Selected Pitfalls in the Life Cycle of a Charity

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The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein. Nonlawyers are advised to consult an attorney before undertaking issues address herein.

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Selected Pitfalls in the Life Cycle of a Charity

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*.

The goal of this paper is to summarize certain rules and restrictions and address pitfalls that face a Texas nonprofit corporation seeking exemption as a public charity as well as to its governing body as a result of its public charity classification.

II. Pitfall Number One: The Organizational Test

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.

Beyond the standard non-distribution constraint applicable to all nonprofit organizations, 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, and must be organized and operated exclusively for charitable purposes. *See* Reg. 1.501(c)(3)-1(a). 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. 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 (Certificate of Formation and Bylaws) 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. 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 the organization is neither organized nor operated to allow any part of the net earnings inures to the benefit of a private individual.

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.

III. Pitfall Number Two: The Exemption 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.[1] Stated differently, failing to file a substantially complete Form 1023 and obtain a determination letter precludes the benefits of exemption, including exemption from federal income tax and the ability to attract deductible donations. 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

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

> 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 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.

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.

IV. Pitfall Number Three: The Operational Test

A. Operating for a Public Purpose

Once the organization is formed and exemption obtained (or in process), the organization must satisfy the operational test to maintain exemption. As addressed above, a charitable organization exempt under § 501(c)(3) must be organized and operated exclusively for charitable purposes (recall that the law defines "exclusively" as "primarily" for this purpose). A derivative of this concept is the idea that the organization operates for public benefit versus private benefit. No organization that operates in more than an

incidental way for private benefit (qualitatively incidental and quantitatively incidental) can continue to qualify for tax exempt status.

Within this broad concept of a prohibition on private benefit are the doctrines of private inurement and intermediate sanctions. The private inurement doctrine is meant to ensure that a tax exempt organization's "insiders" (i.e. persons in a position to influence the organization's affairs) do not use such position to siphon off any of a charity's income or assets for personal use. "Insiders" include the organization's founders, directors, officers, key employees, and members of the families of these individuals, as well as certain entities controlled by these individuals. Common cases of private inurement revolve around payment of excessive compensation (discussed in more detail below), certain rental arrangements, certain lending arrangements, sale of assets for more than fair market value to the organization, etc.

B. Benefits to Insiders and Intermediate Sanctions

There is an absolute prohibition on allowing assets to inure to the benefit of the organization's insiders (referred to as "disqualified persons"). If such action occurs, the IRS may revoke the organization's tax exempt status. However, as an alternative measure, the IRS can impose intermediate sanctions, which are excise taxes assessed directly against the insiders and other decision-makers who have approved the transaction in question. For example, if an insider were paid an excessive salary, rather than revoke the organization's tax exempt status (which would be within the purview of the IRS), the IRS could assert an excise tax sanction against the insider in the amount of twenty-five percent (25%) of the excess benefit (which, if not corrected in a timely manner, will result in a second tier tax of two hundred percent (200%) of the excess benefit) as well as excise tax in the amount of ten percent (10%) of the excess benefit (not to exceed $20,000.00) imposed against decision-makers of the charity who knowingly participated in the transaction. The key in avoiding such transactions is close attention to any transactions where assets pass from the organization directly or indirectly to the insiders of the organization. Not all such transactions are prohibited; however, once these types of transactions are identified, it must be ensured that the insider is not receiving an excess benefit (i.e. that the insider is not receiving some amount which exceeds the economic benefit provided by the insider to the organization). The organization should have a Conflict of Interest Policy and that policy should be reviewed annually as it will assist in avoiding such improper benefit.

A Disqualified Person with respect to a public charity is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a Disqualified Person. I.R.C. §4958(f). Note the difference between a Disqualified Person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes.

The following persons are considered to have substantial influence:

a) Presidents, chief executive officers, or chief operating officers,

b) Treasurers and chief financial officers,

c) Persons with a material financial interest in a provider-sponsored organization (generally, in the context of nonprofit hospitals)

The following persons are deemed NOT to have substantial influence:

a) Tax-exempt organizations described in I.R.C. §501(c)(3),

b) Certain I.R.C. §501(c)(4) organizations,

c) Employees receiving economic benefits of less than a specified amount in a taxable year

Facts and circumstances govern in all other instances. Facts and circumstances tending to show substantial influence:

a) The person founded the organization,

b) The person is a substantial contributor to the organization (within the meaning of I.R.C. §507(d)(2)(A),

c) The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls,

d) The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees,

e) The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole,

f) The person owns a controlling interest (in vote or in value) in a corporation, partnership, or trust that is a Disqualified Person,

g) The person is a non-stock organization controlled directly or indirectly by one or more Disqualified Persons.

Facts and circumstances showing no substantial influence:

a) The person is an independent contractor whose sole relationship to the organization is providing professional advice,

b) The person has taken a vow of poverty on behalf of a religious organization,

c) Any preferential treatment the person receives based on the size of the person's donation is also offered to others making comparable widely solicited donations,

d) The direct supervisor of the person is not a Disqualified Person,

e) The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole. Treas. Reg. §53.4958-3.

