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A Basic Framework of the Nonprofit Sector

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I. INTRODUCTION

The nonprofit sector is vast. In 2011 over 1.6 million nonprofit (tax-exempt) organizations were registered with the Internal Revenue Service ("IRS"). *See* Independent Sector, *Scope of the Nonprofit Sector*, (visited December 20, 2012) <http://www.independentsector.org/scope_of_the_sector>. Section 501(c)(3) and Section 501(c)(4) organizations comprised approximately seventy-five percent (75%) 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 20, 2012) <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 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. *See* Tex. Bus. Orgs. Code Ann § 22.001 et. seq. 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. *See id.* at § 22.001(5) (i.e. the aforementioned non-distribution constraint). It is helpful to note here that income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered. Nonprofit corporations in Texas may be organized for any lawful purpose, but keep in mind that to qualify for recognition of exemption the corporation must be organized with an appropriate purpose identified (e.g. religious, charitable, educational, etc. for Section 501(c)(3) organizations). Pursuant to Chapters 2 and 22 of the BOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes. *See* Tex. Bus. Orgs. Code Ann. §§ 2.001-002, 2.101-102, 3.003 and 22.054. While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. Whereas unincorporated associations lack extensive statutory guidelines and case law guidance, nonprofit corporations in Texas have Chapter 22 and its predecessor, the Texas Non-Profit Corporation Act, with extensive case law interpreting it, as well as the ability to analogize to for profit corporate law.

There are few drawbacks to organizing as a nonprofit corporation, particularly when the organization will be seeking federal tax exemption under Section 501(c)(3); however, those drawbacks are not major roadblocks. While establishing and maintaining a nonprofit corporation does require more work (and therefore more expense) as compared to an unincorporated association, the same work will have to be done for an unincorporated association in the event that it is seeking federal tax exemption. Furthermore, while a nonprofit corporation is subject to the Texas franchise tax, certain federal exemptions (including under Sections 501(c)(3) and 501(c)(4)) qualify the organization for exemption from the franchise tax as well. Finally, many of the various rules that are required for nonprofit corporations applying for exemption (such as specific dissolution clauses and the like under Section 501(c)(3)) are a requirement for any organization seeking exemption. Absent specific circumstances such as an organizer wishing to set up a Section 501(c)(3) entity as a charitable trust to take advantage of the specific

characteristics and benefits of such an entity, it is generally most beneficial to organize as a nonprofit corporation.

E. LIMITED LIABILITY COMPANIES

The final entity eligible for exemption for under Section 501(c) is a limited liability company ("LLC"). LLCs are unique in their eligibility for exemption. Unlike the other forms discussed above, the LLC is used as a single-member entity with an exempt organization as the single member or alternatively as a multi-member LLC with all of the members being exempt. LLCs are governed by the Business Organizations Code and specifically Chapter 101. LLCs can be member-managed or manager-managed. In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting though its own board of directors or can appoint others to manage the LLC with those "others" acting essentially as a board of directors of the subsidiary LLC.

Chapter 101 of the BOC provides that members and managers are shielded from debts, obligations, and liabilities of the LLC. This liability protection, with the simple control (such as management overlap) is a beneficial feature of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities. Furthermore, where the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded meaning that the LLC does not need to separately apply for tax-exempt status (discussed below), but rather will effectively take on the tax attributes of its parent member. On the flip side, if the LLC has not separately applied for exemption, while it will not be taxable for federal income tax purposes, it will remain taxable for Texas franchise tax purposes unless it can qualify for exemption. In other words, because the LLC has itself not obtained 501(c)(3) or 501(c)(4) status, it cannot use such status as its basis for exemption from the Texas franchise tax. This same concern applies with respect to the Texas sales tax. Finally, Texas property tax rules do not provide for any property tax exemption for LLCs—a significant drawback for any LLC that would hold real property that could be exempt on the basis of the type of organization.[1]

Should a single member LLC wish to apply for exemption (as opposed to being disregarded entity) or should the LLC have multiple members, separate conditions apply. The IRS has indicated that it will recognize the 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (which will be discussed below) and meets 12 additional conditions as follows[2]:

1. The original documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.
2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.
3. The organizational language must require that the LLC's members be section 501(c)(3) organizations or governmental units or wholly owned instrumentalities

[1] For example, if a church wanted to place its real property in a subsidiary organization for asset protection purposes, should the church use the LLC form, no property tax exemption would be allowed; however, should the church use a subsidiary nonprofit corporation, the property tax exemption would still be available.
[2] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

of a state or political subdivision thereof (“governmental units or instrumentalities”).

