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## CHAPTER ONE

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# What Is a Nonprofit Organization?

One of the most striking features of life as we settle into the third millennium is the awesome sweep of societal reform around the globe. Freedom of thought and action is now permitted in societies that previously knew only totalitarianism and suppression. Frequently, a country earns the label *emerging democracy* by introducing startling economic and political changes. Sometimes, this is accomplished by elections; sometimes, a revolution is necessary. Struggles for individual freedom are today commonplace throughout the world, whether in Eastern Europe, on the African continent, or in the roiling Middle East.

Countries that are planning transitions to a democratic state are discovering a fact that some Western countries learned a long time ago: In order to create and maintain economic and political freedom, which is the essence of a true democracy, the power to influence and cause changes cannot be concentrated in one sector of that state or society. There must be a *pluralization of institutions* in society, which is a fancy way of saying that the ability to bring about changes and the accumulation of power cannot belong to just one sector—namely, the government. A society that has achieved this type of pluralization is sometimes known as a *civil society*.

A strong democratic state has three sectors: (1) a government sector, (2) a private business sector, and (3) a nonprofit sector. Each sector must function effectively and must cooperate with the others, to some degree, if the democracy is to persist for the good of the individuals in the society. A democratic society must be able to make and implement policy decisions with the participation of all three sectors. Ideally, a democratic society can solve some of its problems with minimal involvement of government if there is a well-developed and active nonprofit sector—charitable, educational, scientific, and religious organizations; associations and other membership organizations; advocacy groups; and similar private agencies.

Of all countries, the United States has the most highly developed sector of nonprofit organizations. The reach of the U.S. government is often curbed by the activities of nonprofit organizations, but that is a prime mark of a free and otherwise democratic society. The federal, state, and local governments acknowledge this fact (sometimes grudgingly) by exempting most nonprofit organizations from income and other taxes and, in some instances, allowing tax-deductible gifts to them. These tax enhancements are crucial for the survival of many nonprofit organizations.

When an individual in the United States perceives either a personal problem or one involving society, he or she does not always have to turn to a government

for the problem's resolution. The individual, acting individually or with a group, can attempt to remedy the problem by turning to a nongovernmental body. There are obvious exceptions to this sweeping statement: Governments provide a wide range of services that individuals cannot, such as national defense and foreign policy implementations. Still, in U.S. culture, more so than in any other, an individual is often likely to use nongovernmental means to remedy, or at least address, personal and social problems.

### A BIT OF PHILOSOPHY

For most Americans, this mind-set stems from the very essence of our political history—distrust of government. We really do not like governmental controls; we prefer to act freely, as individuals, to the extent it is realistic and practical to do so. As the perceptive political philosopher Alexis de Tocqueville wrote in 1835, “Americans of all ages, all conditions, and all dispositions constantly form associations” (meaning nonprofit organizations) and “whenever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.” About 150 years later, John W. Gardner, founder of Common Cause, observed: “In the realm of good works this nation boasts a unique blending of private and governmental effort. There is almost no area of educational, scientific, charitable, or religious activity in which we have not built an effective network of private institutions.”

This “effective network of private institutions” (the nation's nonprofit organizations) is called the *independent sector*, the *voluntary sector*, or the *third sector* of U.S. society. For-profit organizations are the business sector; the governmental sector is made up of the branches, departments, agencies, and bureaus of the federal, state, and local governments.

Nonprofit organizations, particularly charitable ones, foster pluralization of institutions and encourage voluntarism. Society benefits not only from the application of private wealth to specific public purposes but also from the variety of programs that individual philanthropists, making gifts of all sizes, make available for support. Program choice-making is decentralized, efficient, and more responsive to public needs than the cumbersome and less flexible government allocation process. As John Stuart Mill observed, “Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience.”

