NAVIGATING UNFAMILIAR TERRAIN: NONPROFIT LAW FOR THE NON-NONPROFIT LAWYER

DARREN B. MOORE, *Fort Worth*
Bourland, Wall & Wenzel, P.C.

State Bar of Texas
15th ANNUAL
ADVANCED BUSINESS LAW
November 9-10, 2017
Houston

CHAPTER 5

DARREN B. MOORE
Bourland, Wall & Wenzel, P.C.
301 Commerce Street
Fort Worth, Texas

Phone: (817) 877-1088
Email: dmoore@bwwlaw.com
Twitter: @darrenbmoore
Blog: Moorenonprofitlaw.com

Mr. Moore practices with Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represents individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Moore was born in Lubbock, Texas on December 11, 1973. He earned a B.A., cum laude, from Texas A&M University and his J.D., magna cum laude, from Baylor Law School where he served as Editor in Chief of the Baylor Law Review.

Mr. Moore was admitted to practice law in Texas in 2000 and before the United States District Court, Northern District of Texas and United States Tax Court in 2001. He is a member of the State Bar of Texas; Tarrant County Bar Association; American Bar Association (Business Law Section, Section of Taxation); College of the State Bar; and is a Fellow of the Texas Bar Foundation. He was named a "Rising Star" by Texas Super Lawyers from 2009 – 2013. Mr. Moore was selected as a "Top Attorney" in Nonprofit Law by *Fort Worth, Texas* magazine in 2013 and 2014.

Mr. Moore's practice focuses on representation of nonprofit organizations and social enterprises. Mr. Moore advises clients on a wide range of tax and legal compliance issues including organization of various types of nonprofit and social enterprise entities, obtaining and maintaining tax-exempt status, risk management, employment issues, governance, and other business issues, as well as handling IRS audits, attorney general investigations, and litigation matters on behalf of his exempt organization clients.

Mr. Moore is an adjunct professor at Baylor Law School where he has taught Nonprofit Organizations since 2001. He has been a guest lecturer at the University of Texas School of Law and Southern Methodist University Dedman School of Law on nonprofit organization topics. Additionally, he writes and speaks regularly on tax and legal compliance issues. Mr. Moore is co-author of the third edition of Bourland, Wall & Wenzel, P.C.' s publication, Keeping Your Church Out of Court.

TABLE OF CONTENTS

NAVIGATING UNFAMILIAR TERRAIN: NONPROFIT LAW FOR THE NON-NONPROFIT LAWYER[1]

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").[2] Section 501(c)(3) and Section 501(c)(4) organizations comprised approximately seventy-five percent (75%) of that number.[3] It is estimated that Section 501(c)(3) organizations employ approximately 10% of the workforce in United States.[4] In 2009, the nonprofit sector accounted for 5.5% of the GDP for the country.[5] Despite its reach, however, the nonprofit sector can seem foreign to attorneys accustomed to the for-profit market space. Whether confronted with a client engaging in a transaction with a nonprofit, a client wanting to start a nonprofit, or simply serving on a nonprofit board, understanding the basic landscape allows the practitioner to navigate the unfamiliar terrain.

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.

While all organizations that are exempt from federal income tax come within the "nonprofit tent," not all nonprofit organizations are eligible for exemption. Rather, eligibility for exemption depends upon the organization meeting specific requirements for exemption. Certain of these requirements will be discussed in Section III below. Nevertheless, it is critical to understand that the term "nonprofit" simply refers to a category of organizations that contains a prohibition on the distribution of profits other than as reasonable compensation while the term "exempt" refers to organizations that meet specific elements set forth in the Internal Revenue Code, as amended (the "Code" or "I.R.C." herein), for federal tax exemption or under the Texas Tax Code for state tax exemption. As will be discussed below, not every exempt organization is a charity. Charitable organizations are one category of exemption (specifically Section 501(c)(3) of the Code). While that is the largest category of organizations, the Code provides for many different categories of tax-exempt organizations. This paper will focus on charities.

Broadly speaking, this article is intended to cover the life cycle of a charitable organization beginning with the choice of form; moving to exemption, obtaining exemption, maintaining exemption, and operating; and finishing with termination of the organization. Additional helpful materials for the Texas practitioner are available through the Governance of Nonprofit Organizations course offered by the TexasBarCLE and available on its Online Bar Library. Further, various white papers on nonprofit organizations topics are available at moorenonprofitlaw.com.

II. CHOICE OF FORM

While in theory any organizational form can incorporate the nondistribution constraint, only a limited number of organizational forms are eligible for tax-exempt status:

(1) charitable trust;
(2) nonprofit corporation;
(3) unincorporated association; and
(4) limited liability company. The limited liability company is available only where the member or members are exclusively tax-exempt.

Each of these types of entities has unique characteristics and considerations.

A. Considerations in Choosing an Entity Structure

There are several considerations that should be taken into account in determining the choice of entity. These considerations include how quickly the organizer wishes to establish the entity, the organizer's level of concern over liability exposure, the sophistication level and goals of the organizer, the financial resources of the organizers, the type and scale of activities to be conducted by the organization, the type of governance structure desired, and the duties to

[1] The byline of this title was originally used by the Nonprofit Committee of the Business Law Section of the ABA for an excellent presentation.

[2] *See* Independent Sector, Scope of the Nonprofit Sector, (visited December 20, 2012) <http://www.independentsector.org/scope_of_the_sector>.

[3] *See id*.

[4] *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).

[5] *See id*.

be imposed on the directors/trustees in operating the organization.

B. Charitable Trusts

Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601.[6] A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust. Charitable trusts created in Texas are governed by the Texas Trust Code as well as common law relating to trusts and are subject to the oversight authority of the Texas Attorney General.

Aside from the benefit of having many years of established case law, many organizers choose charitable trusts as the organizational form of their entity because of the rigidity of trusts. A settlor is able to establish the trust with specific purposes and be assured that the trust will operate for those purposes absent court intervention. The settlor also has the security of knowing the trustee(s) will be held to higher fiduciary standards in performing his or her duties.

While the rigidity of trusts can be viewed as a benefit, that same feature may be viewed as inflexibility and thus may be viewed as a detriment to others looking to choose an entity. The ability to modify a trust requires court intervention and is not automatic. Trustees are more limited as to their investments as well as their ability to delegate duties. Trustees are additionally subject to more stringent conflict of interest and self-dealing prohibitions and must meet a higher standard for indemnification as compared to directors of unincorporated associations or nonprofit corporations.

C. Unincorporated Associations

Nonprofit unincorporated associations are the default nonprofit organization in Texas. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose.[7] Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the Texas Business Organizations Code ("BOC"). That chapter clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members' interests by all legitimate and legal means. Unincorporated associations have the right to sue or be sued, sue or be sued by a member; acquire, hold, encumber, 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 Section 501(c)(3) or another section. The IRS has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation when it is formed under a contract or bylaws and has elective officers empowered to act for the association. It should be noted that the IRS will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status. These provisions will be discussed more fully below.

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

On the contrary, there are numerous drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the BOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), there is little case law interpreting either Chapter 252 or its predecessor act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, a founder has less assurance that his or her wishes as to the direction and purposes of the organization will remain unchanged. Many unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Finally, choice of law concerns exist where an unincorporated association acts outside Texas as not all states recognize such an entity. Practically speaking, for an unincorporated association to qualify for federal tax exemption under Section 501(c)(3) the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption thereby lessening the benefits discussed above.