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental until or instrumentality.
5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a section 501(c)(3) organization or governmental until or instrumentality in exchange for fair market value.
6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC’s charitable purposes will continue to be devoted to charitable purposes.
7. The organizational language must require that any amendments to the LLC’s articles of organization and operating agreement be consistent with section 501(c)(3).
8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.
9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in section 501(c)(3) or governmental units or instrumentalities.
10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality.
11. The organizational language must state that the LLC’s exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.
12. The LLC must represent that all its organizations document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

III. IDENTIFYING THE APPROPRIATE FEDERAL TAX CLASSIFICATION

A. EXEMPT VS. CHARITABLE

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. As such, at the same time that the organizers of a new nonprofit organization are choosing the appropriate form, they likewise should be considering the appropriate federal tax classification. These decisions (choice of form and federal tax classification) often go hand in hand. For example, it is unusual (though not prohibited) that an operating charity would be established as a charitable trust. Quite typically, operating charities are established in the corporate form while private foundations (discussed below) are more likely to be formed as charitable trusts. Likewise, certain types of non-charitable exempt organizations (such as political organizations) are often formed as associations. In any event, the organizers and their counsel must be cognizant of the purpose of the organization, both in choosing the appropriate form of the organization as well as in applying the appropriate federal tax classification for the organization.

The Internal Revenue Code contains over thirty (30) categories of federal income tax exemption classifications. As addressed above, the overwhelming majority of organizations that are exempt from federal income tax are exempt as organizations described under Section 501(c)(3) of the Internal Revenue Code. However, the organizers and their counsel should consider whether the organization properly qualifies as an organization exempt from federal income tax under Section 501(c)(3)—specifically, as an organization organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. *See* § 501(c)(3). For example, where an organization organized exclusively for the promotion of social welfare (particularly where the organization engages in lobbying activities), that organization will qualify under Section 501(c)(4).

B. ACCEPTABLE PURPOSES UNDER SECTION 501(c)(3)

Even within the classification of "charitable" organizations under Section 501(c)(3), various purposes exist. Section 501(c)(3) organizations include religious organizations, charitable organizations, educational, scientific, and literary purpose organizations, organizations organized to further the prevention of cruelty to children, organizations for the prevention of cruelty to animals, organizations that foster national and international amateur sports competition (but only if no part of the activities involve the provision of athletic facilities or equipment), and organized to conduct testing for public safety. This section will highlight the most commonly used provisions of Section 501(c)(3).

1. Religious

The term "religious organization" includes organizations whose primary purpose is "religious" in nature. Neither the Internal Revenue Code nor the Regulations define the term "religious." Courts have considered the definition of "religious" in the context of whether or not a belief is a "religious belief". For example, the United States Supreme Court, in considering this question, queried whether the belief was deeply and sincerely held by the members of the organization and whether those beliefs involved an issue "of ultimate concern," a phrase borrowed by the Court from the theologian, Dr. Paul Tillich. *See U.S. v. Seeger*, 380 U.S. 163 (1965). Obviously, the parameters of what is a "religious" purpose are vague to say the least. Accordingly, any organization seeking to qualify as a religious organization that does not fit squarely into the mainstream idea of religion should carefully review case law to support its position.

Among the "mainstream" view of religious organizations are churches, associations of churches and integrated auxiliaries of churches. As with the term "religious," the term "church" is found, but not defined in the Internal Revenue Code. In *Foundation for Human Understanding v. Commissioner*, the IRS set out its fourteen factor test for determining whether an organization qualifies as a church. 88 T.C. 1341 (1987). None of the fourteen factors are exclusive. Rather, the test is one utilized by the IRS (significantly, as Schedule A to Form 1023 discussed below) for determining whether an organization has the markers commonly associated with a church. Those factors include the following:

1. Distinct legal existence.
2. Recognized creed and form of worship.
3. Definite and distinct ecclesiastical government.
4. Formal code of doctrine and discipline.
5. Distinct religious history.
6. Membership not associated with another church.
7. Organization of ordained ministers.
8. Ordination after prescribed studies.
9. Literature of its own.
10. Established place of worship.
11. Regular congregations.
12. Regular worship services.
13. Sunday schools for religious instruction of the young.
14. Schools for the preparation of ministers.

While none of the criteria are controlling, it has become increasingly clear that the IRS as well as courts focus on the associational aspect (i.e. people joining together) as central. In a 2004 Technical Advice Memorandum, the IRS noted that churches, while not being required to meet all of the criteria, ought to at least meet some minimum standard—those standards centered around this associational concept—having regular religious worship services, having a regular congregation, having an established place of worship, etc. TAM 200437040. This issue has been litigated in the context of Internet and radio based ministries with courts determining that such organizations lack the requisite associational aspect. *See e.g., Foundation of Human Understanding v. United States*, 88 Fed. Cl. 203 U.S.C.T. Fed. Cl. (2009)).

Not all religious organizations are churches. Rather, religious organizations may also be conventions or associations of churches, integrated auxiliaries of churches, or other organizations that have a religious purpose, but do not qualify in any of the aforementioned categories. The phrase "convention or association of churches" has not been defined in the Code or Regulations either. Rather, it is a historical phrase generally referring to groupings of churches that are congregational as opposed to hierarchical in nature. *See Lutheran Social Servs. of Minn. v. United States*, 758 F.2d 1283, 1288 (8th Cir. 1985). Associations of churches may include both churches and individuals. *See* I.R.C. § 7701(o). Unlike "religious," "church," and "association of churches," the phrase "integrated auxiliary of a church" is defined in the Regulations. Specifically, Section 1.6033-2(h) defines integrated auxiliary of church as referring to a class of organizations related to a church or association of churches that (1) fits the definition of public charity; (2) is affiliated with a church or association of churches; and (3) receives its financial support primarily from internal church sources (with limited exceptions). An organization is affiliated with a church or association of churches if its governing documents evidence such affiliation (through common doctrine, authority to appoint and remove directors, annual reporting, or other similar factors whereby the organization is akin to a subsidiary of the church or association of churches). An organization is internally supported when it receives more than 50% of its support from internal church sources.

