BUSINESS LEAGUES AND TRADE ASSOCIATIONS

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I. INTRODUCTION

After visiting the United States in 1835, Frenchman Alexis de Tocqueville returned home to pen his treatise *Democracy in America*. In seeking to explain what he saw as the American experiment of democracy, de Tocqueville spent considerable time discussing his observations of the unique use of associations. His fascination with associations is perhaps best summarized in the following passage:

> "Americans of all ages, all conditions, all minds constantly unite. Not only do they have commercial and industrial associations in which all take part, but they also have a thousand other kinds: religious, moral, grave, futile, very general and very particular, immense and very small; Americans use associations to give fêtes, to found seminaries, to build inns, to raise churches, to distribute books, to send missionaries to the antipodes; in this manner they create hospitals, prisons, schools. Finally, if it is a question of bringing to light a truth or developing a sentiment with the support of a great example, they associate. Everywhere that, at the head of a new undertaking, you see the government in France and a great lord in England, count on it that you will perceive an association in the United States."[1]

As American tax law continued to develop and was ultimately codified, these associations of which de Tocqueville wrote found themselves in different categories of exemption based in part on whether they served the public or their members primarily and where not charitable—that is, seeking to improve the general public welfare in some way—the economic or other justification for exemption. Tax law has developed to the point that there are at least thirty-nine separate sections of the Internal Revenue Code of 1986, as amended, (the "Code") providing exemption from federal income taxes to nonprofit organizations.[2] One leading commentator points to at least seventy-five categories of organizations enjoying some level of tax exemption under federal law.[3] Whatever the actual number may be, de Tocqueville's commentary on associations continues to hold true today: associations abound.

While the category with the greatest number of organizations is § 501(c)(3), providing exemption for charitable organizations and other organizations that exist primarily to benefit the public welfare, other categories of exemption continue to play a significant part in the nonprofit sector. Noting that the term "association" does not belong to any one specific category of exemption but is general enough to include many different types of organizations exempt under various sections of the Code, for purposes of providing a focused discussion, this article will examine § 501(c)(6) of the Code, which provides exemption to business leagues, sometimes referred to as trade associations or professional associations. These types of associations, while less common than their § 501(c)(3) cousins, impact the working lives of a significant number of Americans, including all of us who, as attorneys, are members of bar associations. The goal of this article will be to provide an introduction to the tax law and selected non-tax concerns of these types of associations.

II. CHOICE OF FORM

Within the broad rubric of the nonprofit sector only a limited number of organizational forms are eligible for tax-exempt status: (1) charitable trust; (2) nonprofit corporation; (3) unincorporated

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[1] ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA, edited and translated by Harvey C. Mansfield and Delba Winthrop (University of Chicago Press, 2000 [1835]), 489.

[2] LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER, 3RD ED. (Foundation Center 2012), 10-11.

[3] BRUCE R. HOPKINS, THE LAW OF TAX EXEMPT ORGANIZATIONS, 11TH ED. (J. Wiley & Sons 2006), Appendix C.

association; and (4) limited liability company. Charitable trusts are not generally an appropriate form for a trade association and will not be discussed. The limited liability company is available only where the member or members are thereunder exclusively tax-exempt entities, which makes the LLC an appropriate form in only limited circumstances. Each form involves basic elements of the nonprofit sector: private, self-governing, non-compulsory organizations that do not distribute their profits to private individuals. Though similar, unincorporated associations and nonprofit corporations each have unique characteristics and considerations that will be discussed below.

A. UNINCORPORATED ASSOCIATIONS

Nonprofit unincorporated associations are the default nonprofit organization in Texas. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose.[4] Formation of an unincorporated association is not governed by statute and does not require any organizational documents, although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the Texas Business Organizations Code ("BOC"). That chapter clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members' interests by all legitimate and legal means.[5] Unincorporated associations have the right to sue or be sued; sue or be sued by a member; acquire, hold, encumber, or transfer real or personal property without the need for trustees; be a beneficiary of a trust, contract, will, or policy of life insurance; apply for property tax exemption; and apply for federal tax exemption under the Code.[6] The Internal Revenue Service (the "Service") has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation when it is formed under a contract or bylaws and has elective officers empowered to act for the association.[7] It should be noted that the Service will expect to see some type of governing document, such as articles of association, with certain provisions regarding organization and operation in order to qualify for exempt status. These provisions will be discussed more fully below.

Benefits of operating as an unincorporated association relate primarily to the informal nature of such an entity. Unincorporated associations are relatively quick and easy to establish and are internally as flexible as the founding members desire. Finally, unincorporated associations have the ability to rely on statutory authority in Texas to ensure that they are recognized as separate legal entities such that members do not have personal liability in tort or contract absent special circumstances.

On the other hand, there are drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the BOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), there is little case law interpreting either Chapter 252 or its predecessor act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, founding members have less assurance that their wishes as to the direction and purposes of the organization will remain unchanged. Some unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Finally, choice of law concerns exist where an unincorporated association acts outside Texas as not all states recognize such an entity. Practically speaking, for an unincorporated association to qualify for federal tax exemption, the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption, thereby lessening the benefits discussed above.

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[4] *See* Tex. Bus. Orgs. Code Ann. § 252.001 et seq.
[5] *See id.* at § 252.006.
[6] *See id.* at §§ 252.003, .004, .007, .009.
[7] *See* 26 CFR 301.7701-3.

B. NONPROFIT CORPORATIONS

Perhaps the most commonly used entity for exemption under § 501(c) is a nonprofit corporation. Nonprofit corporations in Texas are governed by Chapter 22 of the BOC.[8] 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.[9] 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 § 501(c)(3) organizations and furtherance of a common business interest for § 501(c)(6)). 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.[10] 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 a few drawbacks to organizing as a nonprofit corporation, particularly when the organization will be seeking federal tax exemption; 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 §§ 501(c)(3) and 501(c)(6)) qualify the organization for exemption from the franchise tax as well. Absent unique circumstances, it is generally most beneficial to organize as a nonprofit corporation.

