching party must pay.

**Termination**
Conditions that allow either party to terminate the agreement.

**Warranties**
Any warranties which are to be included.

**Assignment**
Whether or not either party may assign the contract to another party. If you assign a contract, you give a third party the rights and responsibilities you have under the contract. If the contract is silent about whether assignment is permitted, a court might not allow assignment in certain situations.

**Communications**
Where notices of default or other communications concerning the contract are to be sent. Typically, parties agree to send communications to their business headquarters.

**Choice of Law**
Which state’s law applies if questions about the contract arise. Although you should include this section in any contract, it is particularly important to specifically address this issue if the parties have operations in different states or the contract is to be performed in more than one state.

**Signature**
Signatures of all parties to the contract.
Formalities of Finalizing a Contract

Signatures

How you sign the contract depends on the legal form of your business.

Sole Proprietor: A sole proprietor can sign his or her name because a sole proprietor is not a separate legal entity. The signature can look like either of the following two examples (DBA means doing business as):

John Smith

DBA John’s Grocery Store
____________________

OR

John’s Grocery Store
By:___________________
John Smith

Partnership: For a partnership the following signature is commonly used:

GROCERY EXPRESS
A California Partnership

By:___________________
John Smith
Its: General Partner

Corporation: For a corporation, use the following format:

GROCERY CONNECTION, INC.
A California Corporation

By:___________________
John Smith
Its: President

You should always make sure that the person signing the contract has the authority to sign. If the other party is a corporation, you might want to ask for a resolution from the board of directors or the bylaws for proof that the person signing has the authority to sign. If the president of the corporation is signing, you do not need to do this because the president is presumed to have the authority to sign contracts for the corporation.

Dates

When you sign a contract, date the contract and make sure that the other person signing does the same. This helps show that there was an agreement between the two parties, which is one of the essential elements. One way to do this is to place a date line next to the place where each person will sign. (Date: __________, 200__). It is acceptable if the dates of
signing are different, and in fact it is common to have the dates differ by a few days or even a week.

Originals

A contract is an original as long as the signatures are originals. It is best if each party has an original contract with all original signatures. You can do this by having each party sign two originals so each party can keep a fully signed contract. A photocopy or faxed copy of a signed contract can still be enforced as long as the judge or arbitrator is convinced that your document is an accurate reproduction of the original.

Revising Contracts

A contract can be revised either before or after it is signed. If minor changes are made to the contract before the parties sign, you can cross out the old wording and write in the new words. Each party should initial each change to show that they properly consented to the changes. If the changes are extensive, use an addendum to describe the new terms. The addendum should contain language that states that in case of a conflict between the main contract and the addendum, the wording in the addendum prevails. Both parties should sign and date the addendum and the main contract.

Once a contract has been signed, you cannot revise it unless both parties agree to make the changes. Essentially, the parties are forming a new contract. The simplest way to make these changes is with an addendum. You should include all of the following information in an addendum:

- Refer to the earlier contract by identifying the date, names of the parties, and the subject matter.
- Identify all of the changes you are making.
- Explain that if there is a conflict between the terms of the original contract and the addendum, the terms of the addendum will prevail.
• State that all of the terms of the original contract, except the ones you are changing, remain in effect.

• Sign and date the addendum and keep it with the original.

Unfair or Illegal Contracts

If you make a bad bargain, you probably cannot call off the deal and invalidate the contract. As long as there is a valid contract, it usually does not matter if you paid too much for something or if you did not get a good deal. Sometimes, however, a court will set aside a contract if the terms are unconscionable, which means that they are shockingly unfair. For example, a judge might release an unsophisticated consumer (such as someone who cannot read or has a learning disability) from a grossly unfair contract prepared by a high-pressure salesperson. Reasonably experienced business people making contracts with each other, however, will rarely have their contracts set aside for unfairness.

If a contract clause is illegal or against public policy, a judge will not enforce it. For example, a contract requiring someone to bribe a city official to obtain a building permit would be invalid.
Additional Clauses

While the clauses mentioned on pages 72-73 are considered standard, there are many other types of clauses which are often included in contracts.

Indemnification

Many contracts, especially form contracts, include indemnification provisions. These clauses require one or both of the parties to indemnify the other party against losses or injury. To indemnify someone means to promise to pay for or reimburse them for certain costs or losses. Indemnification clauses often require a party to defend the other against any lawsuits which may arise because of the contract, and to promise not to sue the other party for certain things. When considering an indemnification clause, be sure to read it carefully and to pay close attention to which potential losses or costs are covered, and to whether only one party indemnifies the other or whether they each indemnify one another. If you agree to indemnify another party, you need to understand that you are taking on a risk of potentially large costs. You can minimize this risk by carrying insurance, having the other party indemnify you, and limiting the situations that are covered under the indemnification provision.

Waiver

Parties to a contract may agree to give up certain legal rights as part of the consideration included in the contract. A waiver clause allows parties to specify exactly which rights they intend to give up (or not give up) through their contract. Legally, some rights cannot be waived, such as constitutional and statutory rights (rights arising as a matter of federal or state law). But most simple contracts will not deal with these. If you are unsure whether you may waive a certain right, however, you should consult an attorney.

In order to draft a valid contractual waiver, the party waiving his rights must do so knowingly and intentionally. This means exactly what it sounds like: each party must understand what it is they are giving up and must then intend to give up this right. With waiver clauses, it is particularly important to specify exactly what the parties intend to waive and rights they do not intend to waive. Courts will generally examine waiver clauses extremely carefully to make sure that the party giving up a legal right truly meant to do so.

Cure

A cure provision allows a party to correct a breach of the contract. Even when both parties to a contract want the agreement to succeed, one party might do something, or fail to do something, that
causes a breach or a default. This may be because of a mistake, a misunderstanding, or something beyond the control of the parties (for example, if a payment gets lost in the mail). A cure provision in a contract allows the breaching party the opportunity to fix the problem before the contract is terminated before the other party sues on the contract.

A cure provision usually identifies the types of breaches or defaults which may be cured, what must be done to cure the breach, how long the party has to cure the breach, and the number of times a party may breach and cure before the contract is terminated.

**Notice**

Often, parties to a contract want to give each party advanced warning before some specific action is taken, such as termination of a contract or filing a lawsuit to enforce the contract. This advanced warning is provided for through a notice clause. A notice clause requires one or both parties to let one another know in advance, i.e. give notice to one another, before they take any action that is specified in the notice clause.

Notice clauses should contain specific procedures for giving notice, such as by mail, in person orally, personal notice over the phone or by delivery of a letter, etc. If the party required to give notice follows the procedure in the contract for giving notice, a court will generally conclude that she fulfilled her contractual duty, even if the other party does not actually receive the notice.

**Arbitration**

A contract may contain a provision that requires the parties to use arbitration to solve their disputes. Arbitration is one form of what is known as "Alternative Dispute Resolution" (an alternative to resolving disputes in court). Although arbitration is less formal than litigation, arbitration results may be enforced in court. In fact, courts are generally unwilling to overturn arbitration results, so if you decide to arbitrate rather than litigate, you should assume that arbitration results will be final.

Arbitration is growing in popularity for precisely the above reasons, but you should consider an arbitration clause carefully before you agree to one. Judges in court are held to certain universal standards, but arbitrators are not. Arbitration clauses should identify the process for selecting the arbitrator.

**Merger or Entire Agreement Clause**

The contract may have a statement that says that the contract is the complete embodiment of all agreements, oral or written. The adding of this clause means that the contract supersedes any other agreements made either before or after the contract was made. This clause in a contract illustrates that the parties have agreed that the contract fully integrates the understanding between them on each issue.
Introduction

This guidebook is designed to assist the small business owner and nonprofit organization to understand and assess their insurance requirements and needs. Every organization’s insurance requirements and needs are different. Thus, the decision to purchase insurance often involves highly complex considerations, which are only highlighted in this guidebook. Be sure to consult with an insurance agent, broker or attorney prior to finalizing your decision to purchase or change insurance coverage.