At the time a constitutional income tax was coming into existence, in 1913, Congress legislated in spare language and rarely embellished on its statutory handiwork with legislative histories. Therefore, there is no contemporary record in the form of legislative history of what members of Congress had in mind when they started creating categories of tax-exempt organizations. It is generally assumed that Congress saw itself adhering to the political philosophical policy considerations that many other governments have adopted over the centuries pertaining to nonprofit organizations, which is that taxation of these entities is inappropriate, considering their contributions to the well-being and functioning of society.

Thus, in the process of writing the Revenue Act of 1913, Congress apparently viewed tax exemption, at least for charitable organizations, as the only way to

consistently correlate tax policy with political theory, and viewed exemption of charities in the federal tax statutes as an extension of comparable practice throughout history. Presumably, Congress simply believed that these organizations ought not be taxed, and found the proposition sufficiently self-evident that an explanation of its actions was not necessary.

The Supreme Court has infrequently ruminated about the rationale for tax exemption for nonprofit organizations. Soon after enactment of the (constitutional) income tax, the Court concluded that the foregoing rationale was the basis for the federal tax exemption for charitable entities. In 1924, it stated that “[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when [they are] not conducted for private gain.”<sup>1</sup>

One of the most significant of the Court’s considerations of the rationale for tax exemption appears in a case concerning the constitutionality of a state’s real estate tax exemption for the real property of religious organizations.<sup>2</sup> The majority opinion in this case focused primarily on the constitutionality of this tax exemption, because the law accorded exemption to churches and other religious entities, but included observations about tax exemption for nonprofit organizations generally.

The real estate tax exemption at issue came into being, wrote the Court, because the state, “in common with the other States, . . . determined that certain entities that exist in a harmonious relationship to the community at large, and that foster its ‘moral or mental improvement,’ should not be inhibited in their activities by property taxation or the hazard of loss of those properties for nonpayment of taxes.”<sup>3</sup> The state granted exemption with respect to a “broad class of property owned by non-profit, quasi-public corporations which include hospitals, libraries, playgrounds, scientific, professional, historical, and patriotic groups.”<sup>4</sup> The Court continued: “The State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification useful, desirable, and in the public interest.”<sup>5</sup> Also: “Qualification for tax exemption is not perpetual or immutable; some tax-exempt groups lose that status when their activities take them outside the classification and new entities can come into being and qualify for exemption.”<sup>6</sup>

A concurring Court opinion observed that a “range” of “private, nonprofit organizations contribute to the well-being of the community in a variety of nonreligious ways, and thereby bear burdens that would otherwise either have to be met by general taxation, or be left undone, to the detriment of the community.”<sup>7</sup> It was stated that nonprofit groups that receive tax exemption contribute to the “diversity of association, viewpoint, and enterprise essential to a vigorous, pluralistic society.”<sup>8</sup>

<sup>1</sup>Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santísimo Rosario de Filipinas, 263 U.S. 578, 581 (1924).

<sup>2</sup>Walz v. Tax Commission of the City of New York, 397 U.S. 664 (1970).

<sup>3</sup>*Id.* at 672.

<sup>4</sup>*Id.* at 673.

<sup>5</sup>*Id.*

<sup>6</sup>*Id.*

<sup>7</sup>*Id.* at 687.

<sup>8</sup>*Id.* at 689.

Another concurring opinion referred to a “class of nontaxable entities whose common denominator is their nonprofit pursuit of activities devoted to cultural and moral improvement and the doing of ‘good works’ by performing certain social services in the community that might otherwise have to be assumed by government.”<sup>9</sup> The Justice added that tax exemptions for nonprofit organizations “are an institution in themselves, so much so that they are . . . expected and accepted as a matter of course.”<sup>10</sup>

Twenty years later, the Court wrote that, for most categories of nonprofit organizations, “exemption from federal income tax is intended to encourage the provision of services that are deemed socially beneficial.”<sup>11</sup>

