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**Operated Exclusively for Charitable Purposes:  
Compliance and Operational Considerations and Structuring**

**Reference Outline**

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## **I. INTRODUCTION**

The nonprofit sector includes organizations of many shapes and sizes. The common link among all such organizations being what has been termed the “non-distribution constraint,” that is, nonprofit organizations may not distribute profits to private individuals in the form of dividends or otherwise. This prohibition on the distribution of profits is what sets the nonprofit sector apart as unique and applies it regardless of the type of nonprofit, basis for exemption, or any other distinction.

While all organizations that are exempt from federal income tax come within the “nonprofit tent,” not all nonprofit organizations are eligible for exemption. Rather, eligibility for exemption depends upon the organization meeting specific requirements for exemption. Certain of these requirements will be discussed in Section III below. Nevertheless, it is critical to understand that the term “nonprofit” simply refers to a category of organizations that contains a prohibition on the distribution of profits other than as reasonable compensation while the term “exempt” refers to organizations that meet specific elements set forth in the Internal Revenue Code, as amended (the “Code” or “I.R.C.” herein), for federal tax exemption or under the Texas Tax Code for state tax exemption. As will be discussed below, not every exempt organization is a charity. Charitable organizations are one category of exemption (specifically Section 501(c)(3) of the Code). While that is the largest category of organizations, the Code provides for many different categories of tax-exempt organizations. This paper will focus on charities. Broadly speaking, this article is intended to cover the life cycle of a charitable organization beginning with the choice of form; moving to exemption, obtaining exemption, maintaining exemption, and operating; and finishing with termination of the organization.

## **II. CHOICE OF FORM**

While in theory any organizational form can incorporate the nondistribution constraint, only a limited number of organizational forms are eligible for tax-exempt status: (1) charitable trust; (2) nonprofit corporation; (3) unincorporated association; and (4) limited liability company.<sup>1</sup> Each of these types of entities has unique characteristics and considerations.

### **A. Considerations in Choosing an Entity Structure**

There are several considerations that should be taken into account in determining the choice of entity. These considerations include how quickly the organizer wishes to establish the entity, the organizer’s level of concern over liability exposure, the sophistication level and goals of the organizer, the financial resources of the organizers, the type and scale of activities to be conducted by the organization, the type of governance structure desired, and the duties to be imposed on the directors/trustees in operating the organization.

### **B. Charitable Trusts**

Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601.<sup>2</sup> A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust. Charitable trusts created in Texas are governed by the Texas Trust Code as well as common law relating to trusts and are subject to the oversight authority of the Texas Attorney General.

Aside from the benefit of having many years of established case law, many organizers choose charitable trusts as the organizational form of their entity because of the rigidity of trusts. A settlor is able to establish the trust with specific purposes and be assured that the trust will operate for those purposes absent court intervention. The settlor also has the security of knowing the trustee(s) will be held to higher fiduciary standards in performing his or her duties.

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<sup>1</sup> The limited liability company is available only where the members are exclusively tax-exempt.

<sup>2</sup> 43 Elizabeth, Chapter 4 (England 1601).

While the rigidity of trusts can be viewed as a benefit, that same feature may be viewed as inflexibility and thus may be viewed as a detriment to others looking to choose an entity. Absent authority granted in the trust, the ability to modify a trust requires court intervention and is not automatic. Trustees are more limited as to their investments as well as their ability to delegate duties. Trustees are additionally subject to more stringent conflict of interest and self-dealing prohibitions and must meet a higher standard for indemnification as compared to directors of unincorporated associations or nonprofit corporations.

### **C. Unincorporated Associations**

Nonprofit unincorporated associations are a default type of nonprofit organization in Texas. In other words, if an organization is nonprofit and neither incorporated or a trust, it will by default be classified as an association if it satisfies the definition. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose.<sup>3</sup> Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the Texas Business Organizations Code (“BOC”). That chapter clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members’ interests by all legitimate and legal means. Unincorporated associations have the right to sue or be sued, sue or be sued by a member; acquire, hold, encumber, or transfer real or personal property without the need for trustees; be a beneficiary of a trust, contract, will, or policy of life insurance; apply for property tax exemption; and apply for federal tax exemption under Section 501(c)(3) or another section. The IRS has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation when it is formed under a contract or bylaws and has elective officers empowered to act for the association. It should be noted that the IRS will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status. These provisions will be discussed more fully below.

Benefits of operating as an unincorporated association relate primarily to the informal nature of such an entity. Unincorporated associations are relatively quick and easy to establish and are internally as flexible as the founder’s desire. Finally, unincorporated associations have the ability to rely on statutory authority in Texas to assure that they are recognized as separate legal entities such that members do not have personal liability in tort or contract absent special circumstances.

On the contrary, there are numerous drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the BOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), there is little case law interpreting either Chapter 252 or its predecessor act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, a founder has less assurance that his or her wishes as to the direction and purposes of the organization will remain unchanged. Many unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Finally, choice of law concerns exist where an unincorporated association acts outside Texas as not all states recognize such an entity. Practically speaking, for an unincorporated association to qualify for federal tax exemption under Section 501(c)(3) the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption thereby lessening the benefits discussed above.

### **D. Nonprofit Corporations**

Perhaps the most commonly used entity for exemption under Section 501(c) is a nonprofit corporation. Nonprofit corporations in Texas are governed by Chapter 22 of the BOC.<sup>4</sup> The BOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation.<sup>5</sup> It is helpful to note here that income may be distributed to individuals performing services on behalf of the corporation

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<sup>3</sup> See Tex. Bus. Orgs. Code Ann. § 252.001 et seq.

<sup>4</sup> See Tex. Bus. Orgs. Code Ann § 22.001 et. seq.

<sup>5</sup> See *id.* at § 22.001(5) (i.e. the aforementioned non-distribution constraint).

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