What Is Insurance?

Insurance is a contract between you and the insurance company. For a price, the insurance premium, the insurance company (the insurer) agrees to compensate or indemnify you (the insured) for a certain specified loss, risk or peril. There are many different types of insurance that an organization may secure. These range from fire insurance to workers’ compensation insurance. We will describe some of the insurance coverages that the small business or nonprofit organization is required to secure and others that you may want to consider securing.

Some insurance, while desirable, may be unavailable for economic reasons or because insurance companies may not offer this type of insurance coverage to your organization or company. The glossary at the end of this guide describes the types of insurance coverage that a small business or nonprofit organization may consider purchasing.
Why Purchase Insurance?

Insurance is designed to provide the organization and individuals who work at the organization with protection against catastrophic loss or liability. For example, if you are driving an automobile on company business and it is involved in a collision with another automobile, the owners of the vehicles, drivers and passengers may be liable for damages incurred as a result of the accident. The amount of liability depends on the extent of damage or injury and the negligence or fault of the parties involved. The State of California requires all registered owners of a motor vehicle to carry a certain amount of liability insurance. This will not only protect the insured against a damage claim but also may require the insurance company to defend the insured in the event of litigation. Of course, the level of protection offered is limited by the amount of the insurance coverage. If you do not have insurance coverage you may not only be required to pay damages to the other party but might also have to defend against any lawsuit that may be filed, and pay for costs associated with your defense, such as attorney’s fees.

Types of Insurance Coverage

A small business or nonprofit organization requires at least a minimal level of insurance to protect against business risks to which all organizations are, to some extent, vulnerable. The types of insurance that an organization may require vary by its activities, revenues, size of workforce, risk experience, and other factors. Six broad areas of exposure include:

- Property
- Directors and Officers
- Crime
- Automobile
- Liability
- Workers’ Compensation

You should take the time to assess whether your organization may have exposure in any of the above areas. At a minimum, almost all organizations will require commercial general liability insurance, which provides coverage for negligent acts performed by the organization or its employees. As stated above, if the organization owns or operates any motor vehicles, it
must obtain an automobile liability policy. If there are any employees, workers’ compensation in insurance coverage is required by the State of California. Also, government agencies or contracts the organization is a party to (including leases) may stipulate that the organization maintain other types or amounts of insurance.

Other types of insurance (not required by law or a third party) will usually be obtained as a business (balance of risk vs. cost) decision on the part of the organization. For example, in the event your employees handle funds belonging to your organization or those of a third party, a crime insurance policy may be appropriate. An organization that has a board of directors should also consider directors’ and officers’ liability insurance. If the organization owns personal property you may want to insure it to cover a loss in the event such personal property is damaged or destroyed. If the organization owns real property, you should insure it to protect against loss, and if the property is mortgaged, the mortgage company will require you to insure it against an unforeseen loss. Finally, if you have employees you may also want to consider offering certain benefits in the form of health or life insurance.

Remember – don’t purchase insurance for every small exposure that you anticipate. In each case (unless the insurance is required by law or a third party) a cost-benefit analysis should be done, so you avoid paying high premiums to cover a relatively low amount of risk.

Directors’ and Officers’ Liability Insurance

One of the most important areas of insurance coverage to consider for a nonprofit or for-profit corporation is Directors’ and Officers’ liability insurance (D&O). This insurance will protect officers and directors from liabilities which they may incur while serving the corporation. This coverage is important since it enables a person to accept a position as an officer or director of a corporation without worrying about being sued and having to pay for legal defense costs out of his/her own pocket. In the nonprofit world, it is essential to obtain D&O coverage so that the organization can successfully attract qualified volunteer board members.

Generally, in the event there is a liability claim against a director or officer, it will be covered under the D&O policy --- and the insurance company (not the individual director or officer) is required to pay the claim. This is also significant from the organization’s perspective because many corporations agree to indemnify and hold employees and directors harmless from certain liabilities they may incur during the performance of their duties. Thus, if there was no
insurance coverage and an employee or director were to incur liability, the organization would probably have to pay for any liability and expenses that the employee or director incurred in defense of the claim.

Remember to talk with other business owners/nonprofit organizations in your field.

How to Shop For Insurance

Before you purchase insurance you should take advantage of the opportunity to receive expert advice and assistance from an insurance agent or broker. The professional insurance agent is generally trained in risk analysis, and will be able to assist you in determining the types and amount of insurance you need. You should obtain quotes (in writing) on your insurance and secure different viewpoints on the most effective insurance coverage for your organization. Remember also that some brokers have only limited markets – which means they may only be able to give you quotes from a few insurance companies. Ask your broker what his market is, and if it is limited, go to a different broker or use several brokers – to ensure that you are getting quotes from the “full universe.”

Of course, you can search online and get quotes from carriers. This will equip you with general price information for different types of insurance. But, don’t purchase insurance without talking to a broker/agent first. Finally, remember to talk with other business
owners/nonprofit organizations in your field. This can provide you with valuable, unbiased and practical information. If you are a member of a trade association or organization, insurance may be available through that group.

**Items to Consider When Purchasing Insurance**

When purchasing any insurance there are various items that you should consider. These include:

**The Amount Of Insurance To Be Purchased**

The vast majority of insurance policies contain limits of liability coverage. The limit of liability is the maximum amount of money the policy will pay in the event there is a claim that falls under the policy. Thus, if you are purchasing a general liability insurance policy you need to determine the amount of coverage that will be enough to protect your organization in the event of a loss.

Also, determine whether the amount of the coverage includes costs such as legal defense. If costs of legal defense are included in the coverage limit, the amount of coverage to be paid on the claim will be offset by legal costs paid in defense of the claim. For example, if the organization purchases coverage in the amount of $500,000.00, and costs of legal defense are
$400,000.00, then the organization will only be given $100,000.00 to pay out the claim. If the claim is for higher than $100,000.00, the organization will have to pay for the excess. Therefore, it is better to negotiate for coverage limits which exclude, rather than include, costs of legal defense.

**The Cost**

The cost of insurance is often difficult to gauge and will be unique to the type of business you run and the type of risks that are prevalent in such a business. However, there are a few things you should know. The first is that insurance is a competitive market, so you should definitely shop around. While it is inevitable that the cost of the policy will vary by the amount of the coverage you secure, shopping around will ensure that you get the most coverage at the least cost. Second, you should find out the basis for your premiums. This will depend on your type of business and the type of insurance. For instance, some businesses’ premiums will be calculated based on payroll, others based on gross sales, and still others based on number of units, office space or square footage. If you can figure out the basis for the premium, you will be able to compare that number with other bases used by other insurance companies. At the very least, you will be knowledgeable when negotiating the cost of the insurance. Finally, note that the easiest way to reduce cost is by raising the deductible – the portion that is self-insured. This is explained in the section of this guidebook entitled “Deductible Amounts of a Policy.”