Lower courts have echoed this theme. A federal court of appeals wrote that the “reason underlying the [tax] exemption granted” to charitable organizations is that the “exempted taxpayer performs a public service.”<sup>12</sup> This court added: “Charitable purposes are those which benefit the community by relieving it pro tanto from an obligation which it owes to the objects of the charity as members of the community.”<sup>13</sup> This federal appellate court subsequently observed, as respects exemption for charitable organizations, that one “stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it.”<sup>14</sup> Another federal court opined that the justification of the charitable contribution deduction was “historically . . . that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.”<sup>15</sup>

Yet another federal court fully articulated this philosophical doctrine, noting that the “very purpose” of the charitable contribution deduction is “rooted in helping institutions because they serve the public good.”<sup>16</sup> As to private philanthropy, the promotion of a healthy pluralism is often viewed as a prime social benefit of general significance. In other words, society can be seen as benefiting not only from the application of private wealth to specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to subsidize.<sup>17</sup> A court concluded: “This decentralized choice-making is arguably more efficient and responsive to public needs than the cumbersome and less flexible allocation process of government administration.”<sup>18</sup>

The essence of these judicial reflections is that the charitable sector (including the religious, educational, and scientific elements of it) provides public services that in most instances the government would otherwise have to undertake. The existence of these charitable entities enhances community life. The charitable programs are a key component of pluralism and the organizations that sponsor them are “beneficial and stabilizing influences in community life.”

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<sup>9</sup>*Id.* at 696.

<sup>10</sup>*Id.* at 698.

<sup>11</sup>*Portland Golf Club v. Commissioner*, 497 U.S. 154, 161 (1990).

<sup>12</sup>*Duffy v. Birmingham*, 190 F.2d 738, 740 (8th Cir. 1951).

<sup>13</sup>*Id.*

<sup>14</sup>*St. Louis Union Trust Co. v. United States*, 374 F.2d 427, 432 (8th Cir. 1967).

<sup>15</sup>*McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972).

<sup>16</sup>*Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff’d sub. nom. Coit v. Green*, 404 U.S. 997 (1971).

<sup>17</sup>*Id.*, 330 F. Supp. at 1162.

<sup>18</sup>*Id.*

## LEGAL DEFINITION OF NONPROFIT ORGANIZATION

Contemporary writing is replete with statements of these fundamental principles. Here are some examples:

... the associative impulse is strong in American life; no other civilization can show as many secret fraternal orders, businessmen's "service clubs," trade and occupational associations, social clubs, garden clubs, women's clubs, church clubs, theater groups, political and reform associations, veterans' groups, ethnic societies, and other clusterings of trivial or substantial importance.—*Max Lerner*

... in America, even in modern times, communities existed before governments were here to care for public needs.—*Daniel J. Boorstein*

... voluntary association with others in common causes has been thought to be strikingly characteristic of American life.—*Merle Curti*

We have been unique because another sector, clearly distinct from the other two [business and government], has, in the past, borne a heavy load of public responsibility.—*Richard C. Cornuelle*

The third sector is ... the seedbed for organized efforts to deal with social problems.—*John D. Rockefeller*

... the ultimate contribution of the Third Sector to our national life—namely, what it does to ensure the continuing responsiveness, creativity and self-renewal of our democratic society.—*Waldemar A. Neilsen*

... an array of its [the independent sector's] virtues that is by now fairly familiar: its contributions to pluralism and diversity, its tendency to enable individuals to participate in civic life in ways that make sense to them and help to combat that corrosive feeling of powerlessness that is among the dread social diseases of our era, its encouragement of innovation and its capacity to act as a check on the inadequacies of government.—*Richard W. Lyman*

The problems of contemporary society are more complex, the solutions more involved, and the satisfactions more obscure, but the basic ingredients are still the caring and the resolve to make things better.—*Brian O'Connell*

## LEGAL DEFINITION OF NONPROFIT ORGANIZATION

The English language does not serve us well in this context, in that the term *nonprofit organization* is often misunderstood. This term does not refer to an organization that is prohibited by law from earning a *profit* (that is, an excess of gross earnings over expenses); *nonprofit* does not mean *no profit*. In fact, it is quite common for nonprofit organizations to generate profits. (These make the better clients.) Rather, the definition of nonprofit organization essentially relates to requirements as to what must be done with the profit earned or otherwise received. This fundamental element of the law is found in the doctrine of *private inurement* (see Chapter 5).