C. LIMITED LIABILITY COMPANIES

The final entity eligible for exemption under § 501(c) is a limited liability company ("LLC"). LLCs are unique in their eligibility for exemption. Unlike the other forms discussed above, the LLC is used as a single-member entity with an exempt organization as the single member or, alternatively, as a multi-member LLC with all of the members being exempt. LLCs are governed by the BOC and specifically Chapter 101. LLCs can be member-managed or manager-managed.[11] In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting through its own board of directors or can appoint others to manage the LLC with those "others" acting essentially as a board of directors of the subsidiary LLC.

Chapter 101 of the BOC provides that members and managers are shielded from debts, obligations, and liabilities of the LLC.[12] This liability protection, with the simple control (such as management overlap), is a beneficial feature of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities. Furthermore, where the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-

[8] *See* Tex. Bus. Orgs. Code Ann. § 22.001 et seq.
[9] *See id.* at § 22.001(5) (i.e. the aforementioned non-distribution constraint).
[10] *See* Tex. Bus. Orgs. Code Ann. §§ 2.001-002, 2.101-102, 3.003 and 22.054.
[11] *See* Tex. Bus. Orgs. Code Ann. § 101.251.
[12] *See id.* at § 101.114.

exempt status (discussed below) but rather will effectively take on the tax attributes of its parent member.[13] On the flip side, if the LLC has not separately applied for exemption, while it will be disregarded and, thus, not taxable for federal income tax purposes, it will remain taxable for Texas franchise tax purposes unless it independently successfully applies for exemption.[14]

III. SECTION 501(c)(6)

A. DESCRIPTION/EXAMPLES

Section 501(c)(6) describes as organizations exempt from federal income tax "[b]usiness leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual."[15] The Treasury Regulations (the "Regulations") expand on this description providing that "[a] business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit."[16] While the Code and Regulations use the term "business league," the more commonly-referenced descriptors are trade association, professional association, or chamber of commerce. The Regulations go on to provide that the activities of an organization described in § 501(c)(6) "should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons."[17] Finally, the Regulations provide the rather circular statement that organizations described in § 501(c)(6) are organizations "of the same general class as a chamber of commerce or board of trade."[18] From the Code and Regulations, one can draw the following elements of a § 501(c)(6) organization: (1) an association composed of persons having a common business interest; (2) with a purpose to promote the common business interest; (3) not organized for profit; (4) that does not engage (other than incidentally) in a business ordinarily conducted for profit; (5) the activities of which are directed toward the improvement of the business conditions of one or more lines of business as distinguished from particular services for individual persons; and (6) of the same general class as a chamber of commerce or board of trade.[19]

Organizations qualifying as exempt under § 501(c)(6) are as varied as the American Dental Association, the Better Business Bureau, the National Cattlemen's Beef Association, the United States Chamber of Commerce, the American Football Coaches Association, and state and local bar associations. As of 2009, there were 71,681 organizations listed in the IRS Exempt Organization Master File under § 501(c)(6) holding revenues of $38.7 billion, making this category of organizations the largest of the mutual benefit (member-serving) organizations of the nonprofit sector.[20] These organizations are not required to promote the public interest or operate in any particular charitable manner. Rather, the distinguishing characteristics of these organizations are their common business interest requirement and their efforts to promote that common business interest in a nonprofit manner without engaging in business ordinarily carried on for profit. In each situation, while the members may have other interests in common, what ties them together are the efforts to promote their common *business* interest. The rationale most often cited for exemption from tax for business leagues is that these "organizations … represent simply a pooling of resources by people with a common interest to conduct activities that, if conducted by the members themselves, would not be profit-making businesses."[21] As a result, the law has developed such that

[13] *See* Treas. Reg. § 301.7701-2(c)(2).
[14] *See* Comptr. Ltr. Rul. 200106900L (June 21, 2001).
[15] I.R.C. § 501(c)(6).
[16] Treas. Reg. § 1.501(c)(6)-1.
[17] *Id.*
[18] *Id.*
[19] *See* Hopkins, *supra* note 3, at 24-25.
[20] *See* Salamon, *supra* note 2, at 30.
[21] John Columbo, Testimony Before the House Committee on Ways and Means, Serial No. 109-6 (April 20, 2005).

"creating an 'association' for members to pool their resources in this manner should not result in taxation of those pooled resources."[22]

B. COMMON BUSINESS INTEREST

As referenced above, the first element for qualifying as a § 501(c)(6) organization is to be an association of persons having a common business interest. Consistent with the language of the Regulation requiring an "association of persons," absent limited and unusual circumstances, § 501(c)(6) organizations must have members. It is common for such organizations to have various classes of members, which may include vendors or others who desire to solicit the association's members but do not share the common business interest. In such situations, the dues received from these "members" (often termed associate members or some other nomenclature to distinguish them from the members sharing the common business interest) will be treated as unrelated business taxable income.[23] While it is acceptable for a § 501(c)(6) organization to generate income other than from its membership, to qualify for exempt status, a meaningful portion of the organization's income must be derived from membership support.[24] For this purpose, membership support includes dues and contributions paid by members, income received from the performance of exempt functions, and contributions and gifts from the general public.[25]

The term "business" is broadly construed and inclusive of practically any activity carried on for the production of income.[26] An association of persons engaging in an activity as hobbyists will not qualify under § 501(c)(6). As can be gleaned from the examples of § 501(c)(6) organizations provided above, the nature of the business is not the relevant inquiry. Rather, the relevant inquiry is whether all members have a common interest in an activity which they carry on for the production of income. Finally, the common business interest must be one that generally involves the members being in competition with each other as opposed to an association of business persons seeking to network with one another and coming from different industries.[27]

Even if all members have some common business interest, the activities of the organization must be focused on furthering that common business interest as opposed to purely social or recreational activity of the members (which could qualify the organization for exemption under § 501(c)(7) if the requisite standards under that subsection were met). Activities that have been found to promote a common business interest include the following:

- Development and distribution of publications pertinent to members' business interest;
- Presentation of information and opinions to governmental agencies;
- Annual conventions and educational seminars;
- Promotion of improved business standards and methods;
- Lobbying as to interest germane to members' common business interest;
- Luncheon meetings to discuss industry-wide problems;
- Programs of testing and certification of an industry's products; and
- Programs to enforce ethical codes on members of a certain trade.