**Who Is Insured Under The Policy?**

This consideration is important when you need to cover not only your organization, but the officers, directors and employees of your organization. For example, Directors’ and Officers’ liability insurance does not generally insure the corporation, unless the corporation is named (along with the directors and officers) as an insured. This could be significant when a director or officer is sued for improper acts, since the corporation is usually also named as a party to the action. If the corporation were not a named insured under the policy it would not be afforded any coverage and would have to secure its own attorney to defend the corporation; the corporation would be required to pay any liability that was attributed to it as a result of the wrongful acts of an officer or director. Also, the policy should cover any additional employees, officers or directors who may join the organization during the term of the policy. Nonprofit organizations should also ask to have volunteers covered as named insureds under the policy.
Deductible Amounts Of A Policy

Another factor to consider when you purchase insurance is the deductible amount of the insurance coverage. For example, if you elect to have a $500.00 deductible on your insurance it means that you are paying the first $500.00 of any claim on that policy before the insurance company is obligated to pay any amount. If the claim is for $1,500.00 you will pay the first $500.00 and the insurance company will pay the next $1,000.00. A deductible provision in an insurance policy is a form of self insurance. The higher the amount of the deductible on an insurance policy the lower the premium should be. You need to weigh how much the organization can afford to pay if there is a deductible on the policy against the cost of full insurance coverage. Insurance companies generally like higher deductible amounts on insurance policies because an insured generally will not file a claim on a loss unless it exceeds the amount of the deductible and thus the insurance company will avoid any expense in the form of a claim, investigation or settlement.

Claims Made Versus An Occurrence Insurance Policy

Insurance is sold either as a “claims made” or “occurrence” type of policy. What type of policy you get will vary with what type of insurance you are buying. For instance, an occurrence type of policy will generally be found in commercial general liability policies. Directors’ and Officers’ insurance is almost always “claims made.” Occurrence type policies generally afford better protection to the insured. An occurrence type of insurance policy provides coverage protection if you are insured when the incident occurs. Thus, if an incident occurs during a period when an insurance policy is in force, and the lawsuit were to be filed many years after the policy expires, you still would be protected if you purchased an occurrence type of insurance policy.

A claims made insurance policy requires the insurance policy to be in effect when the claim occurred and when the lawsuit is filed against you. The policy will contain a specific exclusion for claims based on acts which occurred before the policy goes into effect and excludes claims which arise after the policy expires. Thus, if the event giving rise to a claim occurs, and then the insurance policy expires, and a lawsuit is filed, you would not be protected under a claims made insurance policy. This becomes an important consideration when you initially purchase or change insurance companies. Make sure you receive protection for claims which may fall within this area of no coverage by purchasing an appropri-
ate form of insurance protection. These are commonly referred to as “Prior Coverage” for preexisting claims or a “Tail Coverage” for claims filed after the policy expires.

**What Other Exclusions Are Contained In The Policy?**

All insurance policies contain standard exclusions. For example, punitive damages are not insurable. Some policies will also exclude intentional acts, such as assault or slander. Most insurance policies contain an exclusion for pollution whether you caused it or it was caused by a third party and you are now involved in litigation concerning the pollution. Wrongful employee termination is another area where you may or may not have an exclusion. Carefully review the exclusions in any policy you are considering. If any of these exclusions are areas where you feel you require insurance protection, discuss it with your insurance company or broker. Insurance coverage can almost always be added under a special endorsement or by payment of an additional premium to the insurance company.

**Application For Insurance**

Make sure your information is accurate and complete on your application for insurance. Most insurance companies will require you to complete an application for insurance coverage prior to their agreement to provide you with any insurance. If any of the information contained in the application is incorrect or not complete, the insurance company may attempt to deny you coverage as a result of the improper application information, even if you’ve paid all your premiums, and even if the claim is unrelated to the information! In certain cases you may also be liable for fraud and criminally charged for perjury if you know the information you provided was untrue. If you have any questions about the application for insurance coverage you should contact your insurance agent or an attorney.

**Right To Terminate Or Nonrenewal**

Remember that when you first obtain insurance, the insurance company generally has a 60-day “underwriting” period during which it may review your application for insurance and decide whether it wants to provide you with coverage. If an inspection of the property is required, the insurance company may do so and then verify that the rating of your policy and the premium charged is correct. The company may elect to cancel your policy at any time during this 60-day period, but must give you at least 10 days prior notice.

After the 60-day period has expired the company may not generally cancel the policy, unless you do not pay your premiums or the company discovers fraud. Finally, if the insurance company does not intend to renew your policy, it must give you at least 60 days notice of nonrenewal (prior to the current policy’s expiration).
**Replacement Cost Or Actual Cash Value Coverage**

When you are insuring real or personal property you may have an option to insure for replacement cost or the actual cash value of the property. In the event of a loss, replacement cost insurance provides you with the cost of replacing the lost or damaged property. Thus, if your office building was destroyed and it cost $100,000 to replace, the insurance company would fully reimburse you for the amount of that loss. However, if you insured the actual cash value of the building, and it cost $90,000 but had depreciated in value to $75,000, you would only receive $75,000 from the insurance company to cover your loss.

**Coinsurance Provisions**

Property insurance policies contain a coinsurance clause requiring you to insure your property to the amount specified in the policy. Generally the amount specified is 80% of the actual value of the property. If you do not insure to the actual cash value of the property, you will be coinsuring the loss with the insurance company. Assume for this example that your building’s replacement value is $100,000 with a coinsurance requirement of 80%. Under this example you are required to insure the building for no less than $80,000. If you only insured for $40,000 and there is a total loss of the property, you will have coinsured only 50% of the loss and the insurance company would only pay you $40,000 on the loss.

**Who Is Your Insurance Carrier?**

Some insurance companies, like any other business, are stronger and have greater financial strength than others. You should make sure that the insurance company will still be around (and solvent) when you incur a loss. Since you have paid money to the insurance company for protection, you expect to be paid when and if you have a loss. There are rating agencies that evaluate the financial strength of insurance companies. The most well known agency is A. M. Best Company, Inc. Your insurance broker will have the ability to check on the Best Rating of any insurance company you may want to use. If you do not have an insurance broker, ask the insurance company to provide you with a copy of its Best Rating or check it yourself at the local library or online at www.ambest.com.
The California Department of Insurance licenses insurance companies that do business in the state of California. There are also non-admitted insurance companies that may offer to sell you insurance. Non-admitted insurance companies are riskier because they are not subject to the financial solvency regulations and enforcement provisions which a California admitted insurance company are subject to, and they are not covered by the California Insurance Guarantee Association in the case of insolvency.

Do You Need A Risk Manager?

A risk manager is a trained professional insurance person that will help your organization control the risks that could cause a financial loss and determine the most effective means of financing such loss. As a nonprofit or new business it is unlikely that you will have the ability to afford to hire a risk manager (at least in the start-up phases). Thus, you may want to request this type of assistance from your insurance broker or insurance carrier – since some insurance companies may provide these services without cost. If the insurance company performs an inspection and makes recommendations for improvements, the cost of such improvements could be significant. Following the suggestions contained in the report may prevent an injury or loss from occurring and ultimately save time and money for you and your company.

Once your insurance has been secured you should receive a binder of insurance signed by the agent or the insurance company. The binder will provide all of the information about the insurance being provided. The binder will be valid for up to 90 days pending the issuance of the insurance policy. Your insurance policy is an important legal document that establishes the rights and liabilities of the parties. Make sure you review it to determine that it provides the level of coverage you negotiated and to make sure there are no exceptions that you were not aware of. If you have any questions regarding the policy ask your broker or insurance company. If you have any doubt about the level of coverage provided by the policy, request written confirmation of your conversation. Keep the policy and any correspondence in a safe place and do not forget to pay your premiums when they are due.
Where to Go for Help

In the event you have a problem with your insurance company or broker, you may want to contact the State of California Department of Insurance Consumer Hotline at 800-927-HELP (4357), or (213) 897-8921, or on the Internet at:

http://www.insurance.ca.gov.