The word *nonprofit*, by the way, should not be confused with the term *not-for-profit* (although it often is). (For inexplicable reasons, the accounting profession prefers the phrase *not-for-profit*.) The former describes a type of organization; the latter describes a type of activity. For example, in the federal income tax setting, expenses associated with

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a not-for-profit activity (namely, one conducted without the requisite profit motive, as in the nature of a hobby) are not deductible as business expenses.<sup>19</sup>

The concept in law of a nonprofit organization is best understood through a comparison with the concept of a *for-profit* organization. A fundamental distinction between the two types of entities is that the for-profit organization has *owners* that hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the economic benefit of its owners; the profits of the business undertaking are passed through to them, such as by the payment of dividends on shares of stock. That is what is meant by the term *for-profit organization*: It is an entity that is designed to generate a profit for its owners. The transfer of the profits from the organization to its owners is pure private inurement—the inurement of net earnings to them in their private (personal) capacity. For-profit organizations are *supposed* to engage in private inurement.

By contrast, a nonprofit organization is not permitted to distribute its profits (net earnings) to those who control it. The U.S. Supreme Court defined the term *nonprofit organization* in a case interpreting the reach of the U.S. Constitution's Commerce Clause. The Court wrote that a "nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees."<sup>20</sup>

The Court's definition of *nonprofit organization* is not far off the mark. The matter of *control*, however, is not confined to individuals; control of a nonprofit organization can be exercised by organizations, such as corporations, partnerships, trusts, and estates. Additionally, the Court's definition of the term is somewhat too narrow in that the requisite insider can also be a person who is *in a position* to exercise control over the entity.

Four nitpicks about the Court's definition. One, it is rare that a nonprofit organization's members have sufficient control, or potential for control, over the affairs of it. Two, there is deemed control, in that control persons also include members of the family of directors, trustees, and the like, and further include entities that they control. Three, it is not clear what the words "ordinarily understood" mean in the context of this definition. Four, it is also not clear why the word "principally" is there but presumably it reflects the fact that, pursuant to the statutory law in most states, a nonprofit organization is, in addition to avoiding private inurement, potentially required to adhere to types of purposes and engage in types of activities represented by words such as charitable, philanthropic, benevolent, and eleemosynary.

Subsequently, the Court stated its view that the concepts of nonprofit and for-profit organizations are blurring. It wrote that, "[w]hile it is certainly true that a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so. For-profit corporations, with ownership approval, support a wide variety of charitable causes, and it is not at all uncommon for such corporations to further humanitarian and other altruistic objectives."<sup>21</sup> The Court gave as illustrations for-profit corporations that take costly pollution-control and energy-conservation measures that go

<sup>19</sup>Internal Revenue Code section (IRC §) 183.

<sup>20</sup>Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 585 (1997).

<sup>21</sup>Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2771 (2014).



beyond what the law requires and those that operate facilities in foreign countries that exceed the requirements of local law regarding working conditions and benefits. Another take on this, the Court added, is that “[n]ot all corporations that decline to operate as nonprofits do so in order to maximize profit,” that is, organizations with “religious and charitable aims might organize as for-profit corporations because of the potential advantages of that corporate form, such as the freedom to participate in lobbying for legislation or campaigning for political candidates who promote their religious or charitable goals.”<sup>22</sup>

A wholly incorrect interpretation of the concept of the nonprofit organization appears in a Court concurring opinion, where it was asserted that the fact an entity is organized as a nonprofit one means that it probably is not secular in nature!<sup>23</sup> After that, the Justice expresses the view that many types of nonprofit organizations are operated for religious purposes. The fact is there are 76 categories of tax-exempt organizations; the vast majority of them are by no means religious in nature.