D. Nonprofit Corporations

Perhaps the most commonly used entity for exemption under Section 501(c) is a nonprofit

[6] 43 Elizabeth, Chapter 4 (England 1601).

[7] *See* Tex. Bus. Orgs. Code Ann. § 252.001 et seq.

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

E. Limited Liability Companies

The final entity eligible for exemption for under Section 501(c) is a limited liability company ("LLC"). LLCs are unique in their eligibility for exemption. Unlike the other forms discussed above, the LLC is used as a single-member entity with an exempt organization as the single member or alternatively as a multi-member LLC with all of the members being exempt. LLCs are governed by the Business Organizations Code and specifically Chapter 101. LLCs can be member-managed or manager-managed. In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting 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. This liability protection with the simple control (such as management overlap) is a beneficial feature of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities. Furthermore, where the LLC is a single member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-exempt status (discussed below) but rather will effectively take on the tax attributes of its parent member. On the flip side, if the LLC has not separately applied for exemption, while it will not be taxable for federal income tax purposes, it will remain taxable for Texas franchise tax purposes unless it can qualify for exemption. In other words, because the LLC has itself not obtained 501(c)(3) or 501(c)(4) status, it cannot use such status as its basis for exemption from the Texas franchise tax. This same concern applies with respect to the Texas sales tax. Finally, Texas property tax rules do not provide for any property tax exemption for LLCs—a significant drawback for any LLC that would hold real property that could be exempt on the basis of the type of organization.[11]

---

[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] For example, if a church wanted to place its real property in a subsidiary organization for asset protection purposes, should the church use the LLC form, no property tax

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

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

III. IDENTIFYING THE APPROPRIATE FEDERAL TAX CLASSIFICATION

A. Exempt vs. Charitable

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

The Code contains over thirty (30) categories of federal income tax exemption classifications. As addressed above, the overwhelming majority of organizations that are exempt from federal income tax are exempt as organizations described under Section 501(c)(3) of the Code. However, the organizers and their counsel should consider whether the organization properly qualifies as an organization exempt from federal income tax under Section 501(c)(3)—specifically, as an organization organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children

---

exemption would be allowed; however, should the church use a subsidiary nonprofit corporation, the property tax exemption would still be available.

[12] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

or animals.[13] For example, were an organization organized exclusively for the promotion of social welfare (particularly where the organization engages in lobbying activities), that organization will qualify under Section 501(c)(4).

B. Selected Purposes Under Section 501(c)(3)

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

1. Religious

The term "religious organization" includes organizations whose primary purpose is "religious" in nature. Neither the Code nor the Regulations define the term "religious." Courts have considered the definition of "religious" in the context of whether or not a belief is a "religious belief." For example, the United States Supreme Court, in considering this question, queried whether the belief was deeply and sincerely held by the members of the organization and whether those beliefs involved an issue "of ultimate concern," a phrase borrowed by the Court from the theologian, Dr. Paul Tillich.[14] Obviously, the parameters of what is a "religious" purpose are vague to say the least. Accordingly, any organization seeking to qualify as a religious organization that does not fit squarely into the mainstream idea of religion should carefully review case law to support its position.

Among the "mainstream" view of religious organizations are churches, associations of churches, and integrated auxiliaries of churches. As with the term "religious," the term "church" is found, but not defined in the Code. In *Foundation for Human Understanding v. Commissioner*, the IRS set out its fourteen factor test for determining whether an organization qualifies as a church.[15] None of the fourteen factors are exclusive. Rather, the test is one utilized by the IRS (significantly, as Schedule A to Form 1023 discussed below) for determining whether an organization has the markers commonly associated with a church. Those factors include the following:

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

While none of the criteria are controlling, it has become increasingly clear that the IRS as well as courts focus on the associational aspect (i.e., people joining together) as central. In a 2004 Technical Advice Memorandum, the IRS noted that churches, while not being required to meet all of the criteria, ought to at least meet some minimum standard—those standards centered around this associational concept—having regular religious worship services, having a regular congregation, having an established place of worship, etc.[16] This issue has been litigated in the context of Internet- and radio-based ministries with courts determining that such organizations lack the requisite associational aspect.[17]

Not all religious organizations are churches. Rather, religious organizations may also be conventions or associations of churches, integrated auxiliaries of churches, or other organizations that have a religious purpose but do not qualify in any of the aforementioned categories. The phrase "convention or association of churches" has not been defined in the Code or Regulations either. Rather, it is a historical phrase generally referring to groupings of churches that are congregational as opposed to hierarchical in nature.[18] Associations of churches may include both churches and individuals.[19] Unlike "religious,"

---

[13] *See* § 501(c)(3).

[14] *See U.S. v. Seeger*, 380 U.S. 163 (1965).

[15] 88 T.C. 1341 (1987).

[16] TAM 200437040.

[17] *See e.g., Foundation of Human Understanding v. United States*, 88 Fed. Cl. 203 U.S.C.T. Fed. Cl. (2009)).

[18] *See Lutheran Social Servs. of Minn. v. United States*, 758 F.2d 1283, 1288 (8th Cir. 1985).

[19] *See* I.R.C. § 7701(o).

"church," and "association of churches," the phrase "integrated auxiliary of a church" is defined in the Regulations. Specifically, Section 1.6033-2(h) defines integrated auxiliary of a church as referring to a class of organizations related to a church or association of churches that (1) fits the definition of public charity; (2) is affiliated with a church or association of churches; and (3) receives its financial support primarily from internal church sources (with limited exceptions). An organization is affiliated with a church or association of churches if its governing documents evidence such affiliation (through common doctrine, authority to appoint and remove directors, annual reporting, or other similar factors whereby the organization is akin to a subsidiary of the church or association of churches). An organization is internally supported when it receives more than 50% of its support from internal church sources.

2. Scientific

To qualify as an exempt scientific organization, an organization must meet four tests: (1) the organization must conduct scientific research[20]; (2) the scientific research must not be conducted incident to commercial or industrial operations[21]; (3) the organization must meet the specific public interest test[22]; and (4) the organization must meet the general public interest test stated.[23]

"Scientific" as used in Section 501(c)(3) is defined as research with a scientific purpose carried on in the public interest.[24] Research that is scientific may be practical or applied, fundamental or theoretical.[25] In *Midwest Research Institute v. United States*,[26] the court concluded that research is scientific when it meets a three-part test:

(1) there must be project supervision and design by professionals;
(2) the researchers must design the project to solve a problem through a search for demonstrable truth, using the scientific method; and
(3) the research goal must be discovering a demonstrable truth with the novelty and importance of the knowledge to be discovered being significant in determining whether a particular activity furthers a scientific purpose.