If you are a nonprofit organization and would like assistance in securing insurance you can contact the Nonprofits Insurance Alliance of California, P.O. Box 8507, Santa Cruz, CA 95061-8507, 800-359-6422, http://www.niac.org. In the event you are unable to secure property insurance it may be available through the California Fair Plan, which you can contact at 800-252-0089.

Purchasing insurance is one of the most important business decisions that you will be required to make in the management of your business or nonprofit organization. Your financial future may depend on the insurance you have purchased. It takes time and effort to be a smart shopper for your insurance needs.

Finally, remember that insurance covers only specifically what risks are stated in the policy. You should not just assume, because you bought one insurance policy, that you are protected against all types of risk. Different policies cover different, very specific types of risk. Know what you are covered for by reading your insurance policies carefully!

Your reward for the investment of such time and effort will be an increased understanding of the insurance you have purchased and the peace of mind that will result from knowing that you have a proper insurance program in place.

At the end of this booklet there is a glossary of the various types of insurance available to the nonprofit or small business organization and some of the insurance terms you may encounter.
Part Seven: Federal Tax Considerations For Small Businesses

Introduction

The federal tax laws governing small businesses are quite extensive. The purpose of this guide is to provide small business owners with some basic federal tax information. It will discuss the taxes that businesses must pay, as well as some non-tax considerations that small business owners should be aware of. We recommend that all small business owners contact a tax professional who may provide more detailed tax advice.

Choosing A Business Structure

When you decide to enter into business, you must first choose which form of business you wish to organize. You should consider all of the legal and tax considerations that are involved in each organizational form. This guide addresses some of the federal tax issues that new business owners should consider. For more information, visit the Forms and Publications section of the Internal Revenue Service (IRS) website, at http://www.irs.gov. Before you do that, check the list at the end of this pamphlet to find titles of relevant IRS publications.

This guide considers some of the tax issues that relate to the following forms of business:

- Sole proprietorship
- Partnership
- Corporation
- S Corporation
- Limited Liability Company (LLC)
Organizational Forms

Sole proprietorship

A sole proprietorship is an unincorporated business that a single individual owns and operates. The owner and the business are not treated as different persons for legal and tax purposes. This means that the owner of a sole proprietorship has personal responsibility for all of the business liabilities and risks. A sole proprietor reports his or her business income and expenses on his or her individual tax return.

Partnership

A partnership is also not a separate business entity for legal and tax purposes. Instead, a partnership is the relationship existing between two or more persons who carry on a trade or business together. Because a partnership is merely an arrangement between people, a partnership does not itself constitute a business entity with an existence separate and apart from the people that made the arrangement.

A partnership must file annual information returns with the IRS that detail the partnership’s operations, but a partnership itself does not pay any income tax. However, this does not mean that a partnership’s operations are not subject to tax. Rather, the partners allocate all of the partnership income, loss, deductions, etc. to themselves, and then the partners report their share of these items on their income tax returns.

Corporation

A corporation differs from a sole proprietorship and a partnership in that it is a separate entity that exists apart from its owners, who are called shareholders. Because a corporation has a separate existence, its owners generally are not personally liable for any of the business liabilities and risks. A corporation pays taxes on its income and is required to file an annual income tax return. If a corporation distributes any of its income to its shareholders, they also must report these payments as income on their annual income tax returns.

S Corporation

Smaller U.S. corporations that meet particular requirements may elect to be treated as an S corporation and avoid paying income tax on most of their income. S corporation shareholders, like partners in a partnership, allocate the amounts of the S corporation income, loss, etc. that belong to each shareholder, who then includes those amounts on his or her individual income tax returns.

Limited Liability Company

There are two different types of limited liability companies (LLCs): single-member LLCs, which have one owner, and multi-member LLCs, which have more than one owner (or member). For legal purposes, both forms of LLCs are treated as entities that are separate from their owners. Therefore, owners of LLCs gen-
erally do not have any personal liability for the business’ liabilities and risks. However, single-member LLCs and multi-member LLCs are treated quite differently for tax purposes.

Most multi-member LLCs typically function like a partnership. Therefore, the federal tax law automatically treats an LLC as a partnership for tax purposes. As with a partnership, the members (or owners) file an annual information return with the IRS, and allocate to themselves all of the LLC’s items of income, loss, etc., which the members report on their annual income tax returns.

**Multi-Member LLC Taxed as a Corporation**

The federal tax law allows multi-member LLCs to opt out of being treated as a partnership for tax purposes. These multi-member LLCs may file an election with the IRS to be treated as a corporation for tax purposes. An LLC that is taxed as a corporation is subject to tax on its income, and its members are subject to tax on any amounts that the LLC distributes to them.

---

**Single-Member LLC**

Although a single-member LLC is legally an entity that is distinct from its owner, the federal tax law doesn’t consider such an LLC to be a separate entity for tax purposes. The federal tax law “disregards” a single-member LLC and treats it as if it were non-existent unless it makes a special election to be taxed like a corporation. Therefore, the owner of a single-member LLC reports all of the LLC’s items of income, loss, etc. on his or her or its (if the owner is a business organization) annual income tax return.

**Multi-Member LLC Taxed as a Partnership**

The federal tax law treats a single-member LLC as if it were non-existent.
Basic Tasks for Tax Compliance

A fter you select the form of business that you wish to organize, you must complete some administrative tasks to help your business comply with the federal tax laws.

Apply for an Employer Identification Number (EIN)

The IRS uses employer identification numbers (EINs) to identify businesses. You can think of it as being similar to a social security number (SSN) for your business. The IRS requires all corporations, partnerships, S corporations, and LLCs to have an EIN. Also, any sole proprietorships with employees must have an EIN.

Businesses can get an EIN from the IRS by mail, telephone, fax, or online. Businesses can obtain an EIN immediately by using the telephone or online options or within four business days applying by fax. Businesses using the mail usually receive an EIN in 4 or 5 weeks. It is a good idea to apply for an EIN as soon as you organize your business entity. To get an EIN, complete form SS-4, Application for Employer Identification Number. You can download the form from the Forms and Publications section of the IRS website, http://www.irs.gov, or you can call the IRS at 1-800-829-1933 to apply via telephone or 1-800-829-1040 to request that a form be mailed to you.

Your business should apply for an EIN as soon as possible because the IRS requires most businesses to make filings and deposit tax payments several times each year. If you do not have an EIN by the time your business is required to make a filing or deposit a payment, write “applied for” and the date you applied for the EIN in the area on the form that is designated for the EIN. Do not use your social security number.

Establish a Method to Collect Payee Identification Numbers

Most businesses make payments to recipients (called “payees”) that must be reported to the IRS. These payments are reported on information returns, which are discussed in greater detail below. Businesses must include each payee’s identification number on the information returns so the IRS knows who received each payment.

Employees

Your business is legally required to collect a social security number (SSN) from each employee. When your business pays its employees, it must provide the IRS with information returns that (a) identify the employee, and (b) state the amount that the business paid the employee. The business must include the employee’s SSN on these information returns.
To ensure that your business has an accurate copy of how each employee’s name is shown on his or her social security card, it’s a good idea to make a photocopy of each employee’s social security card on the first day the employee begins to perform services for the business. If an employee doesn’t have a card, or if the name on the card isn’t correct, you should encourage the employee to request a new card by filing Form SS-5, Application for a Social Security Card, with the social security administration (SSA). The employee may get a copy of the form at a local SSA office, by calling 1-800-772-1213, or by downloading the form from the SSA website http://www.ssa.gov.

Other payees

Your business will be required to report many other payments to the IRS that it makes to other individuals and business organizations. If your business makes payments to an individual service provider who is not an employee of your business (for example, an independent contractor) that the business must report to the IRS, you should ensure that the individual provides your business with an accurate SSN. Similarly, if you make payments to another organization that your business is required to report to the IRS, you must ask that organization to provide you with its EIN.