Because compensation is an area so susceptible to violating the private inurement doctrine, a closer look is in order. The compensation of the President/Executive Director ("CEO") serves as a good example. Compensation paid to a Disqualified Person is not excessive if it is reasonable. Reasonableness is determined under an I.R.C. §162 standard, which is the value that would ordinarily be paid by like enterprises under like circumstances. All items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation.

An individual serving as the CEO of a public charity is classified as a disqualified person with respect to such public charity. Accordingly, the compensation paid must be reasonable to avoid private inurement as well as to avoid excise taxes for an excess benefit transaction under the Intermediate Sanctions rules of Section 4958 of the Internal Revenue Code (the "Code"). Section 4958 provides a safe harbor for compensation decisions. Payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax-exempt organization follows the following procedures:

a) The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction,

b) Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services,

c) The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

    (1) The terms of the transaction that was approved and the date it was approved,

    (2) The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,

    (3) The comparability data obtained and relied upon by the authorized body and how the data was obtained, and

    (4) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction. Treas. Reg. §53.4958-6.

If the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

The safe harbor should be the central component for setting compensation; however, complying with the safe harbor requires other fundamental decisions to be made as well. Among these "other decisions" include defining the compensation philosophy of the organization (e.g., what competencies or qualities does the organization most value in setting compensation, where among the market does the organization desire for its compensation to fall, what compensation strategies will the organization utilize to attract and retain qualified and talented individuals), who will make the compensation decisions, what type of comparable data will the organization rely on, where will the organization get that information, and how will the organization position itself to defend its compensation to various "stakeholders" (the IRS, the attorney general, watchdog groups, and the general public).

The first step in determining compensation that will satisfy the safe harbor provisions and be defensible is creating a process. Critically, it should be the compensation committee (which in smaller organizations may be the full Board) who reviews the comparability information, along with any recommendation from officers, to arrive at a recommendation that will then go to the full board and identify to its delegee the type of comparability information it desires. The key for safe harbor purposes is comparing like services to like organizations under like circumstances. In gathering comparability information from various sources, the compensation committee will be able to review a market composite and determine where in relation to the market, it wants to place the CEO's salary. This determination will be based upon things that the board has set forth in its compensation philosophy, such as value of the individual's experience, performance, etc. Leading compensation consultants advise nonprofit clients to generally stay in the range of the 75th percentile, but cautions that the IRS has approved no specific cap. There may be reasons to pay above the 75th percentile as there may be reasons for the organization to pay below it.

Deliberation of the compensation committee should be memorialized in minutes of the committee. Documentation is a key aspect of not only complying with the safe harbor provisions of Section 4958, but also providing defensible compensation with respect to the Attorney General, watchdogs, and the general public. Compensation should ultimately be approved by the full board. The full board should be appraised of the compensation, the basis of the compensation committee's recommendation, be able to ask any questions, and ultimately be the body that approves the compensation for the CEO. The full board needs to have this level of involvement with any other compensation decisions. Once the full board has approved compensation, the minutes should reflect the process described above, again for safe harbor as well as best practice purposes.

Some organizations find it helpful in establishing compensation to obtain information from a qualified compensation consultant. There has been conversation and public statements over the past 18-24 months from members of the Senate Finance Committee as well as the House Ways and Means Committee regarding the safe harbor provisions and questioning whether those safe harbor provisions should be removed from Section 4958 based upon the use of improper comparability data, improper reporting (i.e. reporting only base compensation, but not all benefits, etc.) and other actual or perceived abuses. While no such action has taken place and, in my opinion no such action is likely to

take place in the immediate future, relying on an independent third party compensation consultant provides greater security that the compensation professional will obtain and use appropriate comparability data (and likely have access to other sources of comparability data) and will provide additional defense against anyone arguing that compensation paid is unreasonable.

Note that Form 990 (annual information return) devotes an entire schedule (Schedule J) to reporting compensation information. Some of the highlights include:

a) Did the organization follow a written policy regarding payment or reimbursement or provision of expenses?

b) Did the organization require substantiation (documentation via receipts, etc.) prior to reimbursing or allowing expenses?

c) Methodology for setting executive compensation

d) Questions regarding compensation contingencies, if any

C. Lobbying and Political Activity

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. This means that no substantial part of the activities of the organization may be carrying on propaganda, or otherwise attempting to influence legislation. Furthermore, there is an absolute prohibition against such an organization participating in, or otherwise intervening in any political campaign on behalf of or in opposition to a candidate for elective public office.