Simply stated, a nonprofit organization is an entity that is not permitted to engage in forms of private inurement. This is why the private inurement doctrine is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit organizations for purposes of the law. To reiterate: Both nonprofit and for-profit organizations are legally able to generate a profit. Yet, as the comparison between the two types of organizations indicates, there are two categories of profit: one is at the *entity* level and one is at the *ownership* level. Both categories of entities can yield entity-level profit; the distinction between the two types of entities pivots on the latter category of profit.

Why, then, the confusion as to the meaning in law of the term *nonprofit organization*? The answer: For-profit and nonprofit organizations often *look alike*. (This fact is behind, for example, today’s raging debates about the difference between tax-exempt and for-profit hospitals and exempt credit unions and commercial banks.) The characteristics of the two categories of organizations are often identical, in that both mandate a legal form (see discussion following), have directors (or trustees) and officers, have employees (and thus pay compensation and other employee benefits), face essentially the same expenses (such as for occupancy, supplies, travel, and, yes, legal and other professional fees), make investments, enter into contracts, can sue or be sued, produce goods and/or services, and (as noted) generate profits.

## LEGAL FORM

What form should a prospective nonprofit organization take? A lawyer may say, “It must be a separate legal entity.” What does that mean?

A nonprofit organization generally must be one of three types: (1) a corporation, (2) a trust, or (3) an “other” (usually an unincorporated association). In recent years, the *limited liability company* has emerged as a possible form. (Occasionally, a nonprofit organization is created by a legislature.) A common element in each is that there should

<sup>22</sup>*Id.*

<sup>23</sup>Corporation of the Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints v. Amos, 483 U.S. 327, 344 (1987).

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be a creating document (*articles of organization*) and a document containing operational rules (*bylaws*).

Keep in mind that before an organization can be tax-exempt, it must be a nonprofit organization. Nonprofit organizations are basically creatures of state law; tax-exempt organizations are basically subjects of federal tax law. State tax exemption tends to follow the contours of the federal tax law (although the state real estate tax exemption rules are likely to be more stringent).

Once the decision has been made to form a nonprofit organization, the legal form of the organization must be considered. This is basically a matter of state law; the laws of the state in which the headquarters is based will govern this decision.

Assuming that the nonprofit organization is expected to qualify as a tax-exempt organization under both federal and state law, it is essential to see whether a particular form of organization is dictated by federal tax law. In most cases, federal law is neutral on the point. In a few instances, however, a specific form of organization is required to qualify as a tax-exempt organization. For example, a federal government instrumentality and a title-holding organization must, under federal tax law, be formed as corporations, while entities such as supplemental unemployment benefit organizations, Black Lung benefit organizations, and multiemployer plan funds must be formed as trusts. A multibeneficiary title-holding organization can be formed as either a corporation or a trust.

These are relatively technical types of nonprofit organizations; the vast majority need not be created by a mandated form. Thus, in the absence of a federal (or state) law requiring a particular form for the organization, the choice is made by those who are establishing the entity.

There are several factors to consider in selecting the form of a nonprofit organization. Given the reality of our litigious society, personal liability looms as a major element in the decision. *Personal liability* means that one or more managers of a nonprofit organization (its trustees, directors, officers, and/or key employees) may be found *personally* liable for something done or not done while acting on behalf of the organization. (See Chapter 25.)

## THE FOUR I's

Some of this exposure to personal liability can be limited by one or all of the following: indemnification, insurance, immunity, and incorporation.

