

# A BASIC FRAMEWORK OF THE NONPROFIT SECTOR

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dreamstime

# FACTS AND FIGURES ABOUT CHARITABLE ORGANIZATIONS

- In 2011, over 1.6 million **tax-exempt** nonprofit organizations were registered with the IRS
- About 75% of these make up the “independent sector” – including 501(c)(3)s and (c)(4)s.
  - About 10% are (c)(4)s [examples include the NAACP, the NRA, and the Sierra Club]

# THE THIRD SECTOR: WHAT IS A NONPROFIT ORGANIZATION?

## *Sources of Revenue*

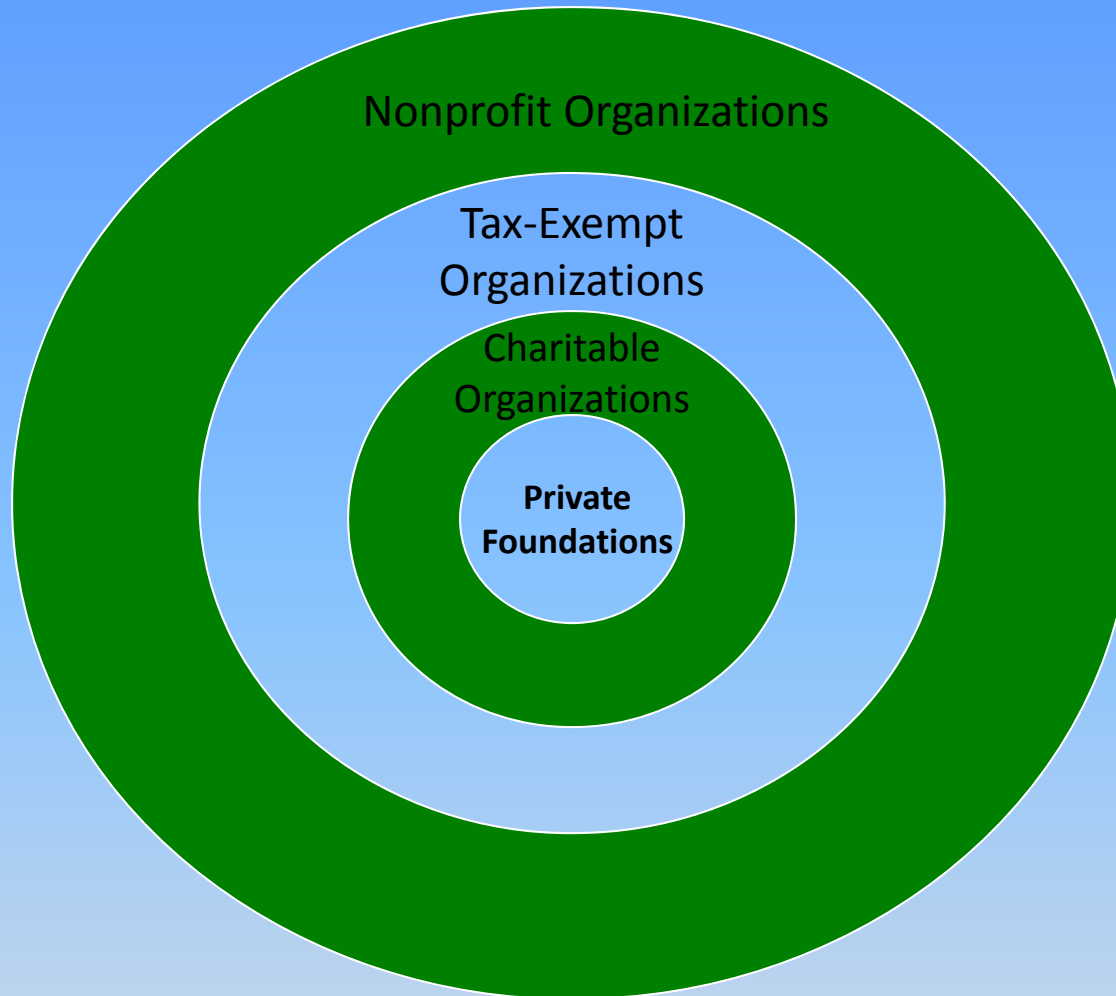
- *Donative nonprofit*
- *Commercial nonprofit*