Scientific research does not, however, include activities ordinarily carried on as incident to commercial or industrial operations, such as ordinary testing or inspection or the clinical testing of drugs where such clinical testing is intended for FDA approval.[27] The court in the *Midwest* opinion cited above defined "testing" as "generally repetitive work done by scientifically unsophisticated employees for the purpose of determining whether the item tested met certain specifications, as distinguished from testing done to validate a scientific hypothesis."[28] Likewise, the IRS suggested that in ordinary testing, "a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive and the procedure is merely a matter of quality control."[29]

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

1. the results of the research are made available to the public on a non-discriminatory basis;
2. the research is performed for the United States, its agencies, a state, or a political subdivision thereof; or
3. the research is directed toward benefiting the public.[30]

Research is directed toward benefiting the public where, for example, it is carried on for the purpose of aiding in the scientific education of college or university students; it is carried on for the purpose of obtaining scientific information published in a treatise, thesis, trade publication, or other forms available to the public; it is carried on for the purpose of discovering the cure for a disease; or it is carried on for the purpose of aiding a community or geographical area by attracting new industry thereto or by encouraging the development of, or retention of, an industry therein.[31] Regulation 1.501(c)(3)-1(d)(5)(iv) provides that an organization is not carrying on scientific research in the public interest when the organization is performing

[20] Reg. 1.501(c)(3)-1(d)(5)(i)

[21] Reg. 1.501(c)(3)-1(d)(5)(ii)

[22] Reg. 1.501(c)(3)-1(d)(5)(iii), (iv)

[23] Reg. 1.501(c)(3)-1(d)(1)(ii)

[24] *See* Reg. 1.501(c)(3)-1(d)(5)(i).

[25] *See id*.

[26] *Midwest Research Institute v. United States*, 554 F. Supp. 1379 (W.D. Mo. 1993), *aff'd*, 744 F.2d 635 (8th Cir. 1984).

[27] *See* Reg. 1.501(c)(3)-1(d)(5)(ii).

[28] *See Midwest Research Institute*, 554 F. Supp. 1379.

[29] *See* GCM 39196 (Aug. 31, 1983).

[30] *See* Reg. 1.501(c)(3)-1(d)(5)(iii).

[31] *See id*.

research (directly or indirectly) only for its creators that are not described under Section 501(c)(3) or is retaining (directly or indirectly) ownership or control of more than an insubstantial portion of the results of the research and not making the results of such research available to the general public.

In addition to showing that the organization is conducting research in the public interest,[32] the organization must also establish, as with all organizations who seek to be classified as exempt, that it serves a public rather than private interest.[33] This requires identifying any private benefit that may be present and analyzing whether that private benefit is more than incidental to the public interest being served.

3. Educational

Section 170(b)(1)(a)(ii) of the Code and Section 1.170A-9(b)(1) of the Regulations provide the definitions for the phrase "educational organization." An educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at a place where its educational activities are regularly carried on. The Regulations further make clear that the term "educational" relates to "(a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community." The Regulations go on to explain that an organization may be educational even where it is advocating a specific viewpoint so long as it gives a "full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion." This phraseology has been the subject of litigation which resulted in the "full and fair exposition test" being struck down as unconstitutionally vague. As opposed to using such test, the IRS now commonly relies on a methodology test whereby it considers the methodology by which the proponent of the purported educational materials developed its argument in an effort to test whether there is "factual foundation for the viewpoint or position being advocated."[34]

4. Charitable

The term "charitable" as used in Section 501(c)(3) is to be taken "in its generally accepted legal sense" and includes the following: "Relief of the poor and distressed or the of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency."[35]

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

IV. PUBLIC CHARITY VS. PRIVATE FOUNDATION

A. Foundations in General

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. Section 509(a) of the Code defines a private foundation as any domestic or foreign organization described in Section 501(c)(3) of the Code other than the following types of public charities:

1. Organizations that are, by definition or by activity, public charities: § 509(a)(1); § 170(b)(1)(A)(i)-(v) ("traditional" public charities);
2. Organizations receiving a substantial amount of support from the general public or from governmental entities: § 509(a)(1); §170(b)(1)(A)(vi) ("publicly supported charities");
3. Organizations receiving a substantial amount of support from the general public or from governmental entities: § 509(a)(2) ("gross receipts" or "service provider" publicly supported charities);
4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations: § 509(a)(3) (supporting organizations); and;
5. Organizations organized and operated exclusively to test for public safety: § 509(a)(4) (beyond the scope of this outline).

[32] Reg. 1.501(c)(3)-1(d)(5)(iii)

[33] *See* Reg. 1.501(c)(3)-1(d)(1)(ii).

[34] *See* Rev. Proc. 86-43, 1986-2 C.B. 729.

[35] Reg. § 1.501(c)(3)-1(d)(2).

In other words, a Section 501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above.

B. Private Nonoperating Foundation

The most common type of private foundation is the nonoperating foundation. It does not generally directly perform any charitable programs or services. It generally receives its funding from one primary source, such as an individual, a family, or a corporation. It does not generally actively raise funds or seek grants. It is required to distribute approximately 5% of its assets annually in qualifying distributions (most often to public charities). Donors' charitable income tax deductions are more limited than when made to a public charity.

C. Private Operating Foundation

The operating foundation has a stated charitable purpose and carries out its own programs. It generally seeks grants rather than awarding grants to other charitable organizations. The operating foundation must expend substantially all of its net investment income directly for the purposes of its own charitable activities. Although donors receive the more liberal public charity income tax deduction limitations, this type of foundation remains subject to the private foundation restrictions because its source of funding is generally from one individual, family or corporation.

D. Institutions

Institutions Code § 509(a)(1); Code § 170(b)(1)(A)(i-v):

a. Churches and conventions and associations of churches;
b. Educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of students in attendance at the place where the activities are regularly carried on;
c. Hospitals and medical research organizations;
d. Endowment funds for state and municipal universities;
e. Governmental units, including a state, a possession of the United States, a political subdivision of a state or the United States, the United States, or the District of Columbia.

E. Publicly Supported Organizations

1. *Code § 509(a)(1) Publicly Supported Organization*: Another type of charitable organization is the publicly supported charity described in Section 509(a)(1) and Section 170(b)(1)(A)(vi) of the Code, sometimes referred to as a "donative" publicly supported charity, because it does not typically provide services (as compared to § 509(a)(2) organizations). It is not a private foundation; rather it is taxed as a public charity. It must meet a public support test and generally must demonstrate that it is organized to attract contributions from a broad range of donors. A community foundation is described in Section 170(b)(1)(A)(vi) of the Code. It is not a private foundation; rather it is taxed as a public charity. It does not perform any charitable programs or services. It is generally established to attract large contributions of capital or endowment for the benefit of a particular community or area. Its attractiveness is enhanced by the donor's ability to benefit multiple charities through the donor's gift to a single community foundation.
2. *Code § 509(a)(2) Publicly Supported Organization*: Another type of charitable organization is the gross receipts, or publicly supported charity, which is described in Section 509(a)(2) of the Code. It is not a private foundation; rather it is taxed as a public charity. It is generally established to attract contributions from a broad range of donors and must meet a public support test.

F. Supporting Organization

Another type of charitable organization is the supporting organization, which is described in Section §509(a)(3) of the Code. It is not a private foundation, but is a sub-category of public charity and is really only indirectly public, meaning that the public that monitors this organization's operations does so through an intervening public charity. That intervening public charity is the entity to which the supporting organization must answer regarding organization and operation. Because of its "public charity" nature, its attractiveness to potential donors is enhanced because donations are allowed the more favorable tax deduction limitation of those made to public charity. However, a donor seeking control is not as likely to favor this organization as the choice for his or her donation because the organization cannot be controlled by the donor, the donor's family, or other "disqualified persons" defined later in this outline.