Definitions are helpful in breaking down this limitation (as to lobbying activity) and prohibition (as to political intervention activity). "Legislation" includes any action by Congress, by any state legislature, by any local council or similar governing body, or by the public in referendum, initiative, constitutional amendment, or similar procedure. An attempt to influence legislation includes contacting (or urging the public contact) legislators or their staff for the purpose of proposing, supporting or opposing legislation or advocating the adoption or rejection of legislation. Lobbying activity does not include nonpartisan analysis, study or research, technical assistance or advice to a governmental body in response to a request for assistance, or appearance before, or communication with, any legislative body that would adversely affect the organization. Because the limitation is that an organization must not have a substantial part of its activities be involved in lobbying, it is critical to understand the definition of substantial. Unfortunately, substantial is not a bright line rule. Generally, factors to consider include the cost of the organization, the time or physical effort of or on behalf of the organization, the importance to the organization's overall activities, and the frequency of the organization's legislative activities. Organizations that expect to lobby on a frequent basis should consider becoming electing organizations under section 501(h) by filing Form 5768. Such an election provides the organization with a bright line test for the amount that may be spent on expenditures. Organizations that make a 501(h) election must pay an excise tax on excess lobbying expenditures equal to 25% of any such excess lobbying expenditures. Organizations that

make a 501(h) election will lose their tax-exempt status if they normally engage in lobbying activity that exceeds specified ceiling amounts.

While organizations may have some involvement in legislative/lobbying activities, there is an absolute prohibition on intervening in political campaigns. To violate the prohibition, the intervention must be a part of a political campaign, the campaign must be with respect to an individual who is a candidate, and the campaign must be for elective public office. Penalties for such intervention include revocation of exemption, an initial tax on "political expenditures" (which for private foundations constitute taxable to petitioners) and a second-tier tax if uncorrected. Allowable activities (i.e. those that do not constitute political campaign intervention) include nonpartisan voter registration guides, nonpartisan voter drives, educational/informational talks with invitations extended on a nonpartisan basis, and activities that further an organization's exempt purposes such as a student newspaper that is endorsing a candidate or a political science course requirement to work in a campaign.

V. Pitfall Number Four: Annual Filing Requirements

Absent certain narrow exceptions for churches and organizations related to churches, public charities are required to file an annual tax return with the IRS. Failure to file the annual tax return for three consecutive years results in automatic revocation of the organization's exempt status.

Exempt organizations are required to file information reports with the IRS on an annual basis. Private foundations file Form 990-PF.[2] Other exempt organizations (including public charities) 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. These documents must be filed even while a Form 1023 application is pending. 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 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.

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

VI. Pitfall Number Five: Governance and the Attorney General

A. 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.

B. 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.

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 non-interested 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.

C. 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.

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.

D. 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.

E. Authority of the Attorney General as to Charitable Organizations

The Office of Attorney General ("OAG") has broad standing and powers with respect to charitable organizations in the State of Texas. The OAG's standing arises from that office's role as the representative of the public interest in charity. *See* TEX. PROP. CODE § 123.001, et. seq. The OAG is charged to ensure charitable assets are used for appropriate charitable purposes and has broad authority to carry out that duty emanating from the Texas Constitution, common law, and various statutes. Where the OAG brings suit alleging breach of one of the fiduciary duties outlined above, venue is in Travis County. *See* TEX. PROP. CODE § 123.005(a). In the event the OAG is successful in its claims of breach of fiduciary duty, the OAG is entitled to recover from the fiduciary actual costs incurred in bringing the suit and may recover reasonable attorney's fees. *See* TEX. PROP. CODE § 123.005(b).

While the public is the beneficiary of the work of charitable organizations and funds held by charitable organizations are said to be held in trust for the benefit of the public, a member of the public lacks standing on such basis to bring a claim against a decision maker. Rather, the OAG is the proper party to protect the public's interest. In very narrow circumstances, a donor may have standing to enforce the terms of his gift when the organization ignores or violates those terms. *See, e.g., Cornyn v. Fifty-Two Members of the Schoppa Family*, 70 S.W.3d 895 (Tex. App.—Amarillo 2001, no petition). Such standing requires that the donor have a *special interest* in the donated gift. *See id.* (holding donors had a special interest where donation was brain tissue for Alzheimer's research)*; see also* GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 411 (Rev. 2d ed. 1991). Generally, however, absent contractual standing created by way of a gift instrument a donor lacks standing to enforce the terms of a completed gift.

In addition to the OAG's common law authority, constitutional authority, and authority under Chapter 123 of the Texas Property Code, the Texas Business Organizations Code ("TBOC") also provides the OAG various powers and investigative authority over nonprofits. Many powers are implied from the provisions of the TBOC, which require corporate compliance (e.g. keeping accurate books and records). The TBOC provides the OAG the authority to present a written request to examine the operations of the nonprofit corporation (without notice), the authority to apply for involuntary dissolution (and liquidation), and the authority to apply for the appointment of a receiver in proper cases. The OAG additionally has certain special authority under the Texas Deceptive Trade Practices Act ("DTPA") with respect to charitable organizations. While the DTPA normally requires that an organization is selling or advertising goods or services, the DTPA application to charitable organizations is a bit more broad. False, misleading, or deceptive acts or practices that occur in the conduct of any trade or commerce are generally governed by the DTPA. However, even if a nonprofit does not charge for services or products, the DTPA applies. This is because the DTPA applies to charitable organizations with respect to fraudulent solicitation regardless of whether goods or services are offered as a part of the solicitation. The DTPA provides authority to the OAG to conduct pre-suit investigations, file lawsuits for enforcement, and impose penalties for noncompliance. In addition, the DTPA allows for an enhanced penalty in the event the OAG determines that the fraudulent act or practice was seeking to acquire or deprive money from a consumer age 65 or older.