In conducting activities promoting a common business interest such as those listed above, a key inquiry is whether such activities are directed to the improvement of one or more lines of business as distinguished from the performance of particular services for individual persons.

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[22] *Id.*
[23] *See* Rev. Proc. 97-12, 1997-1 C.B. 631.
[24] *See* PLR 201203021.
[25] *See* John Francis Reilly, Carter C. Hull, and Barbara Braig Allen, IRC 501(c)(6) Organizations, *IRS Exempt Organizations – Technical Instruction Program for FY2003* at K-13.
[26] *See* Hopkins, *supra* note 3, at 31.
[27] *See id.*; *see also* PLR 201809007.

C. LINE OF BUSINESS REQUIREMENT

The Service defines a line of business as a "trade or occupation, entry into which is not restricted by patent, trademark, or similar device which would allow private parties to restrict the right to engage in business."[28] Based on pronouncements from the Service and case law rulings, the line of business requirement may also be described as a "trade, business (industry), or profession, or a segment of a trade, business, or profession."[29] To satisfy the line of business requirement, the business league/trade association/professional organization must be open to the entire industry or a particular segment thereof. With respect to this latter option, the particular segment may be a geographic segment (such as a local association of attorneys as opposed to a state or national association of attorneys) or may be a segment based on a particular focus of the persons engaged in the business (such as an association of business lawyers as distinguished from an association of family law lawyers or an association of commercial electricians as distinguished from an association of residential electricians). In each case, the slice must be a horizontal slice, meaning all persons similarly described or similarly situated are eligible for membership in the association.

The United States Supreme Court considered the line of business requirement in *National Muffler Dealers Association v. U.S.* in 1979.[30] The National Muffler Dealers Association was a New York Association whose purpose "was to establish a group to negotiate unitedly with Midas Management." The Court noted that it consisted of most Midas franchisees and had its principal activity as serving as a bargaining agent, including negotiating a standard form franchise agreement in addition to other collective-bargaining work. After initial rejection by the Service based on its lack of industry-wide representation, the association amended its bylaws to eliminate the requirement that members be a Midas franchisee; however, no non-Midas franchisees became members. Thus, the Court was faced directly with the question of whether the Service's position requiring industry-wide benefit was sustainable. After analyzing the legislative history of the Regulations and the "line of business" requirement, the Court determined that while the Service's position may not be the "only possible one, it does bear a fair relationship to the language of the statute, it reflects the views of those who sought its enactment, and it matches the purpose they articulated."[31] Further noting that the Regulation had stood (as of 1979) for 50 years and had been consistently interpreted, the position merited "serious deference."[32] As a result, the Court affirmed the judgment of the court of appeals and ultimately the position of the Service "that a tax exemption is not available to aid one group in competition with another within an industry" but rather must seek to promote the business interest of an entire industry or a particular segment of an industry, such as the components of an industry within a specific geographic region.[33]

D. PROHIBITION AGAINST PERFORMANCE OF PARTICULAR SERVICES

Even where the organization itself represents one or more lines of business as required for qualification under § 501(c)(6), "the performance of particular services for individual persons" as opposed to providing industry-wide benefit serves as a basis for denial of recognition of exempt status under § 501(c)(6). One leading commentator has described "particular services" as those "provided to an organization's membership that are either in addition to those that are exempt functions funded by dues (particularly where there is separate payment for them) or that if provided would be a *convenience or economy* in connection with operation of members' businesses."[34] A key question in this regard is whether the activity is one for which an individual member cannot be expected to bear the expense lending itself to

[28] IRS Exempt Organization Handbook (IRM 7751) § 652(1).
[29] *See* Hopkins, *supra* note 3, at 32.
[30] 440 U.S. 472 (1979).
[31] *Id.* at 484.
[32] *Id.*
[33] *Id.* at 488.
[34] Hopkins, *supra* note 3, at 41.

cooperative effort, typically providing only intangible benefit that is indirectly related to an individual business or whether the activity is one that bears a direct relationship to a particular business, particularly where it is done as a convenience or to accomplish an economy for members as they conduct their businesses.[35]

Industry-wide benefits are those benefits that would increase industry knowledge (such as through education or certification), improve conditions in the industry (such as through regulatory efforts or lobbying), or improve the image or marketability of a particular industry or profession. For example, a particular law firm would not generally be expected to bear the cost of producing a journal available to all business lawyers but might, in cooperation with other firms interested in business law, create an association that would produce such a journal. On the other hand, a particular real estate agency would reasonably be expected to list its properties or pay for a multiple listing service and, thus, a real estate board whose primary purpose and activity is the operation of the multiple listing service for members was found to be operated primarily for individual members rather than for the improvement of industry-wide conditions.[36] One court held that considering whether the services are supported by fees and assessments that approximate value of those services is a key factor in determining whether the services are particular services versus industry-wide services.[37] If what a member pays in dues or fees approximates the services received by the member from the association, it is more likely that the services constitute "particular services" as opposed to industry-wide services.[38]