V. OBTAINING AND MAINTAINING TAX-EXEMPT STATUS (501(C)(3))

A. General Requirements for Exempt Status

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the

requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure (as addressed above) and must be organized and operated exclusively for charitable purposes. An action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes. Finally, case law has appended the foregoing elements with the requirement that an organization must not be volitive of public policy in order to qualify for exempt status.

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

1. The Organizational Test

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.[36] 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.[37] 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 to inure to the benefit of a private individual.

2. The Operational Test

An organization is exempt from federal income taxes if it is organized and operated exclusively for one or more exempt purposes.[38] An 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 of such exempt purposes specified in Section 501(c)(3).[39] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[40] The purpose(s) of the organization must be closely evaluated to determine if they are exempt or if they are non-exempt, and if non-exempt, whether the non-exempt purpose is substantial. "Under the operational test, the purposes towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a Section 501(c)(3) organization exempt from tax under Section 501(a)…[I]t is possible for…an activity to be carried on for more than one purpose…[T]he critical inquiry is whether…[an

[36] *See* Reg. 1.501(c)(3)-1(a).

[37] *See* Reg. 1.501(c)(3)-1(b)(4).

[38] IRC §501(c)(3).

[39] Treas. Reg. §1.501(c)(3)-1(c)(1).

[40] Treas. Reg. §1.501(c)(3)-1(c)(1).

organization's] primary purpose for engaging in its…activity is an exempt purpose…".[41]

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 Section 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.[42] 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 Section 501(c)(3) of the Code,
b) Certain Code §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 include:

a) The person founded the organization,

[41] *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 356-357 (1978).

[42] I.R.C. §4958(f).

b) The person is a substantial contributor to the organization (within the meaning of Section 507(d)(2)(A) of the Code),
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 include:

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.[43]

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 the standard set out in Section 162 if the Code -- 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 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.[44]

[43] Treas. Reg. §53.4958-3.

[44] 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).

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.

B. 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 IRS to obtain recognition of exemption.[45] 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

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

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[46] 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. A check made payable to the IRS for payment of the user fee applicable to the organization. The user fee is $850 for initial applications for exempt status for organizations seeking exemption under Section 501(c) of the Code 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.

VI. GOVERNANCE AND THE ATTORNEY GENERAL

A. Generally

Despite the difference in choice of form and exemption status, all decision makers owe certain fiduciary duties to the organizations they serve. A

[46] Treas. Regs. § 1.501(a)-1(b)(2)(iii).

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.[47] 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.[48]

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.[49]

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."[50] 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.[51] 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.[52] 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.[53]

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization.[54] 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.[55] The parameters of the business judgment rule in Texas are not well defined. The BOC provides 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.[56] 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-

---

[47] *See* Black's Law Dictionary 625 (6th ed. 1990).

[48] *See Holloway*, 368 S.W.2d at 576.

[49] *See* BOC § 22.221(a).

[50] Black's Law Dictionary 693 (6th ed. 1990).

[51] *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989).

[52] *See* BOC § 22.224.

[53] *See* BOC § 3.102; BOC § 22.222.

[54] *See* BOC § 22.221.

[55] *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).

[56] *See* BOC § 22.221(a).

interested director absent a challenged action being ultra vires, tainted by fraud, or grossly negligent.[57]

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."[58] Because trusts are generally not operating entities in the sense of carrying on their own programs, the concept does not have the same relevance.[59] 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.[60]

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."[61] 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.[62] Texas law defines such a breach as misappropriating a business opportunity that properly belongs to the corporation.[63] 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.[64] Where the opportunity properly belongs to the corporation, the fiduciary has an obligation to disclose the opportunity and offer the opportunity to the corporation.[65]

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.[66] 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 (1) 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.[67] 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.[68]

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.[69] 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.[70] 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."[71] Significantly, if there has been no approval after full disclosure, the transaction is presumed unfair and the director bears

---

[57] *See Gearhart Industries, Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (discussing and applying Texas law).

[58] *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).

[59] *See, e.g., Stern v. Lucy Webb Hayes Nat'l School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D. D.C. 1974).

[60] *See Landon*, 82 S.W.3d at 672.

[61] *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).

[62] *See Holloway*, 368 S.W.2d at 577.

[63] *See Landon*, 82 S.W.3d at 681.

[64] *See id*.

[65] *See id*.

[66] .*See Landon*, 82 S.W.3d at 672; Torres, 915 S.W.2d at 49.

[67] *See Loy v. Harter*, 128 S.W.3d 397, 407 (Tex. App.—Texarkana 2004, pet. denied).

[68] *See Torres*, 915 S.W.2d at 49.

[69] *See* BOC § 22.230.

[70] *See id*.

[71] *See Holloway*, 368 S.W.2d at 577.

the burden to show fairness.[72] 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."[73] 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.[74] 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.[75]

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.[76] 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."[77]

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."[78] 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

[72] *See id.*

[73] *Miller v. Miller*, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

[74] *See* BOC § 22.225.

[75] *See id.*

[76] *See Gearhart*, 741 F.2d at 719.

[77] *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

[78] *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999).

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 IRS, 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.[79] 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.[80] 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 attorneys' fees.[81]

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.[82] Such standing requires that the donor have a *special interest* in the donated gift.[83] 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 BOC also provides the OAG various powers and investigative authority over nonprofits. Many powers are implied from the provisions of the BOC, which require corporate compliance (e.g., keeping accurate books and records). The BOC 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. FUNDRAISING

A. Charitable Solicitation[84]

Although a charity may feel it does not want to look a gift horse in the mouth, it is important for the charity to consider whether it can, and should, accept the gift, and if it does, how this gift fits within the charitable purposes of the organization. Certain gifts are easy—cash with no strings attached for example. Others should clearly be rejected—nuclear-waste contaminated property. However, for other proposed gifts, the directors and officers must satisfy their fiduciary duties in making the decision to accept or decline a gift.

---

[79] *See* TEX. PROP. CODE § 123.001, et. seq.

[80] *See* TEX. PROP. CODE § 123.005(a).

[81] *See* TEX. PROP. CODE § 123.005(b).

[82] *See, e.g., Cornyn v. Fifty-Two Members of the Schoppa Family*, 70 S.W.3d 895 (Tex. App.—Amarillo 2001, no petition).

[83] *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).

[84] Portions of this Section excerpted from Megan C. Sanders, "Gifts From Cousin Eddie: Acceptance, Ownership & Management Of Bizarre Assets," 32nd Annual University of Texas Nonprofit Organizations Institute, 2015.

1. Issues

Before accepting a potential gift, the board should consider items such as:

Is there liability associated with the asset?

Will accepting and managing the gift cost more than its true value to the organization?

What restrictions have been placed on the gift by the donor?

How is the asset owned by the donor - Is the asset owned outright or within a trust or other entity wrapper? Is this a split ownership or co-tenancy situation in which partition of the asset is necessary?

It must be determined exactly what is being given before going any further in the process.