Use IRS Form W-9, Request for Taxpayer Identification Number and Certification, to get a non-employee individual’s SSN or the organization’s EIN. You can download the form from the Forms and Publications section of the IRS website, http://www.irs.gov, or you can call the IRS at 1-800-829-1040 to request that a form be mailed to you.

Choose an Accounting Method

Accounting methods determine (a) how businesses should report items of income and expense, and (b) when those items should be reported. The IRS requires businesses to select an acceptable and consistent accounting method. Your business must continue to use the accounting method that it uses on its first income tax return until it requests the IRS’ permission to change to a different method. Also, you must request permission to change your business’ accounting for any material item in your business. Therefore, your business should adopt a sound accounting method as soon as possible.

Your business cannot use different accounting methods for figuring its taxable income and for keeping its books. The law also mandates that your business adopt an accounting method that clearly reflects your business’ income. Generally, an accounting method clearly reflects income if it consistently uses accounting principles that are relevant to your business. However, the accounting method must provide similar treatment to all items of income and expense in all of the business’ tax years.

The two most common accounting methods are the
cash method, and an accrual method.

Cash Method: Report income in the tax year it is received. Deduct or capitalize expenses in the tax year they are paid.

Accrual Methods: Generally, report income in the tax year that it is earned, even though payment may arrive in a different tax year. Deduct or capitalize expenses in the tax year they are incurred, whether or not they are paid that year.

NOTE: There is only one cash accounting method, but there are several accrual accounting methods.

NOTE: If your business carries inventory, it must use an accrual method of accounting for business purchases and sales.

**Adopt a Tax Year**

Your business must figure its taxable income and file an income tax return based on an annual accounting period, or a tax year. Usually, a tax year consists of 12 consecutive months. Most businesses can select either a calendar tax year, or a fiscal year. A calendar tax year is a period of 12 consecutive months beginning January 1 and ending December 31. A fiscal tax year usually consists of 12 consecutive months ending on the last day of any month, other than December.

Most businesses that have never filed an income tax return may choose a calendar or fiscal tax year. As with your business’ accounting method, it is a good idea to select your tax year as early as possible, because your business must continue to use the tax year that it adopts in its first income tax return. In any event, your business must choose a tax year by the due date of its first income tax return (not including extensions). In addition, your business must also gain IRS permission to change its annual tax period.

A sole proprietorship must operate on the same tax year as its individual owner. Also, some special rules apply to partnerships, S corporations, and LLCs that are treated as a partnership for federal tax purposes. Also, businesses without adequate records, an annual accounting period, or those with annual accounting periods that do not qualify as a fiscal year must use a calendar tax year.
Federal Taxes that Apply to Businesses

The tax rules that apply to businesses are incredibly lengthy and complex. In this pamphlet we do not attempt to cover any of the particular rules that apply to businesses. We recommend that you consult with a tax professional regarding your business tax issues.

The form of business you operate determines what taxes you must pay and how you pay them. Businesses generally are subject to the following forms of taxation:

- Income tax
- Self-employment tax
- Employment taxes
- Excise taxes

This pamphlet touches upon the procedural aspects of business income tax and the self-employment tax. For a detailed discussion of the rules governing employment taxes, see IRS Publication 15, Circular E, Employer’s Tax Guide, located in the Forms and Publications section of the IRS website, located at http://www.irs.gov. For more information on excise taxes, see IRS Publication 510, Excise Taxes, which is available in the same area of the IRS website.

Income Tax

All businesses except partnerships (and LLCs treated as partnerships for tax purposes) must file an annual income tax return. Partnerships (and LLCs treated as partnerships for tax purposes) file an annual information return.

Although most businesses file an annual income tax return, these same businesses deposit estimated tax payments at various times throughout the taxable year. If your business does not deposit its estimated tax throughout the year, or if it does not deposit enough estimated tax throughout the year, it may be subject to penalties and interest (discussed later).

If you own a corporation (or an LLC treated as a corporation for tax purposes), you generally must make estimated tax payments if you expect the corporation to owe tax of $500 or more when you file its income tax return. The IRS requires your business to deposit these payments. Use Form 1120-W, Estimated Tax for Corporations, to determine the estimated tax.

Certain persons owning interests in business organizations other than corporations (and LLCs treated as a corporation for tax purposes) may be required to deposit estimated tax payments throughout the year. These persons generally must make estimated tax payments if they expect to owe tax of $1,000 or more when the income tax return is due. Use Form
1040-ES, Estimated Tax for Individuals, to determine and pay the estimated tax.

**Self-Employment Tax**

 Owners of sole proprietorships and persons who employ themselves (including persons who work for an LLC or partnership they also own) are subject to a self-employment tax. Generally, the self-employment tax collects social security and Medicare payments for these persons. Self-employment tax payments are credited to your coverage under the social security system.

Persons who have net earnings from self-employment of $400 or more (except church employee income) must pay self-employment tax. Individuals earning church employee income of $108.28 or more must pay self-employment tax.

**Business Expenses**

You can deduct business expenses on your income tax return. These are the current operating costs of running your business. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business, trade, or profession. An expense does not have to be absolutely required to be considered necessary.

There are many expenses that you may be able to deduct. See the form instructions to your income tax return, and Publication 535, Business Expenses, which are all located in the Forms and Publications section of the IRS website, at http://www.irs.gov.

**Filing Information Returns**

As discussed above in the section regarding EINs, if your business makes or receives certain payments, it may be required to report those payments to the IRS on information returns. The IRS uses the information returns to ensure that persons receiving payments report all items of income on their income tax returns. In addition, each person that is identified on an information return that your business files with the IRS, called a “payee,” must receive a copy of the return (or a “payee statement”).

Employers must file Form W-2, Wage and Tax Statement, to report to the IRS payments that the employer made to its employees. An employer must include the following payments on Form W-2:

- Wages, tips, and other compensation,
- Withheld income, social security, and Medicare taxes, and
- Advance earned income credit payments.

Businesses must report most other payments to the IRS on a version of Form 1099. For more information on particular information reporting requirements, see

Federal Tax Law Penalties

The federal tax law provides extensive penalties for businesses and individuals who fail to file returns or pay taxes as required. Individuals and organizations may be subject to criminal penalties for willful failure to file, tax evasion, or making a false statement.

Income Tax Return, Income Tax, and Information Return Penalties

If you do not file required business tax returns by the due date, your business may be required to pay a penalty. The penalty is based on the amount of tax that is not paid by the due date. The instructions for the relevant tax return will have more information about the penalty that applies for failing to file the return.

Similarly, if your business does not pay its taxes by the due date, it will be assessed a penalty for each month, or part of a month, that its taxes are not paid. The instructions for your tax return will have more information about the penalty that applies for failing to pay the tax.

Moreover, if your business does not withhold income, social security, or Medicare taxes from its employees, or if your business withholds taxes but does not deposit them or pay them to the IRS, it may be subject to a penalty of the unpaid tax, plus interest. Your business may also be subject to penalties if it deposits the taxes late.

Information Return Reporting Penalties

If your business does not file information returns by the due date, it can be subject to a penalty. Your business may also be subject to such a penalty if it fails to include all of the information required on the information return, or if it reports incorrect information.

If your business does not provide a payee with a copy of a required statement by the due date, it can be subject to a penalty. Your business may also be subject to such a penalty if it fails to include all of the information required on the payee statement, or if it includes incorrect information.

These information return reporting penalties will not apply if your business can show that its failures were due to reasonable cause and not willful neglect. In addition, your business will not be subject to a penalty for failing to include all the required information,
or for including incorrect information, on a de minimis (or small) number of information returns, if your business corrects the errors by August 1 of the year the returns are due. (To be considered de minimis, the number of returns cannot exceed the greater of 10 or fi of 1% of the total number of returns your business is required to file for the year.)