2. Scientific

To qualify as an exempt scientific organization, an organization must meet four tests: (1) the organization must conduct scientific research (Reg. 1.501(c)(3)-1(d)(5)(i)); (2) the scientific research must not be conducted incident to commercial or industrial operations (Reg. 1.501(c)(3)-1(d)(5)(ii)); (3) the organization must meet the specific public interest test in Reg. 1.501(c)(3)-1(d)(5)(iii), (iv); and (4) the organization must meet the general public interest test stated in Reg. 1.501(c)(3)-1(d)(1)(ii).

"Scientific" as used in Section 501(c)(3) is defined as research with a scientific purpose carried on in the public interest. *See* Reg. 1.501(c)(3)-1(d)(5)(i). Research that is scientific may be practical or applied, fundamental or theoretical. *See id.* In *Midwest Research Institute v. United States*, 554 F. Supp. 1379 (W.D. Mo. 1993), *aff'd*, 744 F.2d 635 (8th Cir. 1984), the court concluded that research is scientific when it meets a three-part test: (1) there must be project supervision and design by professionals; (2) the researchers must design the project to solve a problem through a search for demonstrable truth, using the scientific method; and (3) the research goal must be discovering a demonstrable truth with the novelty and importance of the knowledge to be discovered being significant in determining whether a particular activity furthers a scientific purpose.

Scientific research does not, however, include activities ordinarily carried on as incident to commercial or industrial operations, such as ordinary testing or inspection or the clinical testing of drugs where such clinical testing is intended for FDA approval. *See* Reg. 1.501(c)(3)-1(d)(5)(ii). The court in the *Midwest* opinion cited above defined "testing" as "generally repetitive work done by scientifically unsophisticated employees for the purpose of determining whether the item tested met certain specifications, as distinguished from testing done to validate a scientific hypothesis." *See Midwest Research Institute*, 554 F. Supp. 1379. Likewise, the IRS suggested that in ordinary testing, "a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive and the procedure is merely a matter of quality control." *See* GCM 39196 (Aug. 31, 1983).

Even where an organization conducts scientific research, the scientific research must be carried on in the public interest. Scientific research is considered to be carried on in the public interest in the following circumstances:

1. the results of the research are made available to the public on a non-discriminatory basis;
2. the research is performed for the United States, its agencies, a state, or a political subdivision thereof; or
3. the research is directed toward benefiting the public. *See* Reg. 1.501(c)(3)-1(d)(5)(iii).

Research is directed toward benefiting the public where, for example, it is carried on for the purpose of aiding in the scientific education of college or university students; it is carried on for the purpose of obtaining scientific information published in a treatise, thesis, trade publication, or other forms available to the public; it is carried on for the purpose of discovering the cure for a disease; or it is carried on for the purpose of aiding a community or geographical area by attracting new

industry thereto or by encouraging the development of, or retention of, an industry therein. *See id.* Regulation 1.501(c)(3)-1(d)(5)(iv) provides that an organization is not carrying on scientific research in the public interest when the organization is performing research (directly or indirectly) only for its creators that are not described under Section 501(c)(3), or is retaining (directly or indirectly) ownership or control of more than an insubstantial portion of the results of the research and not making the results of such research available to the general public.

In addition to showing that the organization is conducting research in the public interest (Reg. 1.501(c)(3)-1(d)(5)(iii)), the organization must also establish, as with all organizations who seek to be classified as exempt, that it serves a public rather than private interest. *See* Reg. 1.501(c)(3)-1(d)(1)(ii). This requires identifying any private benefit that may be present and analyzing whether that private benefit is more than incidental to the public interest being served.

3. Educational

Section 170(b)(1)(a)(ii) of the Code and Section 1.170A-9(b)(1) of the Regulations provide the definitions for the phrase "educational organization." An educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at a place where its educational activities are regularly carried on. The Regulations further make clear that the term "educational" relates to "(a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community." The Regulations go on to explain that an organization may be educational even where it is advocating a specific viewpoint so long as it gives a "full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion." This phraseology has been the subject of litigation which resulted in the "full and fair exposition test" being struck down as unconstitutionally vague. As opposed to using such test, the IRS now commonly relies on a methodology test whereby it considers the methodology by which the proponent of the purported educational materials developed its argument in an effort to test whether there is "factual foundation for the viewpoint or position being advocated." *See* Rev. Proc. 86-43, 1986-2 C.B. 729.

4. Charitable

The term "charitable" as used in Section 501(c)(3) is to be taken "in its generally accepted legal sense" and includes the following: "Relief of the poor and distressed or the of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency." Reg. § 1.501(c)(3)-1(d)(2).