VII. Pitfall Number Six: Handling Restricted Gifts

A. What is the effect of a restricted gift?

In general, when a charitable organization accepts a restricted gift the restriction is legally binding on the charity. To understand the state law basis for enforcement of restricted gifts requires an understanding of the characterization of the gift under Texas law and the fiduciary obligations of directors of charitable organizations.

A Texas nonprofit corporation organized for charitable purposes is considered a "charitable entity". *See* Tex. Prop. Code § 123.001(1)(2). Monies donated to a charitable entity are said to be impressed with a charitable trust for the benefit of the public, meaning the funds have to be used for the organization's stated purposes and consistent with any other restrictions. *See Blocker v. State*, 718 S.W.2d 409, 415 (Tex. App.—Houston [1st Dist.] 1986, writ ref's n.r.e.). Although statutory law makes clear directors are themselves not held to the fiduciary standard of a trustee, this law highlights not only the fiduciary nature played by directors but also the role of the charity as a "trust" holding a restricted gift. *See, e.g.*, Texas Business Organizations Code ("BOC") § 22.223.

B. What if we don't understand the restriction?

The Uniform Declaratory Judgments Act provides statutory authority for a court to construe the terms of a grant agreement constituting a contract as well as to construe the terms of a gift constituting a charitable trust. *See* Tex. Civ. Prac. & Remedies Code §§ 37.004, 37.005. Section 37.005 of the Texas Civil Practice and Remedies Code provides that "a person interested as or through an executor or administrator, including an independent

executor or administrator, a trustee, guardian, other fiduciary, creditor, devisee, legatee, heir, next of kin, or cestui que trust in the administration of a trust or of the estate of a decedent, an infant, mentally incapacitated person, or insolvent may have a declaration of rights or legal relations in respect to the trust or estate: (1) to ascertain any class of creditors, devisees, legatees, heirs, next of kin, or others; (2) to direct the executors, administrators, or trustees to do or abstain from doing any particular act in their fiduciary capacity; (3) to determine any question arising in the administration of the trust or estate, including questions of construction of wills and other writings; or (4) to determine rights or legal relations of an independent executor or independent administrator regarding fiduciary fees and the settling of accounts." In the case of a purely charitable trust, it will most often be the trustee(s) who bring a construction action (though a named beneficiary could do so). In the case of a nonprofit corporation, the action may be brought by the corporate entity. The declaration sought from the court should be limited to one of the enumerated areas.

A proceeding to construe the terms of a charitable trust (including one arising as a result of a restricted gift to a nonprofit corporation) is a "proceeding involving a charitable trust" as that term is defined in Section 123.001(3) of the Texas Property Code. As a result, upon initiation of this type of proceeding under Chapter 37 of the Texas Civil Practices and Remedies Code, notice and the opportunity to intervene must be given to the OAG.

C. What if we can't follow the restriction or prefer not to follow it?

When a restriction cannot be fulfilled, or, in the event a charity desires to seek modification of a restriction, the charity should first understand the genesis of the restriction (see Section II, supra) because restrictions arising as a result of the charity's organizational documents offer different considerations.

With respect to restrictions arising from a written statement of intent from the donor or as a result of a program of solicitation, the question is whether the restriction is on an institutional fund or a program-related fund.[3] Charities seeking release or modification of institutional funds will look to rules provided by UPMIFA (defined below). Charities seeking release or modification of program-related funds will look to the doctrines of cy pres and equitable deviation.[4]

Traditionally, the only way to alter or remove the restrictions was through application of the doctrine of cy pres. The doctrine of cy pres applies where a donor has made the donation with general charitable intent, that is, an intent that the funds be devoted to a more general charitable purpose than the specific purpose serving as the basis

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[3] This discussion assumes the charity is a nonprofit corporation and thereby subject to UPMIFA.

[4] There is some debate about whether such an action would be brought under the common law or under Section 112.054 of the Property Code (on the basis that restrictions results in assets being impressed with a charitable trust). Under either circumstance the standards are the same; however, under Section 112.054, the petitioner may seek reasonable and necessary fees in bringing the action under Section 114.064. At the same time Section 163.011 of UPMIFA specifies that the Texas Trust Code does not apply to any institutional fund governed by UPMIFA.

of the restriction. Where the donor manifests general charitable intent, a court may direct use of the funds to purposes as near as possible to the initial purposes when the initial purposes are or become impossible, impracticable, or illegal. *See* Restatement (Second) of Trusts § 399 (1959); *see also* Tex. Prop. Code § 112.054; Johnny Rex Buckles, *When Charitable Gifts Soar above Twin Towers: A Federal Income Tax Solution to the Problem of Publicly Solicited Surplus Donations Raised for a Designated Charitable Purpose*. 71 Fordham L. Rev. 1827 (2003). Importantly, a restrictive purpose does not fail merely because it is not "efficient" to continue it.