If your business does not include its EIN or the taxpayer identification number of another person where required on a return, statement, or other document, your business may be subject to a penalty of $50 for each failure. Your business may also be subject to the $50 penalty if your business does not give its EIN to another person when it is required on a return, statement, or other document.

**Basic Recordkeeping Tips**

Every business must keep records. Good records help you keep track of business income and expenses and keep tabs on your business’ overall health.

Good records help you to monitor the progress of your business. For example, you can use records to determine whether your business is improving, and which products or services are successful or not.

Accurate financial statements are based on good business records. These statements include income (profit and loss) statements and balance sheets. Most banks and creditors require loan and credit applicants to supply accurate financial statements.

Your business will collect money and/or property from many sources. Business records help you to identify the sources of these receipts. This information is necessary to comply with the information reporting requirements described above.

You cannot prepare your business’ tax return without keeping good records. The IRS requires taxpayers to maintain records that support many items of income,
expenses, and credits that businesses may report. Generally, these records are the same as you would use in your business to monitor your business and to prepare financial statements.

The IRS requires businesses to keep their business records available for inspection at all times. Moreover, if the IRS examines any of your business’ tax returns, you may be asked to explain the items reported. Good business records may speed up the examination.

**Types of Records to Keep**

Generally, the federal tax law does not require businesses to keep any specific types of records. You may choose any record-keeping system suited to your business that clearly shows the business’ income. The type of business that you operate affects the kinds of records you need to keep for federal tax purposes. Broadly speaking, you should set up a record-keeping system that uses an accounting method that clearly shows your business’ income for the tax year. Also, if you have more than one business, you should keep a separate set of records for each business.

More specifically, your business’ record-keeping system should include a summary of your business transactions. Keep this summary in your books. In addition, your business’ books must show its gross income, as well as its deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books. In addition, you must keep documents that show the amounts paid and items received or services rendered in your business transactions.

**Supporting Documents**

Most of the transactions and payments you make in your business will generate supporting documents. These documents may include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. Supporting documents reflect the information that you need to record in your books.

You should keep these documents because they support your book entries and the figures on your business tax return. Organize your supporting documents, and keep them in a secure place.

NOTE: The tax law imposes special record-keeping rules that apply to travel, transportation, entertainment, and gift expenses.

**How Long to Keep Records**

The IRS requires taxpayers to keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. Generally, if you owe additional tax, then the period of limitations is 3 years. However, if you do not report income that you should report, and it is more than 25% of the gross income shown on the return,
then the period of limitations is 6 years. Also, if you file a fraudulent income tax return, or if you do not file an income tax return at all, then there is no limit on the period of limitations. If you file a claim for credit or refund after you file your return, the period of limitations is the later of three years or two years after the tax was paid. If your claim for credit or refund is due to a bad debt deduction or due to a loss from worthless securities, then the period of limitations is 7 years. If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Moreover, do not dispose of your records as soon as you do not need them for tax purposes. Many banks, creditors, and insurance companies may require you to maintain these records longer than the IRS does.

You should keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file an amended return.

How to Obtain Additional Information

Taxpayer Advocate

If you have been unable to deal with an IRS problem, you should contact your Taxpayer Advocate. The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

Call the Taxpayer Advocate at 1-877-777-4778.

Call the IRS at 1-800-829-1040.

Call 1-800-829-4059 if you are a TTY/TDD user.
IRS Publications Regarding Business Tax Issues

All of these publications are available in the Forms and Publications section of the IRS website, http://www.irs.gov.

For more information on sole proprietorships, see IRS Publication 334, Tax Guide for Small Business.

For more information on partnerships, see IRS Publication 541, Partnerships.

For more information on corporations, see IRS Publication 542, Corporations.

For more information on S corporations, see the instructions for Form 2553, Election by a Small Business Corporation, and Form 1120S, U.S. Income Tax Return for an S Corporation.

For more information on multi-member LLC elections, see the instructions for Form 8832, Entity Classification Election.

For more information about EINs, see Publication 1635, Understanding Your EIN.

For more information on accounting methods, see IRS Publication 538, Accounting Periods and Methods.

For more information on estimated tax payments, see IRS Publication 505, Tax Withholding and Estimated Tax.

For more information about corporate income tax payments, see IRS Publication 542, Corporations.

For more information about self-employment tax, see IRS Publication 533, Self-Employment Tax.

For more details on information returns and when you have to file them, see the Instructions for Forms 1099, 1098, 5498, and W-2G.

For more information on what to report on Form W-2, see the Instructions for Forms W-2 and W-3.

For more information about penalties relating to failing to pay employment taxes properly, see IRS Publication 15, Circular E, Employer’s Tax Guide.

For more information on the penalties for failing to follow information reporting requirements, see the General Instructions for Forms 1099, 1098, 5498, and W-2G.

For more information on record-keeping requirements for travel, entertainment, and car expenses, see Publication 463, Travel, Entertainment, Gift, and Car Expenses.

For more information on the Taxpayer Advocate, see Publication 1546, The Taxpayer Advocate Service of the IRS.
**Accident insurance.** Insurance that undertakes to indemnify the insured against expense, loss of time, and suffering resulting from accidents causing physical injury, usually by payment at a fixed rate per month while the disability lasts, and sometimes including the payment of a fixed sum to heirs in case of death by accident within the term of the policy.

**Accounts receivable insurance.** Insurance coverage designed to protect against inability to collect because of damage to records which support the accounts.

**Additional insured.** A person other than the named insured, such as the insured’s spouse, who is protected under the terms of the contract.

**Air travel insurance.** Form of life insurance that may be purchased by air travelers according to the terms of which the face value of the policy is paid to the named beneficiary in the event of death resulting from a particular flight.

**All-risk insurance.** Type of policy that protects against all risks and perils except those specifically enumerated.

**Annuity insurance.** An insurance contract calling for periodic payments to the insured or annuitant for a stated period or for life.

**Automobile insurance.** Insurance against loss of or damage to a motor vehicle caused by fire, windstorm, theft, collision, or other insurable hazards, and also against legal liability for personal injuries or damage to property resulting from operation of the vehicle. Policy of indemnity to protect the operator and owner from liability to third persons as a result of the operation of the automobile.

**Business key insurance.** Insurance that protects a business on the disability or death of a key employee.

**Business interruption insurance.** Insurance which protects a business from losses due to inability to operate because of fire or other hazards.

**Casualty insurance.** Insurance that is primarily concerned with losses caused by injuries to persons and legal liability imposed upon the insured for injury or for damage to the property of others.

**Coinsurance.** Provision in a policy of insurance that limits the liability of the insurer to that portion of the loss which the amount of insurance bears to a particular percentage of the value of property at the time of the loss.

**Collision insurance.** A form of automobile insurance that covers loss to the insured vehicle from its collision with another vehicle or object, but not covering
bodily injury or liability also arising out of the collision. Type of coverage that protects insured for damage to his own property in an accident as contrasted with liability insurance which protects the insured in an action or claim for loss to another’s property.

**Commercial insurance.** Indemnity agreements, in the form of insurance bonds or policies, whereby parties to commercial contracts are to a designated extent guaranteed against loss by reason of a breach of contractual obligations on the part of the other contracting party. Policies of contract credit and title insurance are examples of this type of insurance.

**Convertible collision insurance.** Type of collision coverage generally carrying lower premium but requiring higher premium after first loss or claim; an alternative form of deductible collision coverage.