As can be clearly seen from the definition, the concept of a "charitable organization," is expansive. Many specific types of purposes fall within this general rubric. Importantly, to be a charitable organization, the organization must serve a charitable class (that is, an indefinite—typically large—group) in carrying out its activities. Each of the component parts of the definition of "charitable" (e.g. relief of the poor and distressed, lessening of the burdens of government, etc.) have their own definitions as well.

IV. APPLYING FOR EXEMPTION

A. GENERAL REQUIREMENTS FOR EXEMPT STATUS

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure (as addressed above), and must be organized and operated exclusively for charitable purposes. *See* Reg. 1.501(c)(3)-1(a). Pursuant to Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities which are not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose. *See* Reg. 1.501(c)(3)-1(b)(4). Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose. With respect to the operational test, Section 1.501(c)(3)-1(c)(1) of the Regulations provides that "[a]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3)." In other words, "exclusively" means "primarily"; however, a single nonexempt purpose if substantial in nature, is enough to destroy exemption. Furthermore, Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that to be organized and operated for one or more exempt purposes the organization must serve a public rather than a private interest. This last requirement is a requirement that no part of the net earnings inures to the benefit of a private individual.

Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes. Finally, case law has appended the foregoing elements with the requirement that an organization must not be volitive of public policy in order to qualify for exempt status.

While the foregoing are the elements for an organization to demonstrate its qualification under Section 501(c)(3), organizations that are not seeking exempt status under such section but are rather seeking exemption under other sections will need to carefully review such other sections to determine the requirements for exemption. By way of example, to be exempt under Section 501(c)(6) (professional organizations, business leagues, chambers of commerce, real estate boards, boards of trade, and professional sports leagues), the organization must be an association of persons having some common business interest, the purpose of the organization must be to promote that common business interest rather than operating for profit, the organization must not engage in a business ordinarily conducted for profit, and the activities of the organization must be directed to the improvement of business conditions of one or more lines of business. Each of the foregoing elements has its own definitional structures. Accordingly, care should be taken when applying for exemption as an "other than 501(c)(3)" organization that consideration is given to the specific elements which must be met for the applicable exempt classification.

B. THE APPLICATION PROCESS

With certain exceptions, depending upon whether the organization is seeking to qualify under Section 501(c)(3) or another section, the organization will file either Form 1023 (501(c)(3)) or Form 1024 (other sections of 501(c)) with the Internal Revenue Service to obtain recognition of exemption.[3] Forms 1023 and 1024 can be downloaded from the IRS's website (www.irs.gov). Form 1023 is the more detailed of the two, consisting of approximately ten (10) pages with approximately twenty (20) additional pages of schedules and instructions.

A substantially complete Form 1023 contains the following:

1. The signature of an authorized individual;

2. The organization's employer identification number or a completed Form SS-4;

3. Information concerning previously filed federal income tax and exempt organization returns;

4. A statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years) [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and proposed budgets for the next two accounting periods are sufficient.];

5. A statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures;

6. A copy of the articles of incorporation, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original [Note: Any originals submitted will become part of the file and will not be returned.];

7. If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;

8. Form 2848, Power of Attorney and Declaration of Representative, if applicable;

9. Form 8718, User Fee for Exempt Organization Determination letter request, and a check made payable to the IRS in payment of the user fee applicable to the organization. Revenue Procedure 2011, 2011-1 I.R.B. 237, Section 6.07 sets the user fee at $850 for initial applications for exempt status for organizations seeking exemption under I.R.C. Section 501(c) whose actual or anticipated gross receipts exceed $10,000. Applications for exempt status of organizations (other than pension and profit sharing plans) that have had annual gross receipts averaging

[3] For example, churches, associations of churches, and integrated auxiliaries of churches are exempt from the filing requirement.

not more than $10,000 during the preceding four years, or new organizations anticipating gross receipts averaging not more than $10,000 during their first four years, must pay a user fee of $400. If the organization does not include the correct user fee with the application, the application will be returned.

V. THE BASICS OF STATE TAX EXEMPTION (TEXAS)

While filing Form 1023 (or Form 1024) when required and as applicable provides for exemption from federal income tax, such filing does not, standing on its own, create an exemption from state taxes. In Texas, nonprofit organizations, even those qualifying as Section 501(c)(3) organizations, remain subject to the sales and use taxes as well as hotel occupancy taxes. In addition, incorporated organizations remain subject to the revised franchise tax. However, organizations that have obtained recognition of exemption under Section 501(c)(3) and 501(c)(4) are eligible for exemption from each of these taxes upon application being made with the State Comptroller. More specifically, the Texas Tax Code provides exemption from both franchise tax as well as sales tax to nonprofit organizations that have obtained recognition of exemption under Sections 501(c)(3), 501(c)(4), 501(c)(8), 501(c)(10), and 501(c)(19).