The doctrine of cy pres applies to use of the donated funds. A similar doctrine, equitable deviation, applies to modification of administrative terms of a gift when the terms as imposed are or become impossible or illegal, or where compliance would substantially impede the accomplishment of the purposes of the gift due to circumstances not anticipated by the donor. *See* Restatement (Second) of Trusts § 381; *see also* Tex. Prop. Code § 112.054.

Application of the doctrines of cy pres and equitable deviation are restrictive as both necessitate a finding of related to the difficulty of following the restriction (cy pres: carrying out the designated purposes of the gift is, or has become impossible, impracticable, or illegal).

In 2007, Texas adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). It can be found in Chapter 163 of the Texas Property Code. UPMIFA provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending. Additionally, UPMIFA has specific provisions that speak to the release or modification of restrictions in certain cases with respect to institutional funds.

UPMIFA in Texas applies to Texas "institutions" managing "institutional funds" or "endowment funds". "Institution" is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated. *See* Tex. Prop. Code § 163.003(4). "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include: (A) program related assets; (B) a fund held for an institution by a trustee that is not an institution; or (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund. *See* Tex. Prop. Code § 163.003(5). An endowment fund is defined as "an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment for its own use." Tex. Prop. Code § 163.003(2). A "gift instrument" is defined by UPMIFA as a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund." Tex. Prop. Code § 163.003(3).

UPMIFA permits release or modification of restrictions on institutional fund management, investment and/or purpose in limited circumstances.[5] If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution. Tex. Prop. Code § 163.007(a). Absent donor written consent, such as in the case of a deceased or unidentified donor, an institution may apply to a court for modification of a restriction on management or investment of an institutional fund, on the grounds of impracticability or wastefulness, if it impairs the management or investment of the fund, or if, because of circumstances no anticipated by the donor, a modification of a restriction will further the purposes of the fund, and the court may modify. To the extent practicable, any modification must be made in accordance with the donor's probable intention. Tex. Prop. Code § 163.007(b). An institution may apply to a court for modification of a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund, if such purpose or restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, and the court may modify in a manner consistent with the charitable purposes expressed in the gift instrument. Tex. Prop. Code § 163.007(c). If an institution applies to a court for modification, Chapter 123 of the Texas Property Code applies (and therefore the OAG must be notified in accordance with that chapter). *See* Tex. Prop. Code § 163.007(b) and (c).

For certain smaller and older funds, if an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, 60 days after receipt of notice by the OAG, may release or modify the restriction, in whole or in part, if:

- The institutional fund subject to the restriction has a total value of less than $25,000;
- More than 20 years have elapsed since the fund was established; and
- The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

The notification to the OAG must be accompanied by a copy of the gift instrument and a statement of facts sufficient to evidence compliance with the requirements set out above. *See* Tex. Prop. Code § 163.006(d).

Note that UPMIFA does not apply to trusts managed by corporate or individual trustees, but the Act does apply to trusts managed by charities. A charity whose governing instrument is a trust document (and whose trustee is not a charity) is instead governed by the Texas Uniform Prudent Investor Act (located in Chapter 117 of the Texas Property Code) for investment and management issues.

[5] When considering release of restrictions under UPMIFA, keep in mind the definition of "institutional fund" expressly excludes program-related assets.

D. What if we choose to ignore the restriction?

Choosing to ignore a restriction is a recipe for a breach of fiduciary duty claim; however, standing to complain of wrongful conduct by the fiduciary is narrow. With respect to nonprofit corporations, the organization (and/or its members to the extent the organization has members) may bring an action against a director based on an alleged breach of the decision maker's duties. Such derivative suits may be brought by a director, member, or the OAG. The OAG's standing arises from that office's role as the representative of the public interest in charity. *See* Tex. Prop. Code § 123.001, *et. seq.* The OAG is charged to ensure charitable assets are used for appropriate charitable purposes and has broad authority to carry out that duty emanating from the Texas Constitution, common law, and various statutes. Where the OAG brings suit alleging breach of one of the fiduciary duties outlined above, venue is in Travis County. *See* Tex. Prop. Code § 123.005(a). In the event the OAG is successful in its claims of breach of fiduciary duty, the OAG is entitled to recover from the fiduciary actual costs incurred in bringing the suit and may recover reasonable attorney's fees. *See* Tex. Prop. Code § 123.005(b). Other remedies available to the OAG include removal from the fiduciary position, actual damages, disgorgement of benefits, imposition of a constructive trust, and in certain circumstances, exemplary damages.

E. Can we return a donation?

An obligation to return real or personal property donated to a charitable organization only exists in the event an enforceable reversionary right exists by virtue of a deed (real property) or agreement (personal property). This is true because a charitable contribution is, by its nature, an irrevocable gift whereby the donor is releasing control of the property to the charity. *See, e.g., Harmon v. Schmitz*, 39 S.W.2d 587, 589 (Tex. Comm'n App.1931, judgm't adopted) (quoting *Allen–West Comm'n Co. v. Grumbles*, 129 F. 287, 290 (8th Cir.1904)). To be entitled to return, the gift must be subject to an agreement that it will be returned if some event occurs or fails to occur. In such event the gift is a conditional gift. If it is unclear whether a reversion exists based on ambiguity in the gift documentation, judicial guidance should be sought under Chapter 37 of the Texas Civil Practice and Remedies Code.