2. Gift Acceptance Policy

While a gift acceptance policy is not required by the Code or on the Annual Form 990, the development and regular use of such a policy promotes due diligence and fulfillment of the organization managers' fiduciary duties, as well as provides guidance on the complex issues presented to the board when approached with exotic gifts. Any nonprofit organization engaging in fundraising should develop and periodically review the organization's gift acceptance policy. A gift acceptance policy can be used as an internal management tool, reduce the risk of excise taxes for foundations and may provide better results with the IRS when compliance questions arise. It may promote mission-related gifts, encourage donors to give, and help the board to consider the organization's capacity to receive unusual gifts or partial interest gifts in advance.[85]

The policy may serve to protect the organization from unanticipated liabilities, by establishing standards for managing risk associated with certain categories of assets, environmental liabilities, and unmarketable property. It can also enhance the relationship between the charity and both prospective and established donors by providing uniform expectations, providing terms to govern restricted gifts and the use of donations if changed circumstances occur, and enhancing the likelihood that restricted gifts will be potentially deductible. These procedures and policies can also be incorporated into fundraising appeals and specific donor agreements. Further, the policy can help assure that the organization's staff and board members do not benefit personally from gifts received by the organization, which could be deemed a conflict of interest, implicate their duty of loyalty, and possibly be considered prohibited conduct under the Code and Treasury Regulations.

A good gift acceptance policy addresses the types of property the organization is willing to accept, will never accept, and what comes in between. As to the middle ground asset classes, the policy should specify who has discretion to make the acceptance decision and the type of approval process required. The approval process may include considerations such as: Does the gift have conditions that unacceptably tie up the use of the property itself? Will the type of asset tie up the use of other property of the organization, incurring expenses for holding or maintaining the gifted item? Will gifts of real estate be accepted, and if so, will the acceptance be conditioned upon an inspection and evaluation? Will acceptance of the gift hinder or promote the overall mission and purpose? These issues all correspond with the directors' duty of obedience: the considerations noted should be carefully weighed against the best interests of the organization as a whole and its charitable purposes.

The policy should address what classes of assets the organization is willing to accept, i.e., cash, securities, life insurance, retirement benefits and the various types of tangible personal property, real estate, vehicles and other more exotic items. It should also address the types of gifting vehicles the charity is willing to deal with: estate administration, inter vivos trusts, charitable gift annuities, charitable lead trusts, charitable remainder trusts, etc. The policy should specify whether the organization is open to receiving restricted gifts, and if so, what type of restrictions are acceptable and the organization's plan of action when changing circumstances affect those restrictions. The policy may also address what type of acknowledgements should, and must, be provided to donors.

The policy should be reviewed and revised over time. For example, organizations may now want to consider adding provisions in their gift acceptance policies addressing virtual currencies. It would be wise to encourage automatic conversion of Bitcoin upon donation, due to price volatility.[86] Once a donor has decided to make a donation of Bitcoin to a charity, he can use a payment processor, such as BitPay, to immediately convert the donation to cash. BitPay can

---

[85] Donald W. Kramer, Noel A. Fleming, and Deborah J. Zateeny, "Advising Non-Profits: Top Ten Policies and Practices for Nonprofit Organizations," The American Law Institute, March 26, 2013, video presentation.

[86] Bryan Clontz, "Charitable Gifts of Bitcoin: Tax, Appraisal, Legal and Processing Considerations", available at http://www.pgdc.com/pgdc/charitable-gifts-bitcoin-tax-appraisal-legal-and-processing-considerations.

directly deposit the value of the Bitcoin in the charity's bank account, and will process payments for exempt organizations for free. If not using a payment processor such as this, the charity would have to go through a virtual currency exchange to sell the Bitcoin, which can be a more complicated process.[87]

3. Gift Acknowledgments

Including within the gift acceptance policy the circumstances in which the organization should and must provide the donor with a receipt, written acknowledgement, and/or any forms required by the IRS will help with compliance issues as well as the donor properly substantiating his or her gift for income tax deduction purposes. The donee may also desire to provide donor acceptance agreements once the acceptance decision has been finalized, to clarify the donor's intentions of making the gift, provide for flexibility in the organization's use of the contribution over time, and provide for a mechanism for non-judicial modification of the donor's restrictions if changes occur. It may also provide for naming rights, including a variance clause and provisions related to enforcement and state law choice if there is ever litigation raised over the contribution. This type of donor agreement can also be useful as a fundraising tool and encourage donors to make the contribution to the charity.

B. Handling Restricted Gifts

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."[88] 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.[89] 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.[90]

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.[91] 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.[92] 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 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.[93] Importantly, a restrictive purpose does not fail merely because it is not "efficient" to continue it.

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

---

87 *Id.*

88 *See* Tex. Prop. Code § 123.001(1)(2).

89 *See Blocker v. State*, 718 S.W.2d 409, 415 (Tex. App.—Houston [1st Dist.] 1986, writ ref's n.r.e.).

90 *See, e.g.*, BOC § 22.223.

91 This discussion assumes the charity is a nonprofit corporation and thereby subject to UPMIFA.

92 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.

93 *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).

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.[94] "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.[95] 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."[96] 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."[97]

UPMIFA permits release or modification of restrictions on institutional fund management, investment and/or purpose in limited circumstances.[98] 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.[99] 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 not 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.[100] 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.[101] 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).[102]

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.[103]

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.

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

[94] *See* Tex. Prop. Code § 163.003(4).

[95] *See* Tex. Prop. Code § 163.003(5).

[96] Tex. Prop. Code § 163.003(2).

[97] Tex. Prop. Code § 163.003(3).

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

[99] Tex. Prop. Code § 163.007(a).

[100] Tex. Prop. Code § 163.007(b).

[101] Tex. Prop. Code § 163.007(c).

[102] *See* Tex. Prop. Code § 163.007(b) and (c).

[103] *See* Tex. Prop. Code § 163.006(d).

representative of the public interest in charity.[104] 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.[105] 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 attorneys' fees.[106] 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.

Finally, the question is frequently asked—can the charity return a donation rather than follow a restriction? 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.[107] 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.[108]

C. Raffles, Auctions, and Casino Nights

While the details of raffles, auctions, casino nights, and other forms of gaming for fundraising purposes is beyond the scope of this article,[109] it is worthwhile to note a few basic rules. First, the general rule in Texas is that gambling is illegal.[110] Raffles and poker tournaments fall within the definition of gambling under the Penal Code. Notwithstanding the prohibitions of the Penal Code, the Texas Occupations Code includes the Charitable Raffle Enabling Act ("CREA") legalizing charitable raffles conducted in compliance with its regulatory scheme.[111] Further, the Penal Code provides a defense for the criminal offense of gambling if the person reasonably believes his or her conduct was permitted by the CREA.[112] In allowing legalized raffles, the CREA provides significant restrictions. For example, the CREA regulates the type of charity that qualifies to conduct charitable raffles, the number of charitable raffles that may be conducted each year, the types of prizes that may be awarded, how the proceeds must be used, and even information that is required to be printed on the tickets. Any charity considering conducting a charitable raffle must familiarize itself with the regulatory provisions of the CREA. Auctions should be contrasted with raffles, as they are not governed under the CREA and are not considered gambling under the Texas Penal Code. Nevertheless, charities should be mindful of rules regarding auctions of alcoholic beverages (considered the sale of alcoholic beverages thus requiring a license) as well as the requirement to collect sales tax on items sold except with respect to two permitted one-day sales per calendar year (other than for items sold for more than $5,000.00).[113]

---

[104] *See* Tex. Prop. Code § 123.001, *et. seq.*

[105] *See* Tex. Prop. Code § 123.005(a).