Organizations that have obtained exemption under 501(c)(2), 501(c)(5), 501(c)(6), 501(c)(7), 501(c)(16), and 501(c)(25) are eligible for exemption from the franchise tax, but not the sales tax. None of the foregoing organizations (that is organizations exempt based upon a federal classification) are exempt from hotel occupancy tax. However, organizations with other bases for exemption (such as churches, charitable organizations (as that term is defined under the Texas Tax Code), and educational organizations (also as defined in the Texas Tax Code) along with others) may obtain exemption from the hotel occupancy tax as well as the franchise tax and sales tax. Accordingly, organizations should take care to determine whether they qualify for exemption from state taxes only as a result of their recognition of exemption from federal income tax or also as a result of an exempt classification under the Texas Tax Code. The Texas Comptroller of Public Accounts is the governing authority with respect to Texas taxes as well as tax exemptions under Texas law. Publication 96-1045, *Guidelines to Texas Tax Exemptions*, available on the website of the Texas Comptroller provides detailed information as well as statutory references with respect to tax exemptions along with links to the appropriate application forms.

VI. ONGOING COMPLIANCE/GOVERNANCE

A. REQUIRED FILINGS

Exempt organizations are required to file information reports with the IRS on an annual basis. Private foundations file Form 990-PF.[4] Other exempt organizations file Form 990 (or 990-N or 990-EZ depending upon their revenues). Exempt organizations that have unrelated business taxable income are required to file Form 990-T. All of the foregoing filings are public documents along with such organization's Form 1023/1024.

Until such time as exemption is granted, nonprofit organizations subject to the franchise tax must file a Texas Franchise Tax Report. Finally, for nonprofit organizations formed under the Business Organizations Code, an information report (under BOC 22.357) is required once for

[4] At the state level, private foundations must file a copy of their Form 990-PF with the Texas Attorney General.

up to every four (4) years providing such information as name, address, registered agent and office and names and addresses of directors and officers.

For nonprofit organizations with employees, a Texas Workforce Commission Status Report must be filed with the Texas Workforce Commission. Likewise, such organizations must withhold, deposit, pay and report federal income taxes, social security taxes, and federal unemployment taxes, unless specifically excluded by statute.

B. GOVERNANCE

1. Generally

Despite the difference in choice of form, all decision makers owe certain fiduciary duties to the organizations they serve. A fiduciary duty is simply a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person. *See* Black's Law Dictionary 625 (6th ed. 1990). Fiduciary duties are grounded in equity and influenced by the fact-specific and context-intensive flexibility of the law of equity. As such, different rules apply depending on the context, i.e. the relationship between the fiduciary and the beneficiary. Generally speaking, all fiduciaries of nonprofit organizations owe duties of care, loyalty and obedience. While both trustees and corporate directors owe fiduciary duties as a matter of law, because directors are not trustees, the duties owed by directors differ from those owed by trustees. *See* BOC § 22.223. As such, a practitioner must be careful to distinguish case law based on the form of the entity in question.

2. Duty of Care

The duty of care most simplified is a duty to stay informed and exercise ordinary care and prudence in management of the organization. *See Holloway*, 368 S.W.2d at 576.

To satisfy the duty of care, trustees are called upon to exercise the care and skill that a person of ordinary prudence would exercise in dealing with the person's own property. *See* Scott, Law of Trusts § 174. As such, a trustee is liable for simple negligence in the performance of his duties. The duty of care begins with the trustee assuming the duties of trustee. *See* Tex. Trust Code § 117.006 (providing that within a reasonable time after accepting a trusteeship or receiving trust assets, the trustee must review the trust assets and make and implement decisions related to the retention and disposition of assets to ensure the trust is in compliance with the terms of the trust and the Chapter 117 of the Texas Trust Code, where applicable). Once the trustee assumes such role, the trustee is under a duty to administer the trust in good faith according to its terms, the Trust Code, and where not inconsistent, the duties imposed on trustees at common law. *See* Tex. Trust Code § 113.051.

Trustees have a duty to make the assets of the trust productive while properly managing, supervising and safeguarding trust funds. *See InterFirst Bank Dallas v. Risser*, 739 S.W.2d 882, 900 (Tex. App.—Texarkana 1987, no writ). In trusts to which the Uniform Prudent Investor Act (Section 117.001 et seq.) applies, the performance of the entire portfolio should be considered rather than focusing only on individual investments when determining the productivity of the assets of the trust. *See* Tex. Trust Code § 117.004. A trustee may delegate investment decisions if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation

unless the agent is an affiliate of the trustee, arbitration is required by the delegation or the statute of limitations for potential claims is shortened by the delegation. *See* Tex. Trust Code § 117.011.

With respect to nonprofit corporate directors and officers, the duty of care under Texas law mandates that the decision maker act (1) in good faith, (2) with ordinary care, and (3) in a manner he or she reasonably believes to be in the best interest of the corporation. *See* BOC § 22.221(a).

Texas law does not define "good faith" in the context of fiduciaries. Broadly, the term describes "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation." Black's Law Dictionary 693 (6th ed. 1990). In claims for legal malpractice, for example, "good faith" is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989). Thus, at least in the context of legal malpractice (which bears many similarities to breach of fiduciary duty), good faith is measured objectively based on objective facts. "Good faith" can be contrasted with "bad faith".

"Ordinary care" requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances. It should be noted that where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. A director may delegate decisions (including investment decisions) if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation. *See* BOC § 22.224. Put differently, while a director may delegate certain decisions or activities, she cannot delegate her oversight (i.e. governance) responsibility.