Although a charity is only required to return donations when the gift is conditional and the condition fails, there may be other instances in which the question of return arises. Most often this occurs when a project is abandoned or overfunded. In such instances the question is posed as to whether the restrictions should be modified to allow another use by the charity or a transfer to another charity under principles of cy pres. If there was no general charitable intent, it could be appropriate to return the funds. However, this is a decision to be made by the court with notice to (and likely involvement of) the OAG. Additionally, return of donated funds in such an instance creates a tax issue for a donor who previously claimed a deduction.[6]

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[6] *See, e.g.*, Rev. Rul. 76-150, 1976-1 C. B. 38; *see also* Letter from the IRS to Rep. Kay Granger on August 10, 2009, released on September 25, 2009.

VIII. Pitfall Number Seven: Unrelated Business Income

A. UBTI, In General

Unrelated Business Taxable Income ("UBTI") generally arises in two situations: 1) when the charitable organization has income from an unrelated trade or business; or, 2) when the charitable organization has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1); § 514(a)(1); and § 514(a)(2). Failure to understand the creation and impact of UBTI can lend to significant taxes, penalties and interest, and the potential loss of exemption in the event the IRS determines the organization's charitable activities are not commensurate-in-scope with income received from unrelated business activities.

1. Income From an Unrelated Trade or Business

A charitable organization must include in its unrelated business income and pay income tax on the gross income from any regularly conducted trade or business which is not substantially related to the performance of the organization's exempt function. Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986). This includes income when an exempt organization is a partner, limited or general, in a partnership which carries on a trade or business wholly unrelated to the exempt organization's purposes, regardless of whether or not the income from the trade or business is actually distributed. *See* I.R.C. § 512(c)(1); Treas. Reg. § 1.681(a)-2(a). *See* also, *Service Bolt & Nut Co. Profit Sharing Trust v. Comr.*, 78 T.C. 812 (1982). "Unrelated trade or business" does not include: 1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation; 2) any trade or business carried on by an I.R.C. § 501(c)(3) organization or by an I.R.C. § 511(a)(2)(B) governmental college or university, primarily for the convenience of its members, students, patients, officers or employees; or 3) any trade or business which consists of selling merchandise, substantially all of which is received by the organization as gifts or contributions. I.R.C. § 513(a). The income and deductions are subject to the modifications under I.R.C. § 512(b).

2. Exclusion of Items from UBTI

Some items excluded from UBTI are dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, income from research for the U.S., income of a college, university or hospital, or income for fundamental research. I.R.C. § 512(b).

a) <u>Example 1</u>. If the charitable organization holds a pass-through interest (for income tax purposes) in a factory, which is an operating business, the charitable organization will have UBTI to the extent it has income from the operation of the factory.

b) <u>Example 2</u>. If the charitable organization holds an interest in a partnership which owns rental real property, exclusively, and there is no debt related to the property, the charitable organization will not have UBTI because the income is from passive rental real property.

3. Income or Deductions Incurred With Respect to "Debt-Financed Property"

A charitable organization has unrelated business income and must pay income tax if it has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1), § 514(a)(2). "Debt-financed property" includes any property held to produce income (including gains from disposition of property) and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property or the property secures the debt) at any time during the taxable year. I.R.C. §514 (b)(1); Treas. Reg. § 1.514(b)-1.

"Acquisition indebtedness" is generally the indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of the acquisition. *See* I.R.C. § 514(c)(1); Treas. Reg. § 1.514 (c)-1. If proceeds from the debt financed property are used to acquire or improve property, the debt is considered to be "acquisition indebtedness" related to "debt financed property" even if the debt is not secured by the property. Deeds of trust, conditional sales contracts, chattel mortgages, security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow and tax liens not subject to I.R.C. § 514(c)(2) are all treated as similar to mortgages for purposes of applying I.R.C. § 514(c)(2)(A).

4. Exclusions from "Debt-Financed Property"

   a) Property used by an organization in performing its exempt function, I.R.C. § 514(b)(1)(A).

   b) Debt-financed property used in an unrelated trade or business to the extent that the income from the property is taken into account in computing the gross income of the unrelated trade or business so as to prevent double taxation of a single item of income as both income from an unrelated business under I.R.C. § 514(a)(1) and debt-financed income under I.R.C. § 514(b)(1)(B).

   c) Property used to derive research income, I.R.C. §514(b)(1)(C); Treas. Reg. §1.514(b)-1.

   d) Property used in certain excepted trades or businesses [not including any property to the extent that the property is used in a trade or business subject to the volunteer exception, the convenience exception or the donations exception]. I.R.C. § 514(b)(1)(D).

   e) Life income contracts. Treas. Reg. § 1.514(b)-1(c)(3)(i).

   f) Property acquired for prospective exempt use. Treas. Reg. §1.514(b)-1(d).