## *Recipients of benefits*

- *Public benefit*
- *Mutual benefit*

*May not distribute profits to private individuals in the form of dividends or otherwise.*

# NONPROFIT vs CHARITABLE ORGANIZATION



## Choice of Form – State Law

- Charitable trust
- Nonprofit unincorporated association
- Nonprofit corporation
- LLC acceptable as disregarded entity or a stand-alone if all members exempt

# FORMATION – TEXAS CONSIDERATIONS

- *Speed of establishing*
- *Concerns with limited liability*
- *Sophistication & goals of organizers*
- *Financial resources of organizers*
- *Type & scale of activities to be conducted*
- *Permanence*
- *Ease of dissolution/ amendment*
- *Governance*
- *State Tax considerations*
- *Duties of fiduciaries*
- *Federal tax considerations*

# CHARITABLE TRUSTS

Fiduciary relationship with respect to property created by declaration of trust by trustor investing trustee with legal title to property for the benefit of a charitable beneficiary

Ascertainable  
or public  
beneficiary

Governed by  
state's trust  
act

Trustee owes  
fiduciary  
duties

May have one  
or more  
trustees who  
may be  
corporate or  
individual

# CHARITABLE TRUSTS

## Pro's

- ✓ Years of established case law
- ✓ Rigid structure provides assurance to settlor of purposes being followed
- ✓ Higher fiduciary standards for trustees
- ✓ Flexible trustee planning (number, term, successors)

## Con's

- ✗ Inflexibility
- ✗ Limitations on ability to delegate duties if governed by UPIA
- ✗ More stringent standards for trustees (no BJR)
- ✗ UBTI concerns



# NONPROFIT UNINCORPORATED ASSOCIATIONS

Unincorporated association, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose

Governed by the Texas Business Organizations Code (Ch. 252)

Formation *not* governed by statute (usually have Constitution, Articles of Association, or Bylaws)

Powers: Promote aims and purposes and advance members' interests by all legitimate and legal means (not necessarily charitable, e.g. trade association, unions)

# NONPROFIT UNINCORPORATED ASSOCIATIONS

## Pro's

- ✓ Relatively easy to establish
- ✓ Flexible/informal
- ✓ Texas Uniform Unincorporated Nonprofit Association Act (now codified as part of the Texas Business Organizations Code)

## Con's

- ✗ Few established rules
- ✗ Case-law not well-established
- ✗ Difficulty with charitable immunity
- ✗ Potential issues with lenders
- ✗ Conflict of laws concerns

# NONPROFIT CORPORATIONS

- A corporation whose income may not be distributed to its members, directors, or officers in the form of dividends or otherwise (note: salaries paid must be reasonable)
- May be organized for any lawful purpose (with limited exceptions)
- Governed by the Texas Business Organizations Code (specifically Chapter 22)
- Note:** While purposes are broad, care should be taken if later applying for 501)(c)(3) recognition (must be organized exclusively for charitable, educational or religious purposes)

# NONPROFIT CORPORATIONS

## PRO's

- ✓ Well-established rules
- ✓ Well-established case-law
- ✓ Internally flexible
- ✓ Extensive powers as an entity

## CON's

- ✗ Cost to set up & run
- ✗ Even where funded entirely by a single individual, must have at least three directors (IRS will request non-related)
- ✗ Subject to Texas franchise tax unless granted exemption

# LIMITED LIABILITY COMPANY

Entity  
organized  
under Ch.  
101 of the  
BOC

Members  
(owners),  
managers  
(directors)  
shielded  
from debts,  
obligations,  
liabilities of  
the LLC

May be  
managed by  
members or  
managers

Can create  
problems  
with  
franchise  
tax and  
property tax

# LIMITED LIABILITY COMPANY

## Pro's

- ✓ Liability protection
- ✓ Simple control  
(management overlap expected)
- ✓ Disregarded entity for federal income tax purposes if single member