E. PROHIBITION AGAINST CARRYING ON BUSINESS FOR PROFIT

Treasury Regulation 1.501(c)(6)-1 denies business league status to an organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit.[39] This requirement is distinct from the requirement under § 501(c)(6) of the Code that requires the organization not be organized for profit. The latter requirement of the Code referencing the non-distribution constraint is common to all nonprofit organizations. The prohibition in the Regulations against having a purpose of engaging in a regular business of a kind ordinarily carried on for profit is akin to the operational test of a charitable organization where it is said that a single non-exempt purpose, if substantial, will destroy exemption no matter the number of truly exempt purposes. Likewise, if a business league has a substantial purpose of engaging in a business of a kind ordinarily carried on for profit, this substantial non-exempt purpose destroys exemption.[40] Because the unrelated business income tax rules apply to § 501(c)(6) organizations, this requirement may best be understood as a requirement that such an organization may not engage, other than incidentally, in a regular business of a kind ordinarily carried on for profit.[41] If the business is incidental (i.e., non-substantial), it will be dealt with under the unrelated business income tax rules whereas if the business is a substantial purpose, the organization will fail to qualify as exempt under § 501(c)(6).

As with charitable organizations, the question of substantial purpose is a question of fact. For example, § 501(c)(6) business league status has been denied where the organization was determined to primarily be in the business of serving as an employment agency for engineers.[42] Likewise, there are a number of rulings denying business league status to associations selling insurance or reinsurance products.[43] On the other hand, a chamber of commerce developing an industrial park to attract new industry to the community is held to qualify for exemption under § 501(c)(6) by promoting business and

[35] *See id.* (citing Professional Ins. Agents of Mich. v. Comm'r, 726 F.2d 1097 (6th Cir. 1984)).
[36] *See* Rev. Rul. 59-234, 1959-2 C.B. 149.
[37] *See* Professional Ins. Agents of Mich. v. Comm'r, 726 F.2d 1097 (6th Cir. 1984).
[38] *See id.*
[39] Treas. Reg. § 1.501(c)(6)-1.
[40] *See id.*
[41] *See* Hopkins, *supra* note 3, at 40.
[42] *See American Association of Engineers Employment, Inc. v. Comm'r*, 11 T.C.M. 207 (1952).
[43] *See, e.g.*, Rev. Rul. 81-174, 1981-1 C.B. 335; Rev. Rul. 81-175, 1981-1 C.B. 337.

economic development.[44] An applicant must be mindful of the interplay between the prohibition on the provision of particular services to individual persons and the performance of business activities. As an example, in a recent letter ruling, the Service ruled that a trade association of small businesses located along a scenic state highway failed to qualify for exemption under § 501(c)(6).[45] Despite the organization's claims that its purpose was to increase commerce and promote economic development, tourism, and preservation of the historical and the natural resources of the highway corridor (an argument quite similar to the chamber of commerce development of the industrial park in Revenue Ruling 70-81 and 81-138), the Service determined that the association should be denied exempt status as it was providing particular services to individual persons, specifically group advertising for the association members.[46]

In considering whether an organization has a purpose to engage in a regular business of a kind ordinarily carried on for profit, the issue is not whether profit is earned but rather, when considering the nature of the business activity, it is the kind of activity ordinarily carried on for profit.[47] The meaning of business in this context is synonymous with that under § 513 of the Code dealing with unrelated business income tax. If the activity is a trade or a business and the trade or business is one that is ordinarily carried on by others for profit, the issue of whether such activity demonstrates a non-exempt primary purpose becomes the issue of focus. While many trade associations conduct trade shows that sell products and would, thus, seem to be a "business" for § 513/501(c)(6) purposes, the rules under § 513 provide an exception for a qualified convention and/or trade show conducted by a § 501(c)(5) or § 501(c)(6) organization.[48] The qualified convention or trade show is a convention or show designed to attract persons to an industry show to display products to stimulate interest in and demand for industry products or services or, alternatively, to educate persons engaged in the industry when the event is sponsored by a qualifying § 501(c)(6) organization.[49] With these purposes, a qualifying § 501(c)(6) organization is a § 501(c)(6) organization that regularly conducts such trade shows as a substantial exempt purpose.[50]

F. PROHIBITION AGAINST PRIVATE INUREMENT (EBT)

Organizations seeking to qualify as exempt under § 501(c)(6) of the Code face the same private inurement prohibition as organizations seeking to qualify under § 501(c)(3) of the Code. Specifically, these organizations must be organized in a way that "no part of the net earnings … inures to the benefit of any private shareholder or individual."[51] To parse this phrase, "no part" is meant to indicate an absolute prohibition. "Net earnings" means gross earnings minus related expenses, but is construed broadly and not limited to actual income alone. The phrase "inures to the benefit" references a wide range of potential transactions, including excessive salaries, sale or lease transactions that are not at fair market value and unfavorable to the exempt organization, unaccounted for diversions of funds by a party with unfettered control, and other distributions where the value received by the exempt organization is less than the value of what is given up by the exempt organization. The term "private shareholder or individual" means any person having a personal and private interest in the affairs of the organization and the ability to control the organization. These insiders generally include the organization's officers, directors, key employees, and others in a position to control the organization as well as the family members of such individuals. The Service has explained that inurement results from "an expenditure of organizational funds resulting in a benefit which is beyond the scope of benefits which logically flow from the organization's performance of its exempt functions."[52] Likewise, "[i]nurement is likely to arise where the financial benefit represents a

[44] *See* Rev. Rul. 70-81, 1970-1 C.B.B1.
[45] *See* PLR 201811016.
[46] *See id.*
[47] *See* Rev. Rul. 81-174, 1981-1 C.B. 335.
[48] *See* I.R.C. § 513(d)(3).
[49] *See id.*
[50] *See id.*
[51] Treas. Reg. § 1.501(c)(6)-1.
[52] G.C.M. 38559 (Nov. 8, 1980).

transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes."[53]

In the context of § 501(c)(6), inurement may be found when members receive benefits beyond the scope of what would logically flow from exempt activities. For example, certain benefits are inherent in the nature of the organization performing its exempt functions. Such benefits include receipt of newsletters, educational materials, access to discussion groups, etc. These benefits do not constitute inurement. On the other hand, benefits such as the payment of dividends, cash payments as welfare benefits or financial assistance, payments for expenses incurred in defending malpractice suits, and similar types of distributions do not logically flow from the performance of the organization's exempt functions and represent a transfer of the organization's financial resources to the member solely by virtue of the member's relationship to the organization. This does not mean that cash distributions may never be made by the organization to its members. The Service has routinely ruled that such distributions may be made to members if the distributions are not more than a reduction of previously paid dues and are made to all similarly situated members.[54] This type of cash distribution is often made as a rebate associated with tradeshow exhibitions. Nevertheless, a trade association must be careful when making such rebates to treat members and nonmembers similarly. For example, in *Michigan Mobile Home & Recreational Vehicle Inst. v. Commissioner*, distributions of a portion of the net proceeds from a tradeshow were made to exhibitors who were members while exhibitors who were not members received no such distributions. The court agreed with the Service in finding inurement in this differential treatment.[55] The Service's concern in this regard is giving rebates to members from income generated, at least in part, from non-members. The Service subsequently clarified this issue by stating that "all money refunded may come only from dues and other amounts contributed by the class of members receiving the refund."[56]

Finally, § 501(c)(6) organizations should be cautious when considering issues of inurement and not be confused by rules applying to § 501(c)(3) and § 501(c)(4) organizations. In 1996, congress added § 4958 to the Code providing intermediate sanctions as an intermediate or alternative step to revocation of exempt status for applicable tax exempt organizations where inurement is present. Significantly, applicable tax exempt organizations are § 501(c)(3) and § 501(c)(4) organizations; the intermediate sanctions rules of § 4958 do not apply in the context of § 501(c)(6) organizations. As a result, there is no intermediate sanction or alternative to revocation of exemption where the Service makes a finding of inurement. Thus, the phrase "no part" truly means *no* part.

IV. LOBBYING AND POLITICAL ACTIVITIES

A. LOBBYING ACTIVITIES

Organizations recognized as exempt under § 501(c)(6) may permissibly engage in any amount of legislative activity provided it is germane to the common business interest of its members.[57] However, trade associations and business leagues must understand that while they may engage in any amount of lobbying that is germane to their members' business interest, their lobbying activities will result in taxation.[58] Specifically, under § 162 of the Code, a business deduction is disallowed for expenses incurred in connection with influencing legislation.[59] "Influencing legislation" means any attempt to influence any legislation through a lobbying communication as well as "all activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for

[53] G.C.M. 38459 (July 31, 1980).
[54] *See* Rev. Rul. 77-206.
[55] 66 T.C. 770.
[56] Rev. Rul. 81-60, 1981-1 C.B. 335.
[57] *See* Rev. Rul. 61-177, 1961-2 C.B. 117.
[58] *See* Hopkins, *supra* note 3, at 110.
[59] *See* I.R.C. § 162(e).

a purpose of making or supporting a lobbying communication, even if not yet made."[60] A "lobbying communication" means "any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of the legislative body or any other government official or employee who may participate in the formulation of the legislation that refers to specific legislation and reflects a view on that legislation; or clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication."[61] For purposes of § 162 "legislation" means "any action with respect to Acts, bills, resolutions, or other similar items by a legislative body" and includes proposed treaties.[62] "Specific legislation" means a legislative proposal whether or not actually introduced before a legislative body.[63] Finally, "legislative bodies" means "Congress, state legislature, and other similar governing bodies."[64] After passage of the 2017 Tax Act, "legislative bodies" includes local legislative bodies.[65]

At times, it can be difficult for an organization to make the determination of whether its activities, such as research, preparation, planning, and coordination, are engaged in for the purpose of supporting a lobbying communication. The Regulations under § 162 provide factors to be considered, including (i) whether the activity and the lobbying communication are proximate in time; (ii) whether the activity and the lobbying communication relate to a similar subject matter; (iii) whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication; (iv) whether the results of the activity are also used for a non-lobbying purpose; and (v) whether, at the time the association engages in the activity, there is specific legislation to which the activity relates.[66] The Regulations provide a number of examples to assist taxpayers in making this determination. Where the activity is conducted for both lobbying and non-lobbying purposes, the association must make a reasonable allocation of costs.

In the event a § 501(c)(6) organization engages in lobbying activities, the organization must choose between providing an annual disclosure to its members at the time dues are paid, disclosing its reasonable estimate of the non-deductible portion of the dues, or the organization must pay a proxy tax at the highest corporate tax rate on its lobbying expenditures, currently 21%.[67] If choosing to provide the notice, to the extent the lobbying expenses exceed the estimate, the organization must pay the proxy tax on the excess amount or seek permission from the Service to adjust the following year's notice.[68] If choosing to pay the proxy tax rather than give notice, the tax is paid on all lobbying expenditures up to the amount of the dues received in the tax year.[69] Any excess lobbying expenditures are carried forward to the next tax year.[70] Section 162 of the Code provides a de minimus rule allowing a deduction for in-house expenditures that do not exceed $2,000.00 (excluding overhead).[71] Payments to third parties are not treated as in-house expenditures.[72] If political expenditures exceed this de minimus threshold, the first $2,000 of expenditures are not exempt.[73]

