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Back to Basics: Exemption Fundamentals

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INTRODUCTION.

Section 501(a) of the Internal Revenue Code of 1986 (as amended from time to time, the “Code”) provides that “[a]n organization described in subsection (c) or (d) [of section 501] or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503[.]” This Outline focuses specifically on the issues fundamental to qualification and maintenance of federal tax exemption under Section 501(c)(3).

PART I – CHOICE OF ENTITY (STATE LAW)

A. NONPROFIT CORPORATION.

In General. Texas nonprofit corporations are governed by the Texas Business Organizations Code (the “TBOC”), and are formed pursuant to the filing of a certificate of formation with the Texas Secretary of State.¹ Texas nonprofit corporations must adopt and maintain bylaws for internal governance purposes, have at least three (3) directors, and have a president and secretary (who may not be the same person).² The TBOC only permits natural persons to be directors and/or officers of nonprofit corporations, meaning that a corporate fiduciary could not serve in

such position (which is not the case for charitable trusts).³

Advantages & Disadvantages. The nonprofit corporation structure offers relatively broad liability protection to the officers and directors (and members, if any) of the exempt organization.⁴ Also, the governing persons of the nonprofit corporation are generally held to a lower standard of care under applicable common law and the TBOC than “trustees” of charitable trusts, and such liability can be further limited by the entity’s governing documents.⁵ In addition, the TBOC provides more comprehensive governing standards and requirements for nonprofit corporations than for many other nonprofit forms of entities (e.g., regarding meetings, notice requirements, and other such formalities).

B. CHARITABLE TRUST.

In General. Charitable trusts are governed by the Texas Trust Code, which is a subtitle of the Texas Property Code, and are formed pursuant to a trust instrument, which need not be publicly filed with the Texas Secretary of State or any other state office for the legal existence of the charitable trust to commence.⁶ Charitable trusts are governed by trustees.⁷

¹ Tex. Bus. Org. Code § 3.001.

² Tex. Bus. Org. Code §§ 22.102, .204, .231; *but see* Tex. Bus. Org. Code § 22.202 (providing that a Texas nonprofit corporation may vest management authority in its members in its governing documents, in which case it is not required to have a board of directors).

³ *See* Tex. Bus. Org. Code §§ 1.002(16), (38), (61).

⁴ *See* Tex. Bus. Org. Code §§ 22.152, .221.

⁵ *See* Tex. Bus. Org. Code § 22.223.

⁶ *See generally* Tex. Prop. Code, Title 9, Chapters 111–17.

⁷ *Id.*

Advantages & Disadvantages. The provisions of the Texas Trust Code regarding charitable trusts are generally less comprehensive than the provisions of the TBOC regarding nonprofit corporations. As such, although charitable trusts can be formed quickly and confidentially (since no governing document need be filed with the Texas Secretary of State), there are fewer “back-stop” or “default” provisions for the governing persons of a charitable trust to rely on to ensure the trust is compliant with Texas law (although there is a substantial body of common law applicable to charitable trusts). To account for these statutory gaps, in general, the trust instrument that establishes a charitable trust must be carefully, clearly, and comprehensively drafted to create appropriate safeguards and ensure proper governance.

Charitable trusts are generally irrevocable and can be difficult to modify without judicial approval.⁸ While this could be beneficial to a grantor that wants to be reasonably assured that his or her original charitable intent will be difficult for trustees to alter, the relative inflexibility of charitable trusts may hinder trustees who wish to adapt the charitable trust to a changing legal or charitable environment.

Unlike directors of a nonprofit corporation, the trustees of a charitable

trust can be individuals, corporate entities, or both, and there can be as few as one (1) trustee.⁹ Many charitable trusts utilize non-natural persons as trustees in part because trustees of charitable trusts are generally held to a higher standard of care than directors of a nonprofit corporation, and so may be at greater risk of personal liability.¹⁰

C. UNINCORPORATED ASSOCIATION.

In General. An unincorporated nonprofit association is a nonprofit organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose.¹¹ There are no formal filing requirements to form an unincorporated nonprofit association.¹²

Advantages & Disadvantages. Unincorporated nonprofit associations are relatively easy and quick to form and can provide significant operating flexibility. For these reasons, unincorporated nonprofit associations are popular with smaller groups, such as cemetery associations or social clubs. However, there is relatively little binding legal authority regarding unincorporated nonprofit associations, and so parties may have difficulty resolving governance or other disputes with this structure. In addition, not all states recognize this form of entity, which can make it risky for a Texas unincorporated nonprofit association to operate outside of the

⁸ See generally Tex. Prop. Code, Chapter 123.

⁹ See Tex. Prop. Code § 112.008.

¹⁰ See generally Tex. Prop. Code, Chapter 114.

¹¹ See Tex. Bus. Org. Code § 252.001(2).

¹² See Tex. Bus. Org. Code § 252.

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