## Con's

- ✗ Subject to Texas taxes
  - ✗ franchise tax
  - ✗ sales tax
  - ✗ property tax

# TAX EXEMPT ORGANIZATIONS: FEDERAL LAW

- *I.R.C. Section 501(c) lists organizations that are exempt from federal income tax.*
  - *Over 30 categories of federal income tax exemption classification*
- *I.R.C. Section 501(c)(3) lists charitable organizations that are exempt from federal income tax, contributions to which are income tax deductible to the donor under I.R.C. Section 170*

## § 501(c)(3) ELEMENTS

1. *Proper organizational structure*
2. *Organized exclusively for charitable or otherwise exempt purposes*
3. *Operated exclusively for charitable or otherwise exempt purposes*
4. *No part of net earnings inures to benefit of private individual*
5. *Not an action organization*
6. *<<case law>> - not violative of public policy*



# CHARITABLE PURPOSE

- “Primary” or “Exclusive” purpose must be charitable (“exclusive” doesn’t mean “sole”)
- Charitable purposes:
  - Advancement of religion
  - Scientific research
  - Advancement of education
  - Promotion of health
  - Relief of poverty
  - Lessening the burdens of government
  - Other social welfare

# ORGANIZATIONAL/OPERATIONAL TESTS

## Organizational

- Look to enabling documents
- Must be organized exclusively for charitable purpose(s)
- May be general or specific

## Operational

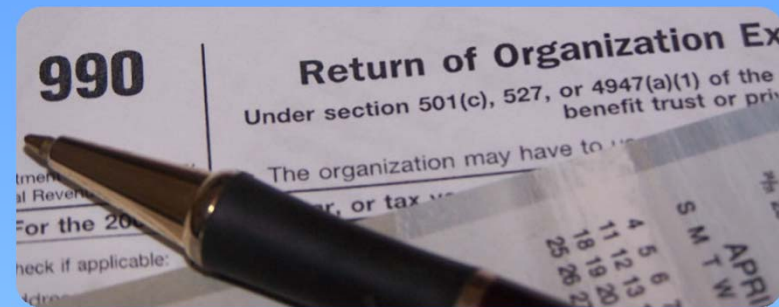
- Look at actual activities of organization
- Must be operated exclusively for charitable purpose(s)
- May not engage in substantial activities that fail to further charitable purposes

# RECOGNITION OF TAX EXEMPT STATUS

1. *Organize for state law purposes*
  - *In Texas, can be unincorporated association, trust or non-profit corporation, or LLC*
2. *File IRS Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*
  - *Exceptions to filing Form 1023: churches, associations of churches, integrated auxiliaries of churches, organizations (other than PFs) normally having annual gross receipts of not more than \$5000*
  - *If seeking exemption under another section, file Form 1024*
3. *Once approved, IRS will issue a determination letter, evidencing the organization's exempt status*
4. *File letter with Texas Comptroller to request exemption from state franchise tax and sales and use taxes*

# ANNUAL MAINTENANCE

1. *Must file applicable 990 annually unless exempt*
2. *Must file 990-T for UBTI in excess of \$1000*
3. *Must file franchise tax return unless exempt*
4. *Must file Form 802, Periodic Report with SoS as requested*
5. *Form 1023, 990, 990-T open to public inspection*
6. *Annual meeting requirements/minutes/etc. depend on form of organization*



# DISSOLUTION AND TERMINATION

- Compliance with state law requirements
  - Nonprofit corporation
    - Resolution approving plan of dissolution adopted by board of directors and members, if any
    - Conveyance of assets pursuant to plan of dissolution
    - Filing of Certificate of Termination
  - Charitable Trust
    - Termination in accordance with provisions of trust agreement or by court order
    - Requires notice to Attorney General

# DISSOLUTION AND TERMINATION

- *Compliance with federal tax requirements*
  - *File final Form 990 and provide a certified copy of the Certificate of Termination*
  - *Special rules govern termination of private foundations*
- *Assets are required to be distributed for charitable purposes*

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The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein. Non-lawyers are advised to consult an attorney before undertaking any issues addressed herein.

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