[60] I.R.C. § 162(e)(3)(A); Treas. Reg. § 1.162-29(b)(1).
[61] Treas. Reg. § 1.162-29(b)(3).
[62] Treas. Reg. § 1.162-29(b)(4).
[63] *See* Treas. Reg. § 1.162-29(b)(5).
[64] Treas. Reg. § 1.162-29(b)(6).
[65] Pub. L. No. 115-97, § 13308.
[66] *See* Treas. Reg. § 1.162-29(c)(1).
[67] *See* I.R.C. § 6033(e)(2)(A)(ii).
[68] *See id.*; § 6033(e)(2)(B).
[69] *See* Hopkins, *supra* note 3, at 121.
[70] *See id.*
[71] *See* I.R.C. § 162(e)(5)(B).
[72] *See id.*
[73] *See id.*

B. POLITICAL ACTIVITIES

The Service takes the position that intervening in political campaigns is not a matter germane to the business interests of members of § 501(c)(6) organizations.[74] As a result, while trade associations may engage in political activities, those political activities cannot be a primary activity, as they are not considered in furtherance of the organization's exempt purpose. As with lobbying expenditures, members are also disallowed a deduction for any portion of their dues attributable to political activity.[75] Section 501(c)(6) organizations have the option to conduct political activities through a separate, segregated fund that would be a political organization under § 527 if unrelated to the association or make payments from the corporate treasury.[76] Most trade associations will set up a separate segregated fund, which is treated as a separate political organization because paying political expenditures from the corporate treasury results in a tax on the lesser of the organization's net income or its political expenditures.[77] By utilizing a separate segregated fund, the association avoids tax on such political expenditures.

V. OBTAINING EXEMPT STATUS AND ANNUAL REPORTING

A. APPLYING FOR RECOGNITION OF EXEMPT STATUS

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. As addressed above, with respect to § 501(c)(6), the organization must be an association of persons having some common business interest, the purpose of the organization must be to promote that common business interest rather than operating for profit, the organization must not engage in a business ordinarily conducted for profit, and the activities of the organization must be directed to the improvement of business conditions of one or more lines of business as opposed to the performance of particular services for individual persons. However, simply satisfying these requirements does not result in the organization being exempt from federal income tax. Rather, the organization must apply to have the Service recognize this exemption. Organizations seeking to be recognized as exempt under § 501(c)(6) are required to file Form 1024 to request such recognition.[78] Form 1024 is the applicable form for a number of different categories of exemption. Organizations seeking recognition of exemption under § 501(c)(6) must complete Schedule C to Form 1024. Provided a substantially-complete Form 1024 is submitted to the Service within 27 months from the end of the month in which the organization was created for state law purposes, upon receipt of its determination letter from the Service, the organization will be treated as exempt from the date of formation.

A substantially-complete Form 1024 contains the following:

1. The current version of the application form found at www.irs.gov;
2. The correct user fee (as of 2018, the user fee is $600.00);
3. The signature of an authorized individual;
4. The organization's employer identification number;
5. A statement of receipts and expenses;
6. A copy of the organization's organizing document(s) that meets the requirements of a conformed copy;
7. A detailed narrative of the organization's proposed activities; and
8. A copy of the organization's bylaws or similar governing rules, if adopted.[79]

[74] *See* Hopkins, *supra* note 3, at 122.
[75] *See* I.R.C. § 162(e)(3).
[76] *See* Hopkins, *supra* note 3, at 129.
[77] *See id.* at 130.
[78] *See* Treas. Reg. § 1.501(a)-1(a)(2), T.D. 9819, 82 Fed. Reg. 29, 730, eff. July 1, 2014.
[79] *See* Rev. Proc. 2016-5, 2016-1 IRB 188.

In the event the Form 1024 submission is substantially complete, it will be reviewed by a determinations specialist who will either ask follow-up questions to ensure the organization meets the requirements for exemption or will issue a determination letter determining that the organization is exempt under § 501(c)(6). In the event an organization receives an adverse determination letter, it may appeal with the initial appeal being filed with the appropriate IRS Appeals Office and, if unsuccessful, a subsequent appeal being filed in the Tax Court, the District Court for the District of Columbia, or the Court of Federal Claims.[80] With respect to these court filings, the organization may either seek a declaratory judgment, or may seek relief in the Tax Court after it has been issued a notice of deficiency, or may sue for a refund in Federal District Court or the Court of Federal Claims after paying the corporate tax.[81]

B. THE BASICS OF STATE TAX EXEMPTION (TEXAS)

While filing Form 1024 and receiving a favorable determination letter 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 remain subject to Texas taxes until application is made with the Texas Comptroller. For incorporated organizations (nonprofit corporations or limited liability companies), Texas law imposes a franchise tax.[82] Organizations that have obtained exemption under § 501(c)(6) are eligible for exemption from the franchise tax.[83] Note that § 501(c)(6) organizations, unlike § 501(c)(3) and § 501(c)(4) organizations, are not eligible for exemption from the Texas sales tax or hotel occupancy tax. 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.[84]

C. ANNUAL REPORTING REQUIREMENTS

Exempt organizations are required to file information reports with the Service on an annual basis. Organizations exempt under § 501(c)(6) will file Form 990, 990-EZ, or 990-N depending upon the organization's annual gross receipts and total year-end assets.[85] The relevant Form 990 series is due on the fifteenth day of the fifth month following the close of the organization's tax year. If an annual return is due prior to issuance by the Service of a favorable determination letter, the organization must, nevertheless, file the annual return. Exempt organizations, including § 501(c)(6) organizations, that have unrelated taxable income must additionally file Form 990-T.[86] All of the foregoing filings are public documents open to public inspection along with the organization's Form 1024 and its attachments.

Until such time as exemption is granted, nonprofit organizations subject to the franchise tax must file a Texas franchise tax report. Additionally, nonprofit corporations formed under Chapter 22 of the BOC must file an information report once up to ever four (4) years (depending on when a request is made from the Texas Secretary of State) providing information, including the name, address, registered agent and office, and names and addresses of directors and officers for the organization.[87] Failure to file this information report when requested by the Texas Secretary of State will lead to revocation of the organization's corporate charter.

