

The Tax Law of Associations

Bruce R. Hopkins



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The Tax Law of Associations



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This book is dedicated to all who lead and manage the associations
I am privileged to represent.

Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France or a man of rank in England, in the United States you will be sure to find an association.

—Alexis de Tocqueville, *Democracy in America* (1835)

About the Author

Bruce R. Hopkins is the country's leading authority on the law of tax-exempt organizations and is a lawyer with the firm Polsinelli Shalton Welte Suelthaus PC. He is also the author of 19 books, including *The Law of Tax-Exempt Organizations, Eighth Edition*; *Planning Guide for the Law of Tax-Exempt Organizations*; *The Tax Law of Unrelated Business for Nonprofit Organizations*; *Nonprofit Law Made Easy*; *650 Essential Nonprofit Law Questions Answered*; *The Law of Fundraising, Third Edition*; *Private Foundations: Tax Law and Compliance, Second Edition*; *The Tax Law of Charitable Giving, Third Edition*; *The Law of Intermediate Sanctions*; and *The Law of Tax-Exempt Healthcare Organizations, Second Edition*; all published by John Wiley & Sons. Mr. Hopkins also writes the monthly newsletter *Bruce R. Hopkins' Nonprofit Counsel*, also published by John Wiley & Sons.

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Preface

A lawyer with a fulltime tax-exempt organizations practice, spanning many years (decades), is privileged to represent several categories of exempt organizations, including colleges, universities, and schools; health care institutions; churches and other religious organizations; other public charities; private foundations; advocacy organizations; associations; social clubs; and fraternal and veterans' organizations. Lawyers in this circumstance may also have the opportunity to serve a cemetery company, a crop operations financing organization, or a state-sponsored workers' compensation entity. Each exempt organization presents unique problems, issues, and forms of gratification (particularly if the problems and issues are satisfactorily resolved).

Tax-exempt organizations lawyers (or, if you will, nonprofit lawyers) know better than to publicly favor one type of exempt organization client over another. Yet favorites are inevitable, because of the nature of the work generated (depth, complexity, variety) and/or the individuals involved (personalities, intelligence, challenges).

Take, for example, associations. The exempt organizations lawyer will find, at these organizations, interesting, energetic, dedicated, and motivated individuals (on the board and on the staff), who preside over a dazzling array of substantive questions and issues of law. As to the latter, the entire panoply of the law of tax-exempt organizations is presented: eligibility for exemption, private inurement, legislative activities, political activities, related foundations, for-profit subsidiaries, partnerships and other joint ventures, annual reporting issues, unrelated business rules, and more. And that is just the federal tax law. A lawyer representing an association and/or affiliated entity can also feast on law concerning antitrust, campaign finance, charitable solicitation, contracts, employee benefits, insurance, intellectual property, and a host of other issues.

* * *

Your author has had, and is having, the pleasure of writing and updating (through editions and supplements) *The Law of Tax-Exempt Organizations*. Some subjects in that book are too expansive to be contained within its pages, generating other law books, such as those directly relating to private foundations and the unrelated business rules. So, too, with the matter of associations. There is a chapter in the exempt organizations book on these entities (business leagues), but it has proved to be insufficient. There was so much more to explore and analyze.

PREFACE

Thus, this book. Here, the association executive, board member, lawyer, accountant, and anyone else interested in the tax law of associations will find full discussions of topics common (and often unique) to tax-exempt associations: the concept, evolution, forms, and roles of associations (Chapter 1); requirements for tax exemption (Chapter 2); private inurement, private benefit, and excess benefit transactions (Chapter 3); lobbying and political campaign activities (Chapter 4); the unrelated business rules (Chapter 5); for-profit subsidiaries and limited liability companies (Chapter 6); partnerships and joint ventures (Chapter 7); association-related foundations (Chapter 8); charitable giving and fundraising (Chapter 9); annual reporting and disclosure requirements (Chapter 10); and non-tax association law (Chapter 11). There is even a little bit of history.