In discharging the duty of care, a director may rely in good faith on information, opinions, reports, or statements, including financial statements or other financial data, concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented. *See* BOC § 3.102; BOC § 22.222.

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization. *See* BOC § 22.221. Reasonableness is based on the objective facts available to the decision maker. Determining whether a proposed action is in the best interest of the corporation requires weighing of many factors including the short-term interests, the long-term interests, the costs, the benefits, etc.

Texas law provides that decision makers of nonprofit corporations are not insurers and thus are not liable so long as those persons exercise their business judgment in making decisions on behalf of the organization. *See, e.g., Campbell v. Walker*, 2000 WL 19143 at * 10,11 (Tex. App.—Houston [14th Dist.] 2000, no writ) (citing *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889); *Cleaver v. Cleaver*, 935 S.W.2d 491, 495-96 (Tex. App.—Tyler 1996, no writ). The parameters of

the business judgment rule in Texas are not well-defined. The Business Organizations Code each provide that a decision maker will not be liable for errors or mistakes in judgment if the decision maker acted in good faith with reasonable skill and prudence in a manner the decision maker reasonably believed to be in the best interest of the corporation. *See* BOC § 22.221(a). Clearly this is merely a restatement of the duty of care. In addressing issues of a director's standard of care, negligent mismanagement of a business enterprise and the exercise of business judgment, case law provides that Texas courts will not impose liability upon a noninterested director absent a challenged action being ultra vires, tainted by fraud or grossly negligent. *See Gearhart Industries, Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (discussing and applying Texas law).

The business judgment rule rests on the concept that to allow a corporation to function effectively, "those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment." *See* Marilyn E. Phelan & Robert J. Desiderio, Nonprofit Organizations Law and Policy 109 (2003) (citing *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973). Because trusts are generally not operating entities in the sense of carrying on their own programs, the concept does not have the same relevance. *See, e.g., Stern v. Lucy Webb Hayes Nat'l School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D. D.C. 1974). While this reasoning may be faulty as trusts may, in fact, carry on their own programs, because the law imposes a higher standard of care on trustees, the business judgment rule does not apply to trustees of charitable trusts.

3. Duty of Loyalty

The duty of loyalty requires that the decision maker act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization. *See Landon*, 82 S.W.3d at 672. As with the duty of care, corporate decision makers are subject to a less exacting application of the duty of loyalty in comparison to a trustee. For example, not all interested transactions are prohibited as will be discussed below.

For trustees the duty of loyalty mandates that a trustee administer the trust property solely for the benefit of the beneficiaries avoiding any transaction that would benefit the trustee to the detriment of the beneficiaries. To ensure compliance with this strict duty of loyalty, the law prohibits conflict of interest transactions even where such transactions are fair to the beneficiaries unless the trustee made full disclosure of the transaction and obtained the consent of the beneficiaries. *See* Tex. Trust Code §§ 113.060; 117.007. The trustee bears the burden to demonstrate full disclosure and consent. If the trustee is unable to satisfy this burden, the transaction may be set aside regardless of its fairness to the beneficiaries. It should be noted that a loan of trust funds to the trustee or a purchase or sale by the trustee of trust property from or to (i) the trustee or an affiliate; (ii) a director, officer, or employee of the trustee or an affiliate; (iii) a relative of the trustee; or (iv) the trustee's employer, partner, or other business associate may be set aside irrespective of disclosure. *See* Tex. Trust Code §§ 113.052; 113.053.

To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. As the Texas Supreme Court has stated, the duty of loyalty requires an "extreme measure of candor, unselfishness, and good faith." *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963). The director must not usurp

corporate opportunities for personal gain, must avoid engaging in interested transactions without board approval, and must maintain the organization's confidential information.

The corporate opportunity doctrine prohibits a corporate director from usurping corporate opportunities for personal gain. *See Holloway*, 368 S.W.2d at 577. Texas law defines such a breach as misappropriating a business opportunity that properly belongs to the corporation. *See Landon*, 82 S.W.3d at 681. An opportunity properly belongs to the corporation where the corporation has a "legitimate interest or expectancy in and the financial resources to take advantage of" the particular opportunity. *Id.* Where the opportunity properly belongs to the corporation, the fiduciary has an obligation to disclose the opportunity and offer the opportunity to the corporation. *See id.*

As referenced above, satisfying the duty of loyalty requires the officer or director to act in good faith and not allow her personal interest to prevail over the interests of the corporation. *See Landon*, 82 S.W.3d at 672; *Torres*, 915 S.W.2d at 49. A common type of violation of the duty of loyalty is the interested director transaction, broadly characterized as a contract between the corporation and a director. An officer or director is "interested" if he or she (a) makes a personal profit from the transaction with the corporation; (2) buys or sells assets of the corporation; (3) transacts business in the officer's or director's capacity with a second corporation of which the officer or director has a significant financial interest; or (4) transacts corporate business in the officer's or director's capacity with a member of his or her family. *See Loy v. Harter,* 128 S.W.3d 397, 407 (Tex. App.—Texarkana 2004, pet. denied). Interested transactions between corporate fiduciaries and their corporations are presumed to be unfair on the part of the officer or director, fraudulent on the corporation and are thus generally voidable. *See Torres*, 915 S.W.2d at 49.