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[80] *See* I.R.C. §§ 7123(c), 7428(a)(1)(E).
[81] *See* I.R.C. § 6213(a); 28 U.S.C. § 1346(a)(1).
[82] *See* Tex. Tax Code Ann. § 171.001.
[83] *See id.* at § 171.063(a)(1).
[84] <https://comptroller.texas.gov/taxes/publications/96-1045.php/>.
[85] *See* I.R.C. § 6033(a)(1).
[86] *See* I.R.C. § 6012(a)(2)(4).
[87] *See* Tex. Bus. Org. Code Ann. § 22.357.

VI. SELECTED NON-TAX ISSUES OF ASSOCIATIONS

A. JUDICIAL NON-INTERFERENCE

Business leagues and trade associations, as private, non-compulsory, self-governing organizations, are given deference by Texas courts with respect to their internal decision making. As far back as 1890, the Texas Supreme Court explained:

> "A member of a voluntary association is bound by a sentence of expulsion against him lawfully rendered by a tribunal created in pursuance of its constitution, and clothed with that power. The rule also applies at least to such incorporated societies as are not organized principally for commercial gain. By uniting with the society, the member assents to and accepts the constitution, and impliedly binds himself to abide by the decision of such boards as that instrument may provide, for the determination of disputes arising within the association. The decisions of these tribunals, when organized under the constitution, and lawfully exercising these powers, though they involve the expulsion of a member, are no more subject to collateral attack for mere error than are the judgments of a court [of] law. But if the tribunal act illegally; if it declare a sentence of expulsion for an offense for which that penalty is not provided by the constitution and laws of the association; and if there be no right of appeal, within the association, reserved for the redress of the injury,—the courts will review the proceedings, and, if found illegal, will treat them as null, and restore the member to his privileges as such…. If his expulsion was illegal, and if the association had refused, upon appeal, to set it aside, it may be that this court would have granted redress."[88]

As explained by the El Paso Court of Appeals, "it is the right of a private, non-profit organization to manage, within legal limits, its own affairs without interference from the courts." "Texas courts will not interfere with the internal management of voluntary associations so long as the governing bodies of such associations do not substitute legislation for interpretation and do not ever set the bounds of reason or violate public policy or the laws of [Texas] while doing so." Texas courts allow this leeway because "[i]f the courts were to interfere every time some member, or group of members, had a grievance, real or imagined, the non-profit, private organization would be fraught with frustration at every turn and would founder in the waters of impotence and debility." By becoming a member, the individual or organization has subjected itself to the association's power and courts will not intervene except "when the actions of the organization are illegal, against some public policy, or are arbitrary or capricious."

For example, in *Dallas County Medical Society v. Ubiñas-Brache, M.D.*, the Dallas Court of Appeals considered a scenario where a physician had been expelled from a medical association.[89] In an attempt to avoid immunity provided to medical peer review organizations under the Texas Medical Practice Act, the physician argued a violation of the open courts provision of the Texas Constitution.[90] This required the physician to establish that his claim constituted a well-established common law cause of action.[91] The court concluded that a breach of contract action to maintain membership in a private association did not constitute such an action because of the doctrine of judicial non-interference.[92] Noting that the physician would need to show that the organization's actions "were illegal, involved some civil or

[88] *Screwmen's Benevolent Ass'n v. Benson*, 76 Tex. 552, 555, 13 S.W. 379, 380 (1890).
[89] 68 S.W.3d 31 (Tex. App.—Dallas 2001, pet. denied).
[90] *See id.* at 40-41.
[91] *See id.* at 41.
[92] *See id.* at 42.

property right, were against public policy, or were arbitrary or capricious," the court held that these requirements for judicial review exceeded a simple violation of organizational policies.[93]

In *Juarez v. Texas Association of Sporting Officials El Paso Chapter*, the El Paso Court of Appeals considered the appeal of an official/referee who, as a member of the association, had been suspended for a one-year period.[94] Despite having been provided a hearing at which he appeared and participated with his attorney, the individual filed suit against the association alleging a violation of due process rights, breach of fiduciary duty, and breach of contract.[95] The court held that the trial court lacked jurisdiction under the judicial non-interference rules.[96] The El Paso Court of Appeals summarized its ruling regarding the alleged due process violation, stating that "we recognize that when an association's bylaws and constitution provide for a process by which action may be taken against a member, the member must participate in and complete the internal administrative process.[97] We hold that the actions of the board of directors of [the association], so long as they are not illegal, not against some public [policy], not arbitrary, capricious, or fraudulent, are proper actions, permissible and binding on the members of this association."[98] Because the individual was given notice, hearing, and an opportunity to be heard, the court would not intervene.[99]

The Fifth Circuit Court of Appeals recently had an opportunity to review and summarize Texas law in the area of judicial non-interference into private association affairs in *Barrash, M.D. v. American Association of Neurological Services, Inc.*, a case involving a claim brought by a neurosurgeon against the association related to a censure he received.[100] The association had provided notice and opportunity for a hearing to the neurosurgeon, who participated, along with his attorney, and presented a defense.[101] The association's Professional Conduct Committee recommended a six-month suspension, but after the physician appealed to the association's board of directors, the board downgraded the suspension to a censure.[102] Despite appealing to the members at-large, the members voted to uphold the censure.[103] Thereafter, the physician filed suit claiming tortious interference with prospective business relations, breach of contract (the association bylaws), and impairment of an important economic interest from denial of due process.[104] The Fifth Circuit recognized the reluctance of Texas courts to interfere in the internal management of voluntary associations and further recognized that to satisfy common law due process, the association must provide "notice and an opportunity to be heard and to defend in an orderly proceeding adapted to the nature of the case."[105] Finding that "no Texas court has allowed a plaintiff to challenge a professional organization's internal disciplinary procedures under a breach of contract theory" and that "[d]ue process in this context is satisfied by notice in the hearing even when an organization's bylaws require more," the court found no due process violation, no cause of action for breach of contract, and affirmed the district court's dismissal of the action.[106]