*Indemnification* occurs (assuming indemnification is legal under applicable state law) when the organization agrees (usually by provision in its bylaws) to pay the judgments and related expenses (including legal fees) incurred by those who are covered by the indemnity, when those expenses are the result of a misdeed (commission or omission) by those persons while acting in the service of the organization. The indemnification cannot extend to criminal acts and may not cover certain willful acts that violate civil law. Because an indemnification involves the resources of the organization, the real value of an indemnification depends on the economic viability of the organization. In times of financial difficulties for a nonprofit organization, an indemnification of its directors and officers can be a classic "hollow promise."

*Insurance* is similar to indemnification. Instead of shifting the risk of liability from the individuals involved to the nonprofit organization, however, the risk of liability is



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shifted to an independent third party—an insurance company. Certain risks, such as criminal law liability, cannot be shifted via insurance. The insurance contract will likely exclude from coverage certain forms of civil law liability, such as libel and slander, employment discrimination, and antitrust matters. Even where adequate coverage is available, insurance can be costly; premiums can easily amount to thousands of dollars annually, even with a sizeable deductible.

*Immunity* is available when state law provides that a class of individuals, under certain circumstances, is not liable for a particular act or set of acts or for failure to undertake a particular act or set of acts. Several states have enacted laws for officers and directors of nonprofit organizations, protecting them in case of asserted civil law violations, particularly where these individuals are functioning as volunteers.

*Incorporation* is the last of the four I's. This additional form of protection against personal liability is discussed next, as part of the summary of the type of legal entity known as the *corporation*.

## CORPORATION

A *corporation* is a separate legal entity. Liability is generally confined to the organization and does not normally extend to those who manage it. For this reason alone, a nonprofit organization should probably be incorporated.

Incorporation has another advantage. The state nonprofit corporation law may provide answers to many of the questions that inevitably arise when forming and operating a nonprofit organization. Here are some examples:

- How many directors must the organization have? What are their voting rights? How is a quorum ascertained? How is notice properly given? What is the length and number of their terms of office?
- What officers must the organization have? What are their duties? What is the length and number of their terms of office? Can more than one office be held by the same individual?
- How frequently must the governing board meet? Must the board members always meet in person, or can the meetings be by telephone conference call or video teleconferencing? Can the board members vote by mail or unanimous consent? Can they use proxies?
- If there are members, what are their rights? When must they meet? What notice of the meetings must be given? How can they vote?
- What issues must be decided by members (if any)? By directors?
- May there be an executive committee of the governing board? If so, what are its duties? What limitations are there on its functions?
- What about other committees, including an advisory committee? Which are standing committees?
- How are the organization's governing instruments amended?
- How must a merger of the organization occur?
- What is the process for dissolving the organization? For distributing its assets and net income on dissolution?

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Nearly every state has a nonprofit corporation act. The answers to these and many other questions may be found in that law. If the organization is not a corporation, these and other questions are usually unanswered under state law. The organization must then add to its rules the answers to all the pertinent questions (assuming they can be anticipated) or live with the uncertainties.

There is a third reason for the corporate form: More people will know what the entity is. People are familiar with corporations. The IRS knows corporations. Private foundations understand corporations as potential grantees. In general, the work in which the nonprofit organization will be functioning is compatible with the concept of a corporation.

In contrast to the three advantages of incorporation—limitation against personal liability, availability of information concerning operations, and the comfort factor—what are the disadvantages of incorporation? Generally, the advantages far outweigh the disadvantages. The disadvantages stem from the fact that incorporation entails an affirmative act on the part of the state government: It “charters” the entity. In exchange for the grant of corporate status, the state usually expects certain forms of compliance by the organization, such as adherence to rules of operation, an initial filing fee, annual reports (which are public documents), and annual fees. These costs are frequently nominal, however, and the reporting and disclosure requirements are usually not extensive.

