

Presented:
29th Annual Nonprofit Organizations

January 18, 19-20, 2012
Austin, TX

Overview of Nonprofit Organizations: The Basic Framework

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I. INTRODUCTION

The nonprofit sector is vast. In 2009 there were an estimated more than 1.9 million nonprofit organizations in the United States. *See* Independent Sector, *Scope of the Nonprofit Sector*, (visited December 8, 2011) <<http://www.independentsector.org/scope-of-the-sector>>. Section 501(c)(3) and Section 501(c)(4) organizations comprised approximately eighty percent (80%) of that number. *See id.* It is estimated that Section 501(c)(3) organizations employ approximately 10% of the workforce in United States. *See* Independent Sector, *The Sector's Economic Role*, (visited December 8, 2011) <<http://www.independentsector.org/economic-role>> (citing figures released by the National Center for Charitable Statistics). In 2009, the nonprofit sector accounted for 5.5% of the GDP for the country. *See id.*

As would be expected from such a large industry sector, 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.

II. STARTING OUT

Within the broad rubric of the nonprofit sector 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. The limited liability company is available only where the member or members are exclusively tax-exempt. 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. 43 Elizabeth, Chapter 4 (England 1601). 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.

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. 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 the default nonprofit organization in Texas. 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. *See* Tex. Bus. Orgs. Code Ann. § 252.001 et seq. 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, 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

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First appeared as part of the conference materials for the
29th Annual Nonprofit Organizations Institute session
"Overview of Nonprofit Organizations: The Basic Framework"