Texas law provides a safe harbor of sorts for interested transactions. Where the material facts are disclosed and a majority of the disinterested directors, in good faith and the exercise of ordinary care, authorize the transaction, the transaction is not void or voidable solely because of the director's interest or the director's participation in the meeting at which the transaction is voted on. *See* BOC § 22.230. Further, such a transaction will not be void or voidable if it is fair to the corporation when it is authorized, approved or ratified by the board. *See id.* However, a transaction from which a corporate fiduciary derives personal profit is "subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about." *See Holloway*, 368 S.W.2d at 577. Significantly, if there has been no approval after full disclosure, the transaction is presumed unfair and the director bears the burden to show fairness. *See id.* Factors considered in evaluating the fairness of a transaction include "whether the fiduciary made a full disclosure, whether the consideration (if any) is adequate, and whether the beneficiary had the benefit of independent advice." *Miller v. Miller*, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.). Of course there may be instances in which there can be no disinterested vote as in a situation with a family foundation and an all family board. In such situations it is advisable to document disclosure of the conflict, careful consideration of the transaction, and the methodology used to determine that the transaction would be fair to the corporation.

Because it is imperative that in the event an issue arises in which a decision maker has a personal interest the decision maker disclose the interest related to the decision being made and abstain from any vote, it is prudent for the organization, and beneficial to the decision makers, for the organization to adopt a conflict of interest policy requiring disclosure of material facts related to

actions between the decision maker and the organization and abstention from voting by the interested decision makers. It is important to note that neither state law nor the Code require a nonprofit corporation exempt as a public charity under Section 501(c)(3) to have a conflict of interest policy (with the exception of health care organizations). With that said, the IRS is pushing organizations to adopt such policies and includes a question on Form 1023 as well as Form 990 inquiring whether an organization has adopted such a policy. Additionally, the IRS has provided a suggested conflict of interest policy for charitable entities. Industry groups such as The Panel on the Nonprofit Sector convened by the Independent Sector suggest adoption of a conflict of interest policy as well. With the heightened scrutiny on governance practices of all corporations, including nonprofit corporations, wisdom dictates at least carefully considering the formal adoption of a conflict of interest policy.

Certain interested transactions between directors and the nonprofit corporations which they serve are strictly prohibited under Texas law. For example, loans to directors are not allowed. *See* BOC § 22.225. Further, directors who vote for or assent to the making of such loans in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid. *See id.*

Finally, the duty of loyalty requires a decision maker to maintain confidentiality and therefore prohibits disclosure of information about the corporation's business to any third party, unless the information is public knowledge or the corporation gives permission to disclose it.

4. Duty of Obedience

Along with the duties of care and loyalty, decision makers of nonprofit organizations owe the additional duty of obedience, the duty to remain faithful to and pursue the goals of the organization and avoid *ultra vires* acts. *See Gearhart*, 741 F.2d at 719. In practice, the duty of obedience requires the decision maker to follow the governing documents of the organization, laws applicable to the organization, and restrictions imposed by donors and ensure that the organization seeks to satisfy all reporting and regulatory requirements. The duty of obedience thus requires that directors see that the corporation's purposes are adhered to and that charitable assets are not diverted to non-charitable uses. It should be noted that "Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act." *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

The duty of obedience is somewhat unique to the nonprofit context and particularly tax-exempt organizations. Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to a for profit business which may be organized to conduct all lawful operations of whatever kind or nature. One court has noted the distinction stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization." *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999). With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions. That realm can be even more narrowly defined when funds are raised for specific purposes.

Because the duty of obedience requires pursuit of the mission of the organization and protection of charitable assets, it is clearly important to understand the purposes of the organization. In the context of a nonprofit corporation, the purpose is stated in the organization's governing documents (Articles of Incorporation/Certificate of Formation/Bylaws) and may be amplified by other documents such as testamentary documents directing the creation of the organization, the application for exempt status filed with the Internal Revenue Service or solicitations for contributions. Each of these sources should be consulted though the basic statement of purpose in the Articles of Incorporation/Certificate of Formation should be given primacy.

5. A Note on Governance

While governance deals with much more than the duties of directors and officers, the concepts do intersect. Good governance can protect against liability. Practices such as having an audit committee, a code of ethics, and a conflict of interest policy are all aspects of good governance and each contributes to liability protection for board members. Investment policies are considered absolutely essential in light of recent investment fund scandals. The revised Form 990 reveals the importance the IRS places on whistleblower policies and document retention and destruction policies. Governance has evolved from regular meetings and recordkeeping into much more of a corporate practice, with corporate policies and procedures.