An association should not take these cases and others like them as license to act without deliberateness. As the cases make clear, if due process (notice, hearing, and an opportunity to participate in the hearing) is absent or the association acts with fraud, arbitrariness, or capriciousness, a court will intervene. Thus, an association should ensure that its bylaws provide appropriate due process in all disciplinarian complaint situations and that any membership decisions (particularly decisions regarding

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[93] *Id.*
[94] 172 S.W.3d 274 (Tex. App.—El Paso 2005, no pet.).
[95] *See id.* at 277.
[96] *See id.* at 278-79.
[97] *See id.* at 280.
[98] *See id.* at 281.
[99] 812 F.3d 416 (5th Cir. 2016).
[100] *See id.* at 418.
[101] *See id.*
[102] *See id.*
[103] *See id.*
[104] *See id.*
[105] *Id.* at 419.
[106] *Id.* at 420.

censure, suspension, or expulsion) are given serious consideration with the goal of evenhanded and fair treatment.

B. ANTITRUST CONCERNS

The nature of trade associations being organizations of persons with a common business interest makes them particularly susceptible to violations of antitrust laws. Sections 1 and 2 of the Sherman Act prohibit contracts, combinations, and conspiracies that operate as an unreasonable restraint of trade and monopolization/attempted monopolization, respectively.[107] Section 1 is where associations should focus most of their attention. Section 1 provides that "every contract, combination in the form of trust or otherwise, or conspiracy, and restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal."[108] Unfair methods of competition are additionally prohibited under § 5 of the Federal Trade Commission Act. These provisions are enforced by the U.S. Department of Justice and the Federal Trade Commission (the "FTC"), and violations can carry significant monetary penalties and injunctions as well as serving as a basis for private cause of action with treble damages and attorneys' fees in certain circumstances.[109] Individuals who violate the Sherman Act can face felony charges and significant fines as well as prison time.[110] Because of this, it is imperative that business leagues and associations recognize the potential for anticompetitive practices and guard against them.

Certain types of anticompetitive activities are per se illegal regardless of any procompetitive justifications while such justifications are considered for other types of conduct under the "rule of reason" analysis. For example, price fixing agreements, market allocation agreements, and agreements to limit production are per se antitrust violations while activities such as industry market research and information exchanges, depending upon how carried out, can be lawful.[111] To avoid violating antitrust laws, associations should consult with antitrust counsel and ensure that their meetings, online listservs, and forums that are intended for competitors to further a common business interest do not turn into discussions regarding pricing or output decisions, complaints about specific competitors, or other anticompetitive activity.[112] Likewise, if the association is conducting industry market research and hosting information exchanges, the association should ensure that it is done in a way that does not allow for the data of specific responders to be identified.[113]

In addition to these types of concerns, the FTC and Department of Justice give scrutiny to association bylaws and policies that those agencies view to be anticompetitive in nature.[114] For example, in 2015, the FTC entered a consent order against the National Association of Animal Breeders as a result of a provision of the association's code of ethics that disallowed naming members or competitors when making statements comparing the products and services of a member with the products and services of the other member/competitor and publicizing or disclosing information relating to the purchase and sale of animals.[115] While these code of ethics limitations may have been viewed as an attempt toward collegiality and fairness among the industry, the FTC determined that these provisions prevented disclosure of truthful and non-deceptive information and, thus, served an anticompetitive purpose.[116] A similar consent order was entered earlier in 2015 against the Professional Skaters Association on the basis that the association's

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[107] *See* 15 U.S.C. §§ 1-2.
[108] *15* U.S.C. § 1.
[109] *See id.*; 15 U.S.C. § 15.
[110] *See id.* at §1.
[111] Robert Davis, *Associations Can Run Afoul of Antitrust Rules*, THE NONPROFIT TIMES (Sep. 27, 2012) <http://www.thenonprofittimes.com/news-articles/associations-can-run-afoul-of-anti-trust-rules/>.
[112] *See id.*
[113] *See id.*
[114] Peter S. Frechette, Andrew E. Bigart, Robert P. Davis, *FTC Continues Focus on Antitrust Violations in Association Codes of Ethics*, VENABLE LLP ARTICLES (Oct. 2015) <https://www.venable.com/ftc-continues-focus-on-antitrust-violations-in-association-codes-of-ethics-10-01-2015/>.
[115] *See id.*
[116] *See id.*

bylaws contained a non-solicitation provision prohibiting solicitation of a fellow member's customers.[117] To avoid innocent (or intentional) antitrust violations, an association should consider best practices, including engaging antitrust counsel and developing an antitrust compliance program that would educate associational leaders on antitrust concerns to be mindful of when conducting association activities.[118]

VII. CONCLUSION

More than 180 years after Alexis de Tocqueville marveled over the use of associations in the United States, Americans continue to join together for nonprofit purposes. While charitable organizations remain the largest part of the nonprofit sector, business leagues and trade associations are a thriving and vibrant part of the nonprofit world. Whether professional associations of doctors or lawyers, associations of professional sports teams, or trade associations of skilled occupations, these gatherings of individuals with pursuing common business interests all find themselves subject to § 501(c)(6) of the Code, and thus, lawyers seeking to work in the nonprofit space must be aware of those rules and, particularly, how they differ from the more familiar rules of § 501(c)(3). Understanding § 501(c)(6) and the many years of rulings and case law will enable practitioners to best serve their association clients, thereby allowing those associations to continue doing the important work of advancing the common business interests of their members.

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[117] *See id.*
[118] *See id.*