   g) Although a very limited exclusion, I.R.C. § 514(c)(9)(A) provides that indebtedness incurred in acquiring or improving any real property is excluded from the application of I.R.C. § 514, subject to the exceptions outlined in I.R.C. § 514(c)(9)(B). The four "qualified organizations" eligible to use the exception under I.R.C. § 514(c)(9) are as follows:

      i. Educational organizations described in I.R.C. §170(b)(1)(A)(ii);

ii. Affiliated support organizations described in I.R.C. § 509(a)(3) of educational organizations described in I.R.C. § 170(b)(1)(A)(ii);

iii. Qualified trusts under I.R.C. § 401 that consist of a trust that forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees and their beneficiaries; and,

iv. Multiple-parent title holding organizations described in I.R.C. § 501(c)(25).

IX. Pitfall Number Eight: Public Disclosure

An organization's Form 990 (or 990–N, 990–EZ, or 990–PF) as well as the organization's Form 990–T are required to be held open for public inspection. Organizations may make such documents available on a website or may choose to make such documents available upon request. Many organizations use their Form 990 to "tell their story," and thus view the Form 990 and its public disclosure as an important part of how the organization communicates with public.

In addition to the Form 990 and 990–T being publicly available, an organization must keep its Form 1023 and determination letter available for public inspection as well. An organization should know where to find its Form 1023, and, if the organization has misplaced the Form 1023 or determination letter, should contact the Internal Revenue Service to receive a copy the file.

At the state level, foundations formed in the corporate form are required to keep records, books, and annual reports of the financial activity of the corporation for at least three years making same available to the public for inspection and copying at the corporation's officer during regular business hours. *See* Bus. Org. Code § 22.353. Certain exceptions exist to the foregoing requirements including organizations that solicit funds only from members; organizations that do not intend to solicit and receive, and do not actually raise or receive during the fiscal year, contributions exceeding $10,000 from a source other than its own membership; certain private or independent institutions of higher education; religious institutions that are a church or place of worship; trade associations or professional societies which principally derive income from membership dues and assessments, sales, or services; certain alumni associations; and insurers license regulated by the Texas Department of Insurance.

Organizations that are related to public entities (e.g. a school district foundation or a charitable entity formed by a city) or organizations that have *ex officio* members of its Board of Directors that are public officials should consult with legal counsel to determine whether Board meetings fall within open records requirements under state law.

X. Pitfall Number Nine: Substantiating Gifts[7]

A. Charitable Contributions.

The basic rules of § 170, as they apply to public charities, are summarized as follows:

a) Contributions by corporations are deductible up to ten percent (10%) of adjusted gross income of the donor corporation;

b) Contributions by individuals are subject to the following limitations: fifty percent (50%) of adjusted gross income for cash or non-appreciated property (excess may be carried forward for five (5) succeeding taxable years), and thirty percent (30%) adjusted gross income on gifts of long-term capital gain property (same five (5) year carry forward rule); provided that

c) With respect to monetary contributions (cash, check, or other monetary gift), regardless of the amount, a donor must maintain a bank record or written communication from the organization listing the name of the organization, the date, and the amount of the contribution in order to substantiate his or her deduction. While this is the donor's responsibility, the Corporation should make efforts to assist its donors by providing written substantiation of any donations made, listing the contribution amount and the day it was donated. There are specific rules that relate to the donation of non-cash property. If you would like me to expand on those rules, please let me know.

While the rules above relate to the deduction available to a donor, in order for a donor to claim an income tax deduction for a charitable gift (cash or property), the donor must (1) keep some type of record of the donation; (2) obtain a written acknowledgement of the gift; and (3) in quid pro quo contributions over $75, obtain a written disclosure from the charitable donee.

1. Recordkeeping Requirement
   a. Donor must maintain a record of the contribution in the form of a bank record (i.e. cancelled check) or a written communication from the charitable donee (a receipt or letter)
      i. The record should include:
         1. Name of donee,
         2. Date (and location, if a gift of property) of contribution, and
         3. Amount of contribution, or if it was a gift of property, a description of the property in detail (estimated value is not required to be stated on the receipt)
   b. If the charitable contribution is made by a payroll deduction, donor may use both of these documents as the "written communication" from the charity:

[7] The author gratefully acknowledges Megan C. Sanders for her contribution to this section.

    i. Pay stub, form W-2, wage and tax statement, or other employer-furnished document; and
        1. Must show the amount withheld and paid to the charitable organization
    ii. Pledge card prepared by, or at the direction of, the charitable organization