The concept of "good governance" has received heightened attention in the past few years in the wake of various corporate scandals in both the for-profit and non-profit worlds. Although a thorough discussion is not permitted by time and length of this paper, the reader may wish to consider recent publications created by the Nonprofit Sector and the Internal Revenue Service. The Panel on the Nonprofit Sector's Advisory Committee on Self-Regulation of the Charitable Sector has developed 29 principles of effective practices for charitable organizations. The 29 principles can be broken into four broad categories: (1) Facilitating Legal Compliance; (2) Effective Governance; (3) Strong Financial Oversight; and (4) Responsible Fundraising. The Committee recommends all charities hold these principles as aspirational goals and that large public charities (those with annual revenues of at least $1M) and large private foundations (those with assets of at least $25M) implement the principles. It should be noted that despite the number of charities signing on to these principles, others reject full-scale adoption as a one-size fits all approach in a diverse field (see, for example, materials from the Philanthropy Roundtable).

VII. DISSOLUTION/TERMINATION

While a nonprofit organization will face many significant events during its life, the ultimate significant event is when the organization reaches the end of its life. This can come about by dissolution (voluntary or through an involuntary proceeding) or through a merger.

Nonprofit corporations as well as limited liability companies are governed by the BOC in regard to winding up as well as mergers. Charitable trusts are governed by the Texas Trust Code with respect to dissolution or termination. The procedures set forth in the requisite statutes must be followed to affect a winding up/dissolution/merger as the case may be. For example, when winding up a nonprofit corporation under Chapter 22 of the BOC, a resolution to wind up must be adopted. If the corporation has no voting members, the board of directors adopts such resolution. If the corporation has voting members, the resolution must be approved by the

members. Because a voluntary winding up and adoption of a plan of distribution is considered a "fundamental action" under the BOC, the vote required by the members is 2/3 of the votes that members present in person or by proxy are entitled to cast or simply the affirmative vote of the majority of directors in office if there are no voting members. *See* BOC § 22.164. A proposed plan of distribution must receive a like vote. The organization must then pay or make provision for the payment of liabilities and obligations before conveying its assets pursuant to its plan of distribution. Once assets are appropriately conveyed (including following any provisions of the organization's governing documents regarding transfer of assets on dissolution), an officer of the organization must sign and file a certificate of termination.

While the foregoing discussion describes the Texas requirements for terminating an organization formed under the auspices of the Business Organizations Code, a charitable trust as a non-Code organization, will not follow such steps. Rather, a charitable trust terminates pursuant to any provisions in the trust agreement relating to termination. Otherwise, termination requires court approval. *See* Tax. Prop. Code § 112.054. In any proceeding involving a charitable trust, including a proceeding seeking court approval to terminate the trust, proper notice must be given to the Texas Attorney General and the Texas Attorney General may choose to intervene in the proceeding. *See* Tax. Prop. Code §§ 123.002; 123.003.

Significant care should be taken when terminating an exempt organization. IRS Publication 4779, *Facts About Terminating or Merging Your Exempt Organization* should be consulted by any organization terminating its existence or merging into another exempt organization. Terminating/merging organizations must inform the IRS of this action by filing a final Form 990, 990-PF, 990-N or 990-EZ (as applicable) by the 15th day of the 5th month after the end of the period for which the return is due. The final form should reflect that it is a final form with the filer checking the "terminated" box in the header and providing answers as appropriate with respect to questions regarding liquidation, termination, dissolution, or significant disposition of assets. In addition, Schedule N, *Liquidation, Termination, Dissolution or Significant Disposition of Assets* must be provided with respect to Form 990 and Form 990-EZ. Finally, the organization must provide a certified copy of its Articles of Dissolution or Merger or such other applicable document.

With respect to a private foundation, the organization must follow a certain series of steps or risk the imposition of a termination tax. A private foundation may terminate "voluntarily" under Section 507(a)(1) or "involuntarily" under Section 507(a)(2). In either event, the foundation must pay a termination tax under Section 507(c) equal to the lesser of its "aggregate tax benefit" (i.e. all tax benefits accruing to the organization and its contributors) resulting from its Section 501(c)(3) status or the net fair market value of its assets. The "aggregate tax benefit" is the sum of four amounts: (1) the aggregate increase in income, estate and gift taxes to substantial contributors if contribution deductions have been disallowed; (2) the aggregate increase in income tax which would have been imposed on the foundation if it had not been exempt from income tax and in the case of a trust, if deductions under Section 642(c) have been limited to twenty percent (20%) of the taxable income of the trust; (3) any amounts received by one private foundation from another private foundation if a tax is imposed upon the termination; and (4) interest on the increases in tax for each of the increases under (1) – (3) from the date on which each increase would have been due and payable to the date on which the organization

ceases to be a private foundation. Clearly this is a significant burden. To avoid this significant burden, the private foundation must either make a grant of all assets to an organization which has been classified as a public charity for a sixty (60) month continuous period, or convert the private foundation to into a supporting organization by amending its organizational documents to create the required relationship with the public charity as is required with a supporting organization, giving appropriate notice to the Internal Revenue Service of a sixty (60) month termination and reclassification as a public charity under Section 509(a)(3). Alternatively, the private foundation may merge with another private foundation and then begin a voluntary termination under Section 507(b)(1) paying no termination tax because it no longer has any assets. In other words, the foundation must transfer its assets to a public charity, merge with another private foundation where it is not the survivor, or reclassify itself as a public charity to avoid the termination tax. In such event, the private foundation would still be required to file a final Form 990-PF.