A nonprofit organization that is a corporation is formed by preparing and filing *articles of incorporation*, with its operating rules embodied in *bylaws*. The contents of the articles of incorporation, dictated in part by state law, will usually include

- The name of the organization
- A general statement of its purposes
- The name(s) and address(es) of its initial director(s)
- The name and address of its registered agent
- The name(s) and address(es) of its incorporator(s)
- Language referencing the applicable federal tax law requirements

The bylaws of an incorporated nonprofit organization will usually include provisions with respect to

- Its purposes (it is a good idea to restate them in the bylaws)
- The election and duties of its directors
- The election and duties of its officers
- The role of its members (if any)
- Meetings of members and directors, including dates, notice, quorum, and voting
- The role of executive and other committees
- The role of its chapters (if any)
- The function of affiliated organizations (if any)
- The organization’s fiscal year
- Language referencing the applicable federal tax law requirements (again, a good idea to repeat this in the bylaws)

## UNINCORPORATED ASSOCIATION

Some organizations adopt operational rules and policies stated in a document that is neither articles of incorporation nor bylaws. These rules may be more freely amended than articles or bylaws. They should not, however, be inconsistent with the articles or bylaws.

## TRUST

A nonprofit organization may be formed as a *trust*. This is rarely an appropriate form for a nonprofit organization other than a charitable entity or some of the funds associated with employee plans. Many private foundations, for example, are trusts. Those created by a will are known as testamentary trusts.

Most nonprofit organizations, however, particularly those that will have a membership, are ill-suited to be structured as trusts.

The principal problem with structuring a nonprofit organization as a trust is that most state laws concerning trusts are written for the regulation of charitable trusts. These rules are rarely as flexible as contemporary nonprofit corporation acts and frequently impose fiduciary standards and practices that are more stringent than those for nonprofit corporations.

A nonprofit organization that is to be a trust is formed by the execution of a *trust agreement* or a *declaration of trust*. Frequently, only one trustee is necessary—another reflection of the usual narrow use of trusts.

The trustees of a trust do not have the protection against personal liability that is afforded by the corporate form.

Although a fee to the state is rarely imposed on the creation of a trust, most states impose on trusts an annual filing requirement for the trust agreement or declaration of trust.

It is unusual—although certainly permissible—for the trustee(s) of a trust to adopt a set of bylaws.

## UNINCORPORATED ASSOCIATION

The final type of the usual nonprofit organization is the *unincorporated association*.

To the uninitiated, a nonprofit corporation and a nonprofit unincorporated organization look alike. For example, a membership association has the same characteristics, whether or not it is incorporated. The shield against individual liability provided by the corporate form, however, is unavailable in connection with an unincorporated association.

An unincorporated association is formed by the preparation and adoption of a *constitution*. The contents of a constitution are much the same as the contents of articles of incorporation; the contents of bylaws of an unincorporated association are usually the same as those of a nonprofit corporation.

It is relatively uncommon for an unincorporated association to have to register with and annually report to a state (other than for fundraising regulation purposes; see Chapter 12).

Occasionally, nonprofit organizations will have articles of incorporation, a constitution, and bylaws. This is technically improper. For an incorporated nonprofit organization, the constitution is a redundancy.

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Trusts and unincorporated associations are likely to have less contact with the state than nonprofit corporations, but this advantage is usually overshadowed by more substantive disadvantages.

In some states (e.g., California and New York), the nonprofit corporation and trust law is far more refined. Careful examination of these and other relevant laws is essential when an organization is to be formed in, or to operate in, one or more of these states. In addition, some states have far more stringent laws concerning mergers and dissolutions.

In summary, as a general rule, a nonprofit organization has clear advantages if it is organized as a corporation. Nonetheless, the facts and circumstances of each situation must be carefully examined to be certain that the most appropriate form is selected.