[106] *See* Tex. Prop. Code § 123.005(b).

[107] *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)).

[108] *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.

[109] For a detailed analysis of fundraising issues involving charitable raffles, casino nights, and auctions, *see* Collier, Tyree, *The Perils of Fundraising*, 10th Annual Governance of Nonprofit Organizations Course, State Bar of Texas CLE.

[110] Tex. Pen. Code, Chapter 47.

[111] Tex. Occ. Code, Chapter 2002.

[112] Tex. Pen. Code § 47.02(c)(2); *see also* Tex. Pen. Code § 47.09(a)(1)(B) (providing a defense to the offense of operating a place of gambling where the activity is permitted under the CREA).

[113] Texas charities are permitted under the Texas Tax Code to hold up to up to two one-day sales of taxable items each calendar year without collecting sales tax provided that sales tax must still be collected on items sold over $5,000.00 that

Outside of the provisions of the CREA, gambling is not permitted as a charitable fundraising technique. Notwithstanding this fact, many readers may be familiar with charities that conduct casino nights or poker nights. Generally speaking, if these events include the payment of consideration for participation, a chance at winning, and prizes to be awarded, these events constitute gambling and are prohibited under Texas law.[114] For a charity to successfully navigate this restriction requires thought and planning to ensure that at least one of these three elements is not present for its event. For example, an organization could charge entry and give door prizes but not give prizes for winning hands, in which event the second element (chance) is missing.

D. Commerciality Concerns

Many charities are funded through commercial and revenue-generating activities. Hospitals and universities are examples where organizations may be for profit or nonprofit. Some charitable organizations, such as symphonies or zoos, operate in a commercial manner in a space not typically occupied by for-profit entities. Other charities engage in businesses that may not be related to their exempt purposes simply to raise funds. While it is well recognized that unrelated business activities can generate unrelated business taxable income (discussed in Part VIII below) and potentially risk exempt status, even related business activities can at times prove problematic. If a related business is undertaken in a way that the IRS deems to have a "distinctively commercial hue," the organization may risk its exempt status.[115] The terminology of an organization having a "distinctively commercial hue" is most often referenced in the context of the commerciality doctrine—a non-Code doctrine examining whether an organization operating a business is truly doing so in furtherance of an exempt purpose.[116] This doctrine is typically utilized with respect to organizations that operate in the same space as for-profit businesses, though traditional public charities such as hospitals are given a pass provided they satisfy the specific requirements for exemption.[117]

The commerciality doctrine uses a counterpart analysis. Among the factors considered are whether the organization sells goods and services to the public for a fee, whether the organization is "in direct competition" with for-profit organizations, whether the organization set prices based on pricing formulas common in the industry, whether the organization utilizes promotional materials normally utilized by for-profit organizations, whether the organization advertises its services in a commercial manner, whether the organization has activities and hours that are basically the same as for-profit enterprises, how the organization calculates payment for its management, and whether the organization receives charitable contributions. [118]

For example, in *Easter House*, the Claims Court considered qualification for exemption of an adoption agency.[119] After reciting the operational test, the court noted that "the key to determining whether an organization, which at first blush might appear to be engaged in commercial activities that would disqualify it from exemption under Section 501(c)(3), is qualified for exemption is whether the business purpose of the activities is incidental to the charitable purpose or vice versa."[120] In agreeing with the IRS and finding that the business purpose was primary, the court noted the agency's competition with commercial adoption agencies, the accumulation of substantial profits, a fee schedule intended to derive a profit, and a lack of any support from solicitations.[121]

Likewise, in a case frequently cited in the commerciality area, the Seventh Circuit affirmed the determination of the IRS and the holding of the Tax Court in holding that an organization operating restaurants and health food stores ostensibly for the purpose of furthering the religious work of the Seventh-Day Adventist Church did not qualify for exemption.[122] There, the court explained that, in considering the effect of substantial commercial purposes on qualification for exemption, a court looks to "various objective indicia" including the "manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of

---

were not manufactured by or donated to the charity. Tex. Tax Code § 151.310(c).

[114] *See, e.g.*, Op. Tex. Att'y. Gen. No. DM-112 (1992).

[115] *See, e.g.*, *Airlie Foundation*, 283 F. Supp.2d 58 72 AFTR2d 93-5026 (D. DC, 2003).

[116] For an in-depth look at the commerciality doctrine, see generally Hopkins, *The Law of Tax-Exempt Organizations*, §4.11 (John Wiley & Sons, Inc., 2011).

[117] For example, Section 501(r) requires charitable hospitals to meet certain requirements, including conducting a community health needs assessment, offering a financial assistance policy, and providing emergency care without regard to financial capacity, among others.

[118] *See, e.g.*, *Living Faith, Inc.*, 950 F.2d 365 69 AFTR2d 92-301 (CA-7, 1991).

[119] *Easter House*, 60 AFTR2d 87-5119, *aff'd*846 F.2d 78 (Fed. Cir., 1988).

[120] See *id.* at 60 AFTR2d 87-5124.

[121] See *id.* at 60 AFTR2d 87-5125-26.

[122] See *Living Faith*, *supra* note 27 at 950 F.2d 376-77.

annual or accumulated profits...."[123] The Seventh Circuit noted that the entity was in direct competition with other restaurants, had a price structure set competitively with other businesses and a lack of any below-cost pricing, used promotional materials to enhance sales, and lacked any plans to solicit contributions.[124]—Noting that the corporation did not accumulate net profits, the court considered that but one factor that was outweighed by the other "indicia" of commerciality.[125]

In *Airlie Foundation*,[126] the district court for the District of Columbia agreed with the IRS that the subject organization failed to qualify for exemption as its activities evidenced a primary commercial purpose. The organization was organized for educational purposes and carried out its mission through organizing, hosting, conducting, and sponsoring educational conferences.[127] The organization additionally provided certain administrative support for environmental studies conducted at its facility. In clearly setting out the commerciality doctrine, the court stated that "[i]n cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose."[128] The court analogized the facts in *Airlie* to the organization in *BSW Group*, noting that the organization did not directly benefit the public (rather, it benefited other organizations that benefited the public) and did not limit its activities to tax-exempt organizations.[129] The court balanced the entity's fee structure and its willingness to subsidize certain attendees (both indicative of a non-commercial purpose) against the nature of the entity's clients (both taxable as well as tax-exempt), competition with commercial organizations, advertising expenditures, and significant revenues derived from weddings and special events, ultimately determining that the entity was organized for a substantial commercial purpose.

While the commerciality doctrine is not new, the continuing increase in charitable organizations seeking sustainability through commercial activities, or seeking to operate as social enterprises, has given the commerciality doctrine increased exposure. While greater license may be given to tax-exempt organizations operating social enterprise subsidiaries, it would be unwise to ignore the application of the commerciality doctrine altogether in this context.[130] There is a clear tension that exists between a doctrine that seeks to define charity as acting in a non-commercial manner and the idea of social enterprise, which involves charitable purposes achieved directly through commercial activities. Because the commerciality doctrine is court-created rather than legislatively crafted, no bright line or safe harbor exists to guide the charitable entrepreneur.