* * *

The Internal Revenue Service, a few years ago, embarked on an ambitious project to examine, on a statistical analysis basis, the entire tax-exempt sector. The agency conceived of the sector as consisting of around 40 market segments; the plan was to analyze each one and use the resulting data to support regulation projects, examination criteria, public and private rulings, and perhaps proposed legislation. Summary data from these analyses was to be made public, the first in early 2004. The project has not been faring well, with IRS resources diverted to other ends.

One of the first of the market segment studies concerned business leagues. When this book was conceived, there was to be an epilogue, which was to be based on the market segment analysis of the nation's tax-exempt associations. As of mid-2006, that report has not materialized; the same fate befell the epilogue. Perhaps, some day, that analysis will emerge and when it does it will be incorporated into this book, in a supplement, cumulative supplement, or edition.

* * *

This book is infused with (and, in part, stimulated by) admiration and appreciation for those who lead and manage associations. Your author has been representing associations for nearly four decades, and is grateful for the tough legal problems, all the air travel, and sheer fun. Association conventions, conferences, seminars, and board meetings generate many memorable occurrences, some of which ought not to be recounted here. Association representation can even lead to marriage.

* * *

I wish to express my deep and sincere thanks for the help and support on this project provided by senior editor, Susan McDermott, and senior production editor, Kerstin Nasdeo.

BRUCE R. HOPKINS
June, 2006

The Tax Law of Associations

CHAPTER ONE

Associations, Society, and the Tax Law

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The term *association* does not have legal efficacy; although used constantly, it is, like many other terms bandied about in the nonprofit sector (such as *fund*, *foundation*, or *society*), not a formal term of law (as opposed to *corporation* or *trust*). Niceties of the law aside, however, associations are plentiful, powerful, increasing in number, and a significant component of a free society and a democratic state. Current estimates are that there are over 140,000 associations in the United States; there are thousands more in other countries.¹

§ 1.1 INTRODUCTION TO ASSOCIATIONS

Dictionaries provide many definitions of the word *association*; the one that casts the term, as a noun, to mean a form of organization in essence states that an association is an organization of persons having a common interest. Synonyms are *society*, *league*, and *union*. The term, of course, derives from the verb *associate*, which means (in this context) “to join, share, or unite with others.”

The principal advocate for associations in the United States is the American Society of Association Executives (ASAE), located in Washington, D.C. This organization, generally regarded as the “association of associations,” defined the term *association* as a nonprofit organization that is “membership-based,” “private” (as opposed to for-profit or governmental), and “legally incorporated,” and has a “public benefit purpose.”² This definition is essentially correct,³ and thus, for purposes of this book:

Association is defined as a nonprofit membership organization that provides services to its members in achievement of an objective of enhancing conditions within a trade, industry, or profession, and, in the process, provides substantial benefits to the public.⁴

Members of an association can be individuals, organizations (for-profit and/or nonprofit, tax-exempt or taxable), or both.

Most associations in the United States are exempt from federal income taxation. State income taxation exemption is usually also available. The federal tax law, since 1913,⁵ characterizes most of these organizations as *business leagues*.⁶

¹ The Union of International Associations, headquartered in Brussels, Belgium, states that it is a clearinghouse for information on over 40,000 “international organizations and constituencies” (www.uia.org).

² This definition is in a brochure prepared by ASAE titled “How Associations Make a Better World,” available at www.asaenet.org/betterworld (referenced throughout as ASAE, “How Associations Make a Better World”).

³ A finicky lawyer will take issue with the third of these elements, noting (1) that the phrase “legally incorporated” is redundant, in that an entity is either incorporated pursuant to a statute or it is not (and it is difficult for an organization to be “illegally incorporated”) and, more important, (2) an organization can be an association without being incorporated.

⁴ The Department of Commerce once defined a *trade association* as a “nonprofit, cooperative, voluntarily joined, organization of business competitors designed to assist its members and its industry in dealing with mutual business problems” (Judkins, *National Associations of the United States* vii (1949)). This definition, however, excludes from the ambit of the term *association* professional societies and associations the members of which are tax-exempt organizations.

⁵ Tariff Act of October 3, 1913, 38 Stat. 114, 172.

⁶ Internal Revenue Code of 1986, as amended, section (IRC §) 501(c)(6).