## LIMITED LIABILITY COMPANY

A limited liability company with two or more members that are charitable (or governmental) entities may qualify as a tax-exempt charitable organization, if it satisfies 12 conditions. These requirements include statement of a charitable purpose in the organizational documents, dedication of the LLC's assets to charity on dissolution, a prohibition on conversion to a for-profit entity, there must be a contingency plan should a member cease to qualify as a charitable entity, and the members must be required to "expeditiously and vigorously" enforce their rights in the LLC. The IRS has yet to establish a position as to whether an LLC can qualify as any other type of exempt organization, although it appears that an exempt social club cannot be structured as an LLC because the members, not the club itself, would directly control the entity's assets.

## HYBRIDS

The Supreme Court observed that, "recognizing the inherent compatibility between establishing a for-profit corporation and pursuing nonprofit goals, states have increasingly adopted laws formally recognizing hybrid corporate forms."<sup>24</sup>

The most common of these hybrid entities is the *low-profit LLC*. Known as *L3Cs*, these organizations are likely to be for-profit, taxable entities, with one or more taxable members. An *L3C* has as its primary purpose the accomplishment of one or more charitable purposes, with income production a permissible secondary purpose. The principal federal tax law issue with *L3Cs* is whether investments by private foundations in them constitutes a program-related investment. (See Chapter 7.)

Another of these hybrids is the *B corporation*, which is a business corporation certified by the B Lab (a tax-exempt charitable entity) as a company working to solve social and environmental problems. Still another is the *benefit corporation*, which is an organization that elects to pursue ends such as environmental preservation, promotion of health, and promotion of the arts and sciences. Efforts are underway to create another of these hybrids—the *flexible purpose corporation*, which would look and act much like a benefit corporation.

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<sup>24</sup>Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2771 (2014).

## LOCATION

The starting point for organizing a nonprofit organization is the law of the state. But which state? Although it can operate in more than one jurisdiction, an organization can be created or formed under the law of only one jurisdiction (at a time). In most instances, this means selecting the jurisdiction in which the organization will be headquartered.

Because the process of qualifying an organization to do business in a state is about the same as incorporating it, there usually is no point in forcing the organization to comply with the laws of two states. There are exceptions to this rule: A stock-based nonprofit organization may be appropriate or perhaps only one director is desired. Another consideration is the degree of regulation imposed by the office of a state's attorney general or comparable agency; this element varies widely from state to state. If an organization is formed in one state but has offices in one or more other states, this duplication of effort is unavoidable.

A caution: If a nonprofit organization is formed in one jurisdiction and the plan is to qualify it in another, be certain that the organization will meet the requirements of the law of the state of qualification. For example, not all states allow a nonprofit organization formed as a corporation with stock to qualify.

### *Checklist*

- ☐ Form of organization:
  - ☐ Corporation
  - ☐ Unincorporated association
  - ☐ Trust
  - ☐ Other
- ☐ Type of articles of organization:
  - ☐ Articles of incorporation
  - ☐ Constitution
  - ☐ Declaration of trust
  - ☐ Trust agreement
  - ☐ Other
- ☐ Date organization formed \_\_\_\_\_
- ☐ Place organization formed \_\_\_\_\_
- ☐ States in which qualified to do business \_\_\_\_\_
- ☐ Date(s) of amendment of articles \_\_\_\_\_
- ☐ Date operational rules (e.g., bylaws) adopted \_\_\_\_\_
- ☐ Date(s) of amendment of rules \_\_\_\_\_
- ☐ Membership: Yes \_\_\_\_\_ No \_\_\_\_\_
- ☐ If yes:
  - Annual meeting date \_\_\_\_\_
  - Notice requirement \_\_\_\_\_

## WHAT IS A NONPROFIT ORGANIZATION?

- ☐ Chapters: Yes \_\_\_\_\_ No \_\_\_\_\_
- ☐ Affiliated organizations \_\_\_\_\_
- ☐ Committees:
  - ☐ Executive
  - ☐ Nominating
  - ☐ Development (fundraising)
  - ☐ Finance and/or audit
  - ☐ Long-range planning
  - ☐ Other(s)
- ☐ Fiscal year \_\_\_\_\_