The Tax Court has made clear that in determining whether an organization is operated to further a substantial non-exempt purpose, the decision maker is to look to the purposes furthered by an organization's activities rather than the nature of those activities.[131] The commerciality doctrine, in looking at the manner in which an organization carries out its activities in order to determine purpose, sets up a logical fallacy where purpose is the lens through which activities are viewed, yet those same activities somehow serve as an indication of purpose.[132] This circular argument is exemplified by the decision in *Living Faith*, in which the court initially noted that it must "focus on 'the purposes toward which an organization's activities are directed,' and not the nature of the activities" but subsequently stated that "[a]n organization's activities ... determine entitlement to tax exemption," and that "[w]hile 'the inquiry must remain that of determining the purpose to which the ... business activity is directed,' the activities provide a useful indicia of the organization's purpose or purposes."[133]

This type of ambiguity creates uncertainty and can lead to disparate results. No clear guidance exists to allow an organization comfort that its operations will show that its charitable or other exempt purpose trumps profit making. Indeed, in the hospital context (another situation in which taxable and tax-exempt organizations exist in the same sector), Congress

---

[123] See *id.* at 950 F.2d 372.

[124] See *id.* at 950 F.2d 373-374.

[125] See *id.* at 950 F.2d 374.

[126] Note 25, *supra.*

[127] See *id.* at 283 F. Supp.2d 60.

[128] See *id.* at 283 F. Supp.2d 63 (emphasis in original).

[129] See *id.* at 283 F. Supp.2d 65.

[130] See, e.g.,*Council for Bibliographic and Information Technologies*, TC Memo 1992-364 (ignoring the Service's arguments concerning the commercial hue of certain activities noting that the organization at issue was formed by and controlled by a tax-exempt organization). In addition to the fact that the organization was formed by a tax-exempt organization, it should not be overlooked that the organization was providing services that the court viewed as necessary and indispensable exclusively to tax-exempt organizations.

[131] See *B.S.W. Group, Inc*, 70 TC 352 (1978).

[132] See Chaney, "Commerciality, Charter School Management Organizations, and Social Enterprise," 27 Exempts 5, page 3 (Mar/Apr 2016).

[133] *Living Faith*, *supra* note 27, 950 F.2d at 370, 372.

enacted rules setting forth specific areas in which hospitals must provide demonstrable evidence that charitability trumps profit.[134] Outside of the hospital context, however, exempt organizations are left with the commerciality doctrine, discussions of a "commercial hue," and trying to ascertain indicia of commerciality. Rather than exist in this state of unknown, organizations at risk of violating the commerciality doctrine may choose to spin such activities off into a taxable subsidiary or related organization to avoid such risk.

VIII. UNRELATED BUSINESS INCOME/UNRELATED DEBT-FINANCED 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.[135] 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.[136] 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.[137] "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 a Section 501(c)(3) organization or by a Section 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.[138] The income and deductions are subject to the modifications under Section 512(b) of the Code.

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.[139]

a) Example 1. 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) Example 2. 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.

B. Unrelated Debt-Financed Income

1. 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.[140] "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.[141]

"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.[142] If proceeds from the debt financed

---

[134] Section 501(r).

[135] I.R.C. § 512(a)(1); § 514(a)(1); and § 514(a)(2).

[136] Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986).

[137] *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).

[138] I.R.C. § 513(a).

[139] I.R.C. § 512(b).

[140] I.R.C. § 512(a)(1), § 514(a)(2).

[141] I.R.C. §514 (b)(1); Treas. Reg. § 1.514(b)-1.

[142] *See* I.R.C. § 514(c)(1); Treas. Reg. § 1.514 (c)-1.

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 Section 514(c)(2) of the Code are all treated as similar to mortgages for purposes of applying Section 514(c)(2)(A) of the Code.

2. Exclusions from "Debt-Financed Property"

a) Property used by an organization in performing its exempt function, Code § 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 Section 514(a)(1) of the Code and debt-financed income under Section 514(b)(1)(B) of the Code.
c) Property used to derive research income, Code § 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]. Section 514(b)(1)(D) of the Code.
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, Section 514(c)(9)(A) of the Code provides that indebtedness incurred in acquiring or improving any real property is excluded from the application of Section 514 of the Code, subject to the exceptions outlined in Code § 514(c)(9)(B). The four "qualified organizations" eligible to use the exception under Section 514(c)(9) of the Code are as follows:

i. Educational organizations described in Code § 170(b)(1)(A)(ii);
ii. Affiliated support organizations described in Code § 509(a)(3) and educational organizations described in Code § 170(b)(1)(A)(ii);
iii. Qualified trusts under Code § 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 Code § 501(c)(25).

IX. ANNUAL FILING REQUIREMENTS AND PUBLIC DISCLOSURE

A. 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.[143] 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.

B. Public Disclosure

An organization's annual information return—Form 990 (or 990–N, 990–EZ, or 990–PF)—as well as the organization's Form 990–T (disclosing UBTI) are required to be held open for public inspection.

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

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 IRS to receive a copy of 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 office during regular business hours.[144] 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. CHARITABLE IMMUNITY

A. No Common Law Charitable Immunity

Historically, a doctrine in Texas law held that charities were immune from liability for the negligent acts of their servants, for which those charities would incur vicarious liability without the immunity. For example, if a church's agent acted negligently within the scope of the agent's responsibilities, under the doctrine of charitable immunity the church would not have been vicariously liable for the acts of the agent.

However, in 1971, the Texas Supreme Court abrogated the doctrine of charitable immunity with respect to causes of action alleging vicarious liability. Therefore, since that date, charitable organizations have been subject to vicarious liability for negligent acts of their agents taken within the agent's scope of authority.

B. Chapter 84 of the Texas Civil Practice and Remedies Code

1. Definition of a Charitable Organization

In response to the growing increase in liability against entities carrying out charitable purposes, the Texas legislature passed the Charitable Immunity and Liability Act of 1987 (the "Act"), codified in Chapter 84 of the Texas Civil Practice and Remedies Code. One of the stated purposes of the statute is to remedy the unwillingness of volunteers to serve in organizations due to their perception of the risk of personal liability related to those services.

The threshold issue to qualify for the protection afforded by the Act is whether the organization is a "charitable organization" as that term is defined therein. Section 84.003 defines charitable organization as follows:

> (1) "Charitable organization" means:
>
> (A) any organization exempt from federal income tax under Section 501(a) of the Internal Revenue Code of 1986 by being listed as an exempt organization in Section 501(c)(3) […] of the code, if it is a corporation, foundation, community chest, church, or fund organized and operated exclusively for charitable, religious, […] or educational purposes […];
>
> (B) any bona fide charitable, religious, […] or educational organization […] or other organization organized and operated exclusively for the promotion of social welfare by being primarily engaged in promoting the common good and general welfare of the people in a community, and that:
>
> (i) is organized and operated exclusively for one or more of the above purposes;
>
> (ii) does not engage in activities which in themselves are not in furtherance of the purpose or purposes;
>
> (iii) does not directly or indirectly participate or intervene in any political campaign on behalf of or in opposition to any candidate for public office;

[144] *See* Bus. Org. Code § 22.353.

(iv) dedicates its assets to achieving the stated purpose or purposes of the organization;
(v) does not allow any part of its net assets on dissolution of the organization to inure to the benefit of any group, shareholder, or individual; and
(vi) normally receives more than one-third of its support in any year from private or public gifts, grants, contributions, or membership fees.