2. Written Acknowledgement
    a. For a contribution of $250 or more, the donor must obtain a contemporaneous, written acknowledgement from the charitable organization in order to claim the tax deduction
        i. Separate contributions of less than $250 will *not* be aggregated (for example, a donor's weekly offerings to a church of less than $250, even though the donor's annual total contributions are $250 or more)
    b. Acknowledgment must include:
        i. Name of charitable organization;
        ii. Amount of cash contribution, or a description (but not the value) of a non-cash contribution;
        iii. Statement that either:
            1. No goods or services were provided by the organization in return for the contribution, or
            2. Description and good faith estimate of the value of goods or services provided by the organization in return for the contribution ("goods or services" include cash, property, services, benefits or privileges; see exceptions below); and
        iv. If applicable, a statement that the goods or services provided by the organization in return for the contribution consisted entirely of intangible religious benefit
            1. In this case, the acknowledgement need not describe or value these benefits, it only needs to make this statement – see the exceptions below in part (g) for a definition
    c. To be considered "contemporaneous", the acknowledgment must be received by the donor by the <u>earlier</u> of:
        i. The date of filing his/her federal income tax return for the year of the contribution, or
        ii. The due date of the return, including extensions
    d. A separate acknowledgement can be provided for *each* contribution of $250 or more, *or* one acknowledgment (i.e. an annual summary) may be used to substantiate several of these contributions of $250 or more
        i. Each *payroll deduction* amount of $250 or more is treated as a separate contribution for purposes of this threshold requirement

        1. Again, the donor can use both a pay stub/W-2/Wage and Tax Statement/other employer-provided statement *and* a pledge card stating that no goods or services were given to the donor by the charity in consideration for the contribution as the written acknowledgement (as with the recordkeeping requirement in part 1(b) above)
    ii. If a donor makes a single contribution of $250 or more in the form of unreimbursed expenses, the donor must obtain a written acknowledgment which includes all of the above requirements (except instead of amount of contribution, a description of the services provided by the donor)
        1. Example: out-of-pocket transportation expenses incurred in order to perform donated services for the organization
        2. The donor should also maintain adequate records of these unreimbursed expenses

e. There is no required or suggested form by the IRS for this acknowledgment
    i. Can be letter, postcard, or the charity's own forms, either paper or provided electronically

f. The donor is *not* required to include the acknowledgement with his/her income tax return, but must keep it with the donor's records to substantiate the contribution

g. Exceptions to "goods and services" provided in exchange for a contribution
    i. Insubstantial
        1. The payment occurs in the context of a fundraising campaign, in which a charitable organization informs the donor of the portion of the contribution which is deductible, and
            a. The fair market value of the benefits received does not exceed the lesser of 2% of the payment, or $96[8], or
            b. The payment is at least $48, the only items provided bear the organization's logo (i.e. mugs, posters, calendars), and the cost of these items is considered within the definition of "low-cost articles" ($9.60).
        2. Also, free, unordered low-cost articles are considered insubstantial
    ii. Membership Benefits
        3. An annual membership benefit provided in exchange for an annual payment of $75 or less, which includes annual recurring rights or privileges – examples:
            a. Free or discounted admissions to the charity's facilities or events
            b. Discounts on purchases from the charity's gift shop
            c. Free or discounted parking

[8] These numbers are adjusted for inflation each year.

d. Free or discounted admission to member-only events, sponsored by the charity, where a per-person cost is within "low-cost articles" limits

iii. Intangible Religious Benefits

1. Generally, these are benefits provided by a tax-exempt organization operated exclusively for religious purposes, and not usually sold in commercial transactions outside of a gifting context
2. Example:
   a. Admission to a religious ceremony and a *de minimis* tangible benefit, such as wine used in a religious ceremony
3. What is *not* considered "intangible religious benefits":
   a. Education leading to a recognized degree
   b. Travel services
   c. Consumer goods

3. Written Disclosure
   a. If a donor makes a contribution exceeding $75 in exchange for goods or services provided by the charitable organization (i.e. "quid pro quo"), the organization must provide a written disclosure statement to the donor. (See IRC § 6115)
   b. This must include:
      i. Statement informing the donor that his/her deduction is limited to the excess of the amount contributed over the value of goods/services provided by the organization; and
      ii. Give the donor a good-faith estimate of the fair market value of the goods or services provided.
   c. This disclosure must be given either with the solicitation or receipt of the quid pro quo contribution
   d. It must be made in writing, and in a manner likely to come to the attention of the donor
   e. It is *not* required where:
      i. The goods or services meet the exceptions listed above, in (2)(g), or
      ii. Where there is no donative element in the transaction
         1. Example: typical museum gift shop sale
   f. Penalty tax is imposed on a charity which does not fulfill this requirement, of $10 per contribution, not to exceed $5,000 per fundraising event or mailing
      i. This can be avoided if the organization can show the failure to meet the requirements was due to reasonable cause.

4. Gifts of Property/Non-Cash – Special Rules

A donor must procure an appraisal as part of completing Form 8283 in the case of claimed contributions of non-cash items over $500, and to include as an attachment to his

or her income tax return, when claiming a deduction for a non-cash gift of over $5,000. Finally, the charitable organization must file Form 8282 when it disposes of the contributed property within three years of the donation.

XI. Pitfall Number Ten: Ending the Organization

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 are governed by the BOC in regard to winding up as well as mergers. 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.

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.

XII. Conclusion

While many of these issues and pitfalls may be caught through the annual Form 990 return filed with the IRS, it is critical to do a thorough review once every few years to ensure the organization understands and avoids potential missteps so that it may continue to serve the public interest.

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