**Convertible insurance.** A policy that may be changed to another form of insurance by contractual provision and without evidence of insurability. Usually used to refer to term life insurance convertible to permanent insurance.

**Convertible life insurance.** Generally a form of term life insurance that gives the insured the right to change to permanent life insurance without medical examination.

**Credit insurance.** Type of insurance protection against losses due to death, disability, insolvency or bankruptcy of debtor. Policy covers balance of debt due, with proceeds payable to creditor. Commonly offered by banks and other lenders. Terms and conditions are regulated by federal and state statutes, e.g., Truth-in-Lending laws.

**Crime insurance.** Insurance that protects insured from losses due to criminal acts against insured such as burglary.

**Crop insurance.** Insurance coverage against financial loss due to destruction of agricultural products resulting from rain, hail and other elements of nature. This type of insurance is sponsored by Federal Crop Insurance Corporation.

**Decreasing term insurance.** A term insurance policy where the premiums are uniform throughout its life, but the face value of the policy declines over time.

**Employer’s liability insurance.** In this form of insurance the risk insured against is the liability of the insured to make compensation or pay damages for an accident, injury or death occurring to an employee in the course of his employment, imposing such liability on employers. Coverage which protects employer as to claims not covered under workers’ compensation insurance.

**Endowment insurance.** Type of protection which combines life insurance and investment so that if the insured outlives the policy the face value is paid to him. If he does not outlive it, the face value is paid to his beneficiary.

**Errors and omissions insurance.** Insurance that indemnifies the insured for any loss sustained because of an error or oversight on his or her part.

**Excess insurance.** Coverage against loss in excess of a stated amount or in excess of coverage provided under another insurance contract.
Extended term insurance. A non-forfeiture provision in most policies which continues the existing amount of life insurance for as long a period of time as the contract’s cash value will purchase term coverage.

Fidelity insurance. Form of insurance in which the insurer undertakes to guarantee the fidelity of an officer, agent, or employee of the insured, or to indemnify the employer for losses caused by dishonesty or lack of fidelity on the part of such a person.

Fire insurance. A contract of insurance by which the underwriter, in consideration of the premium, undertakes to indemnify the insured against losses on his property caused by means of accidental fire happening within a prescribed period.

Fleet policy insurance. Type of blanket insurance covering a number of vehicles of the same insured, e.g., covers pool or fleet of vehicles owned by a business.

Floater insurance. A form of insurance that applies to moveable property whatever its location, within the territorial limits imposed by the contract.

Government insurance. Life insurance underwritten and offered by federal government to war veterans.

Group insurance. A form of insurance in which individual lives of a group of persons, usually employees, are insured for a fixed premium based on average age and paid either by employer in whole or partially by both employer and employee, insuring each for a definite sum so long as the employee remains in such employment and the premiums are paid.

Group-term life insurance. Life insurance coverage obtained by an employer for a group of employees.

Guaranty or fidelity insurance. A contract whereby one party agrees to indemnify another against loss arising from the want of integrity or fidelity of employees and persons holding positions of trust, or embezzlements by them, or against the insolvency of debtors, losses in trade, loss by non-payment of notes, or against breaches of contract.

Hail insurance. Insurance which provides protection against loss of crops or grain because of hail storms.

Health insurance. An insurer is obligated to pay or allow a benefit of pecuniary value with respect to the bodily injury, disablement, sickness, death by accident or accidental means of a human being, or because of any expense relating thereto, or because of any expense incurred in prevention of sickness.

Homeowners insurance. Policy insuring individuals against any, some, or all of the risks of loss to personal dwellings or the contents thereof or the personal liability pertaining thereto.

Indemnity insurance. Insurance which provides indemnity against loss, in contrast to contracts which provide for indemnity against liability. The latter are known as liability contracts or policies, and the former as indemnity contracts or policies.

Inland marine insurance. Originally, a form of insurance protection for goods transported other than on the ocean. Now, this term applies to a variety of insurance coverages on personal property and to general liability while the property is in the possession of
third parties.

**Joint life insurance.** Form of life insurance on two or more persons and payable on the death of the first to die.

**Key man life insurance.** Type of life insurance written on the life of an important or key officer or employee in a business organization. The business is the beneficiary and is entitled to the proceeds on the death of the insured.

**Level premium insurance.** Type of life insurance in which the cost is spread evenly over the premium paying period.

**Liability insurance.** Insurance that covers claims against the insured for such damages as injury or death to other persons or property damage.

**Life insurance.** A contract between the holder of a policy and an insurance company (i.e., the carrier) whereby the company agrees, in return for premium payments, to pay a specified sum (i.e., the face value or maturity value of the policy) to the designated beneficiary upon the death of the insured.

**Limited policy insurance.** Type of coverage which offers protection against specific perils or accidents and against no others.

**Major medical insurance.** Insurance protection against large medical, surgical and hospital expenses of the insured.

**Malpractice insurance.** Type of liability insurance which protects professional people (e.g. doctors, lawyers, accountants) against claims of negligence brought against them.

**Marine insurance.** A contract whereby one party, for a stipulated premium, undertakes to indemnify the other against certain perils or sea-risks to which his ship, freight, and cargo, or some of them, may be exposed during a certain voyage, or for a fixed period of time.

**Mortgage insurance.** Insurance from which the benefits are intended by the policy owner to pay off the balance due on a mortgage upon the death of the insured or to meet the payments on a mortgage as they fall due in case of the death or disability of the insured.

**No-fault auto insurance.** Type of automobile insurance in which claims for personal injury (and sometimes property damage) are made against the claimant’s own insurance company (no matter who was at fault) rather than against the insurer of the party at fault. No-fault statutes vary from state to state in terms of scope of coverage, threshold amounts and other provisions.

**Nonassessable insurance.** Type of insurance in which the rate of premium is guaranteed and no additional assessments may be made against the policyholder.

**Old line life insurance.** Insurance on a level or flat rate plan where, for a fixed premium payable without condition at stated intervals, a certain sum is to be paid upon death of the insured.
**Ordinary life insurance.** Whole life and permanent life insurance as distinguished from term, group and industrial insurance.

**Paid-up insurance.** Insurance policy on which all premiums have been paid and on which no further premiums are due and for which benefits the company is liable.

**Participating insurance.** Insurance issued by a mutual company in which policyholder may participate in dividend distributions.

**Partnership insurance.** Life insurance on lives of partners designed to enable surviving partners to buy out deceased partner’s interest.

**Product liability insurance.** Type of liability coverage which protects manufacturers and suppliers from claims for accidents arising out of the use of their products.

**Public liability insurance.** Insurance liability protection against claims arising out of the insured’s property, the insured’s conduct or the conduct of the insurer’s agent.

**Renewable term insurance.** Term life insurance in which the premiums are level during each term, but increase at each new term with the age of the insured. The insured generally has the right to renew for additional terms without a medical examination.

**Retirement income insurance.** Type of insurance in which the insurer guarantees payment of the policy if the insured dies before a certain age and an annuity if the insured survives beyond the specified period.

**Self insurance.** Plan in which the insured (e.g., business) places in a fund sufficient sums to cover liability losses that may be sustained. Commonly, under such plan the business will self insure itself up to a certain amount and then carry regular liability insurance to cover any excesses losses.

**Single premium insurance.** Type of policy on which the insured makes one premium payment.

**Split dollar insurance.** Type of insurance in which the insurer divides the premium dollar between life insurance protection and investment for the benefit of the insured.

**Step rate premium insurance.** Insurance in which the premium may vary from time to time at the option of the insurer.

**Surety and fidelity insurance.** Form of insurance which approximates a bond to protect the insured against dishonesty of employees, agents and the public.