To be described in Section 501(c)(3) of the Code, an organization must be organized and operated exclusively (which the Treasury Regulations define as "primarily") for certain exempt purposes (including charitable and religious), must not allow its net assets to inure to the benefit of shareholders or other insiders (though reasonable compensation is allowed), must not be an action organization (by means of substantial lobbying or political campaign intervention), and must not be organized for a purpose that violates public policy. To be organized for exempt purposes, the purpose of the organization in its governing documents must be appropriately exempt (such as charitable, religious, or educational) and the organization must pledge that on its discontinuance its assets will pass to another Section 501(c)(3) organization or a local, state or federal government. To be operated for exempt purposes, the organization's activities must be primarily in pursuit of its exempt purposes as identified in its governing documents.

While an organization meeting the elements set out above is described under Section 501(c)(3) of the Code, to be entitled to exemption from federal income tax and to be able to accept deductible donations, it is generally required that an organization apply to the IRS on Form 1023, Application for Recognition of Exemption, and receive a determination letter from the IRS in response. Thereafter the organization will be listed by the IRS in its Exempt Organizations Business Master File ("BMF"). Exceptions to the filing requirement are made for churches, associations of churches, integrated auxiliaries of churches, and organizations that normally receive less than $5000 per year in gross revenues. These organizations, though exempt from federal income tax and able to accept deductible donations, are not included in the BMF unless they take the extra step of applying on Form 1023. However, the IRS has a process for what it terms a "group exemption" whereby an organization may apply on behalf of itself and its subordinates. Once the group exemption is recognized, the group exemption holder and its subordinates are listed in the BMF. An extract of the BMF showing the list of organizations recognized as exempt by the IRS is publicly available online at https://www.irs.gov/charities-non-profits/exempt-organizations-business-master-file-extract-eo-bmf.

Section 84.003(B) was included to address organizations that do not file Form 1023 to be listed in the BMF or would not be eligible to file Form 1023 on the basis that they are not charitable but rather are organizations such as homeowners associations or chambers of commerce. Rather than being listed in the BMF, the organization must be a "bona fide" charitable, religious, or other defined type of organization "organized and operated exclusively for the promotion of social welfare by being primarily engaged in promoting the common good and general welfare of the people in a community" and satisfying certain other standards as quoted above.

Once it has been determined that an entity falls within the definition of a charitable organization under the Act, the volunteers and employees of the organization, as well as the organization itself, enjoy the immunities described below. However, charitable organizations and their employees and volunteers are still well-advised to confirm that adequate liability insurance coverage exists with respect to their activities.

2. Volunteer Immunity

A volunteer is a person who renders services for or on behalf of a charitable organization but who does not receive compensation in excess of reimbursement for expenses incurred. "Volunteer" includes a person serving in the capacity of a director, officer, trustee, or direct service volunteer.

A volunteer of a charitable organization is immune from civil liability for any act or omission resulting in death, damage, or injury if the volunteer was acting in the course and scope of the volunteer's duties or functions, including as an officer, director, or trustee within the organization.

All volunteers, without regard to the type of service they provide to the charitable organization, are liable for death, damage or injury to a person or a person's property that is proximately caused by an act or omission arising from the operation or use of any motor driven equipment, including an airplane or boat, to the extent of insurance coverage required by Texas law, or, if greater, any existing insurance coverage applicable to the act or omission. Thus, a volunteer who acts within the scope and course of his or her duties is not liable other than to the extent of liability insurance that he or she is required to have under Texas law or that he or she actually has in place. This is intended to make available any liability insurance coverage for the injured individual, without subjecting the volunteer to additional out-of-pocket exposure.

3. Employee and Organizational Immunity

An employee is defined as any person, including an officer or director, who is in the paid service of a charitable organization (regardless of the level of compensation), but this definition does not include an independent contractor. A non-hospital charitable organization and employees of such an organization enjoy limited immunity only if the charitable organization has certain amounts of liability insurance coverage in place for the act or omission of the organization, its employees, and its volunteers. The minimum amounts are as follows: (i) $500,000 for each person; (ii) $1,000,000 for each single occurrence for death or bodily injury; and (iii) $100,000 for each single occurrence for injury to or destruction of property. These amounts must be provided under a contract of insurance or other plan of insurance authorized by statute and may be satisfied by the purchase of a $1,000,000 bodily injury and property damage combined single limit policy. The employee and the non-hospital charitable organization enjoy immunity for any liability in excess of those amounts. For the limited immunity to apply, the employee of a non-hospital charitable organization must act in the course and scope of the person's employment at the time of the act or omission resulting in death, damage, or injury.

The purpose of this limited immunity is to allow liability to remain to the extent of the amount of liability insurance coverage the legislature has decided would be prudent for the charitable organization to have in place to cover itself and its employees and volunteers, without causing the charitable organization or the employee to pay any out-of-pocket amounts with respect to such liability. The Act provides that the insurance coverage must apply to any act or omission to which the Act applies. Accordingly, it is reasonable to assume that for the limitations provided under the Act to apply, the charitable organization must have the requisite amounts of insurance to cover the subject liability. In other words, a church should review its activities and, working with its insurer, seek to have appropriate coverage in terms of both amount and scope.

4. Exceptions

The Act does not apply to any act or omission that is intentional, willfully negligent, or done with conscious indifference or reckless disregard for the safety of others (more extreme than ordinary negligence). With respect to this standard, Texas courts have analogized to the standard of gross negligence. Texas Civil Practice & Remedies Code Section 41.001(11) defines gross negligence as follows:

> "Gross negligence" means an act or omission: (A) which when viewed objectively from the standpoint of the actor at the time of the occurrence involves an extreme degree of risk, considering the probability and the magnitude of the potential harm to others; and (B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others."

The Act also does not limit or modify the duties or liabilities of the leaders of an organization to the organization itself or to its members and shareholders. Other exceptions exist that are generally not applicable to churches.

C. Federal Volunteer Protection Act

Federal law also provides limited immunity for volunteers of charitable organizations. The Volunteer Protection Act of 1997 provides civil liability protection for nonprofit or government volunteers if:

(i) the volunteer was acting within the scope of his/her responsibility at the time of the alleged act or omission;
(ii) the volunteer was properly licensed, certified or authorized to engage in the activity or practice (if required by the state in which the damage occurred) and those activities were within the scope of the volunteer's responsibility;
(iii) the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct or a "conscious, flagrant indifference" to the rights or safety of the individual harmed by the volunteer;
(iv) the harm was not caused by the operation of a motor vehicle, vessel, or aircraft for which an operator's license or insurance is required by the state; and
(v) the volunteer either receives no compensation other than reimbursement or expenses, or does not receive anything of value in lieu of compensation in excess of $500 per year.

As can be seen, the federal law does not greatly expand the broad protection already afforded to volunteers in Texas.

XI. 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.[145] 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 fifth 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 this article touches upon a number of different topics, it should still be seen as a broad overview intended for practitioners practicing outside of the area of nonprofit organizations. Each of the subject matters addressed in this article could, in turn, be stand-alone articles of their own. Needless to say, if nothing else, the "non-nonprofit lawyer" should be aware that nonprofit organizations, and particularly charitable organizations, are highly regulated both under state and federal law and the practitioner is advised to consider these regulations and their impact on a particular charity any time advice is given.

[145] *See* BOC § 22.164.