**Term insurance.** Form of pure life insurance having no cash surrender value and generally furnishing insurance protection for only a specified or limited period of time, although such policy is usually renewable from term to term.

**Title insurance.** Insurance against loss or damage resulting from defects or failure of title to a particular parcel of realty, or from the enforcement of liens existing against it. This form of insurance is taken out by a purchaser of the property or one loaning
money on a mortgage, and is furnished by companies specially organized for the purpose, and which keep complete sets of abstracts or duplicates of the records, employ expert title examiners, and prepare conveyances and transfers of all sorts.

*Unemployment insurance.* Form of taxation collected from business to fund unemployment payments and benefits.

*War risk insurance.* Insurance offered by the federal government to protect persons against wartime loss of vessels and property on the high seas, and against death or injury while in the armed forces.

*Workers’ compensation insurance.* Type of protection purchased by employers to cover payments to employees who are injured in accidents arising out of and in the course of their employment; governed by statutes in all jurisdictions.

**Other Insurance Terms:**

*Blanket policy.* Policy covering more than one type of property in one location, or one or more types of property at more than one location.

*Comprehensive coverage.* A simple and convenient form of indemnity now commonly available in contracts of automobile insurance. It includes not only the conventional coverages against loss caused by fire, theft, wind, water, or malicious mischief, but is generally designed to protect against all damage to the insured vehicle except collision or upset.

*Concurrent insurance.* Insurance which to any extent insures the same interest against the same casualty, at the same time, as the primary insurance, on such terms that the insurers would bear proportionately the loss happening under the provisions of both policies.

*Insurance adjuster.* One who undertakes to ascertain and report the actual loss to the subject matter of insurance due to the peril insured against. The adjuster also settles claims against the insurer. An adjuster may be employed either by the insurer or the insured.

*Insurance agent.* Person authorized to represent insurer in dealing with third parties in matters relating to insurance.

*Insurance broker.* One who acts as middleman between insured and company. A broker solicits insurance from the public under no employment from any special company and places order of insurance with a company selected by insurer or, in absence of any selection, with company selected by such broker. Broker is agent for insured though at same time, for some purposes he may be agent for insurer, and his acts and representations within scope of his authority as such agent are binding on insured.

*Insurance commissioner.* A public officer in most states, whose duty is to supervise the business of insurance as conducted in the state by foreign and domestic companies, for the protection and benefit of policy holders, and especially to issue licenses,
approve rates, make periodical examinations into the condition of such companies, and receive, file and publish periodical statements of their business as furnished by the companies.

**Insurance company.** A corporation or association whose business is to make contracts of insurance. They are generally either mutual companies or stock companies.

**Insurance premium.** The consideration paid by insured to insurer for insurance protection.

**Insurance rating.** The process by which the insurance premium for a policy is set after considering the risks involved.

**Insurance trust.** An agreement between insured and trustee, whereby proceeds of an insurance policy are paid directly to trustee for investment and distribution to designated beneficiaries in manner and at such time as insured has directed in trust agreement.

**Interinsurance.** Insurance system whereby several individuals, partnerships, or corporations, through common attorney in fact, underwrite one another's risks against loss under agreement that underwriters act separately and severally. It is distinguishable from all other forms of insurance, in that every insured is interinsurer, and every insurer is insured.

**Mutual insurance.** That form of insurance provided by mutual companies. An essential characteristic of a mutual insurance company is collective and entire ownership and control by its members, all of whom must be policyholders. A mutual company may collect cash premiums from members in advance or it may assess members to pay losses and overhead. To be a mutual insurance company, it is also essential that the company provide insurance to its members substantially at cost.

**Over-insurance.** Insurance on property, either in one or several companies, in an amount which, separately or in the aggregate, exceeds the actual value of the property.

**Reinsurance.** Insurance of an insurer; a contract by which an insurer procures a third person (usually another insurance company) to insure it against loss or liability, or a portion of such, by reason of the original insurance.

**Umbrella policy.** A type of supplemental insurance policy that extends normal liability limits to $1 million or more for a relatively small additional premium.

**Under-insurance.** Insurance coverage for less than the value of the property. Under such policy, coverage for loss or damage to property will be reduced by percentage of underinsurance.
Workweeks (Generally)

- A workweek must begin and end at the same time each week.
- The employer may decide when the workweek begins and ends.
- If an employer fails to do so, the Division of Labor Standards Enforcement will assume that each workday starts at midnight and that each workweek starts at midnight on Sunday.
- Scheduling a workweek is important for overtime issues.

Alternative Workweeks

- Defined as "any regularly scheduled workweek requiring an employee to work more than eight hours in a 24 hour period."
- There are requirements for an alternative workweek including an employee vote. THIS TYPE OF SCHEDULE CANNOT BE UNILATERALLY IMPOSED BY THE EMPLOYER.
- Cannot exceed 40 hours in one week.
- AB 60 absolutely precludes a regular schedule exceeding 10 hours a day at straight-time rates.

Overtime

- AB 60 reinstated the daily overtime and 7th day premium standards for all California employees who do not qualify for the "white collar exemptions" or another exemption.

Instances when overtime applies:

When time and a half is due:

- Work in excess of 8 hours in a single workday.
- Work in excess of 40 hours in a single workweek.
- The first eight hours of work on the seventh consecutive day of work in any workweek.

When double time is due:

- Work in excess of 12 hours in any one day.
- Work in excess of 8 hours on the seventh consecutive day of work in any workweek.
- Different overtime rules apply where an alternative workweek schedule has been adopted or a partial overtime exemption exists.
Union Employees

- Union employees are not covered by overtime rules if the employees are "covered by a valid collective bargaining agreement if the agreement expressly provides for the wages, hours of work, and working conditions of the employees" and satisfies 2 conditions:
  - Premium wage rates for all overtime hours worked and;
  - A regular hourly rate of not less than 30% more than the state minimum wage.

Makeup Time

- The legislation allows for employers to APPROVE, at their option, a written request of an employee to make up lost work at straight time (no overtime rates), even if it occurs after 8 hours are worked in the workday.
- Straight time pay is appropriate if (all 6 requirements must be met):
  - Make up must occur in the same workweek as lost time;
  - Written request each time make up is requested;
  - Employee missed the time because of personal obligations;
  - Made up time must not cause employee to exceed 11 hours in one workday or 40 hours in one work week (if it does, employee must be paid at OVER TIME rate).
  - Employer must approve the employee's written request; and
  - Employer must not encourage or solicit the employee to request its approval to take personal time off and make up missed time.

Meal Periods

- Governed by California Labor Code §512
- The legislation prohibits a work period of more than 5 hours without a meal period of at least 30 minutes. But, if the employee does not work more than 6 hours, the employee and employer may mutually agree to waive the meal period.
- If an employee works more than 10 hours, the employee must receive a second meal period of at least 30 minutes.

Exception:

1. the employee works 12 or fewer hours,
2. the employee agreed with the employer to waive the second meal period, and
3. the first meal period has not been waived.

On Duty Meal Periods:

- Permitted only when the nature of the work prevents an employee from being relieved of all duty and the employee and employer agree in writing to an on-the-job paid meal period.

Sick Leave

- The law does not require employers to provide sick leave or specify the amount employers must provide to eligible employees.
- But, if the employer chooses to provide sick leave, eligible employees must be able to use at least an amount equal to that which would have been accrued over a 6 month period to attend to an illness of a child, parent or spouse.
Remember that understanding legal issues can safeguard your business.

We wish you all the success in the world!

Southern California Edison

If you have any questions regarding this guide, or if you would like additional copies, please contact one of the project managers:

Ana Barbosa or Rebecca Jones
Economic and Business Development
Southern California Edison
P.O. Box 800, Rosemead, CA 91770
1-800-3-EDISON