NONPROFIT LAW MADE EASY

Bruce R. Hopkins

John Wiley & Sons, Inc.
About the Author

Bruce R. Hopkins is a lawyer in Kansas City, Missouri, with the firm of Polsinelli Shalton Welte Suelthaus PC, having practiced law in Washington, D.C., for 26 years. He specializes in the representation of tax-exempt organizations. His practice ranges over the entirety of tax matters involving exempt organizations, with emphasis on the formation of nonprofit organizations, acquisition of recognition of tax-exempt status for them, the private inurement and private benefit doctrines, the intermediate sanctions rules, legislative and political campaign activities issues, public charity and private foundation rules, unrelated business planning, use of exempt and for-profit subsidiaries, joint venture planning, review of annual information returns, Internet communications developments, the law of charitable giving (including planned giving), and fundraising law issues.

Mr. Hopkins served as chair of the Committee on Exempt Organizations, Tax Section, American Bar Association; chair, Section of Taxation, National Association of College and University Attorneys; and president, Planned Giving Study Group of Greater Washington, D.C. He was accorded the Assistant Commissioner’s (IRS) Award in 1984.


Mr. Hopkins earned his J.D. and L.L.M. degrees at the George Washington University and his B.A. at the University of Michigan. He is a member of the bars of the District of Columbia and the state of Missouri.
# Table of Contents

## Preface ix

### Chapter 1 Forming a Nonprofit Organization 1
- A Philosophical Framework 1
- Defining Nonprofit Organization 5
- Purpose of Organization 6
- Location of Organization 9
- Selection of Organization Form 10
- Name of Organization 12
- Composition of Governing Body 13
- Officers and Key Employees 18
- Management Companies 22
- Minutes 22
- Other Documents 24
- Summary 26

### Chapter 2 Acquiring and Maintaining Tax-Exempt Status 29
- Concept of Tax Exemption 29
- Eligibility for Tax-Exempt Status 30
- Recognition of Tax-Exempt Status 31
- Categories of Tax-Exempt Organizations 31
- Selection of Appropriate Category 33
- Application Process 34
- Timing 36
- Exceptions 37
- Notice Requirements
  - for Political Organizations 38
- Preparation of Applications 39
- Reliance on Determination 40
- Maintenance of Exempt Status 41
- Changes in Organizational Form 41
- Material Changes 42
- Group Exemption 43
- Summary 46
# Table of Contents

## Chapter 3 Public Charities and Private Foundations 47
- Defining Private Foundation 47
- Defining Public Charity 48
- What Difference Does It Make? 51
- Disqualified Persons 52
- Determining Public Support—Tricks of the Trade 53
- Focus on Supporting Organizations 58
- Hybrid Foundations 62
- Rules for New Organizations 64
- Private Foundation Rules 65
- Termination of Status 70
- Donor-Advised Funds 72
- Summary 73

## Chapter 4 Reporting Requirements 75
- Federal Law Basics 75
- A Multitude of Forms 82
- Form 990 Glossary 83
- Annual Information Return—A Law Perspective 87
- Law Perspective on Preparation of Returns 89
- State Law Requirements 94
- Watchdog Agencies 95
- Summary 96

## Chapter 5 Charitable Giving 97
- Basic Concepts 97
- Defining Charitable Gift 98
- Qualified Donees 99
- Gifts of Property 100
- Limitations on Deductibility 101
- Deduction Reduction Rules 103
- Twice-Basis Deductions 104
- Contributions of Vehicles 105
- Contributions of Intellectual Property 106
- Partial Interest Gifts 106
- Gifts of Insurance 107
- Planned Giving 107
- Summary 117
Chapter 6  Disclosure Requirements 119
Applications for Recognition of Exemption 119
Annual Information Returns 121
Gift Substantiation Requirements 121
Quid Pro Quo Contributions 123
Disclosure by Noncharitable Organizations 126
Disclosure of Gifts of Property 128
Dispositions of Contributed Property 130
Appraisal Requirements 131
Offering of Information or Services 135
Tax Shelters 136
Summary 138

Chapter 7  Unrelated Business Activities 139
Statutory Framework 139
Affected Tax-Exempt Organizations 141
Conduct of Business 142
Regularly Carried-On Businesses 144
Related or Unrelated? 145
Unrelated Business Taxable Income 147
Exempted Activities 147
Exempted Income 150
Exceptions to Exceptions 151
Corporate Sponsorships 152
Internet Activities 156
Commerciality Doctrine 157
Summary 158

Chapter 8  Fundraising Regulation 159
State Regulation of Fundraising 159
State Charitable Solicitation Acts 160
States’ Police Power 167
Constitutional Law Considerations 168
Federal Regulation of Fundraising 170
Fundraising by Means of the Internet 176
Summary 183

Chapter 9  Building on the Basics 185
Fundamentals of Bifurcation 185
Definition of Subsidiary 188
Determining Need for Subsidiary 189
Legal Form of Subsidiary 191
<table>
<thead>
<tr>
<th>Chapter 10</th>
<th>Nonprofit Law Traps</th>
<th>209</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Primary Purpose Rule</td>
<td>209</td>
</tr>
<tr>
<td></td>
<td>Private Inurement</td>
<td>210</td>
</tr>
<tr>
<td></td>
<td>Private Benefit</td>
<td>216</td>
</tr>
<tr>
<td></td>
<td>Intermediate Sanctions</td>
<td>218</td>
</tr>
<tr>
<td></td>
<td>Legislative Activities</td>
<td>221</td>
</tr>
<tr>
<td></td>
<td>Political Activities</td>
<td>226</td>
</tr>
<tr>
<td></td>
<td>Summary</td>
<td>230</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 11</th>
<th>Still More Law</th>
<th>231</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Constitutional Law</td>
<td>231</td>
</tr>
<tr>
<td></td>
<td>Postal Laws</td>
<td>235</td>
</tr>
<tr>
<td></td>
<td>Federal Election Laws</td>
<td>237</td>
</tr>
<tr>
<td></td>
<td>Securities Laws</td>
<td>246</td>
</tr>
<tr>
<td></td>
<td>Antitrust Laws</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>Management of Institutional Funds Act</td>
<td>251</td>
</tr>
<tr>
<td></td>
<td>Other Laws</td>
<td>252</td>
</tr>
<tr>
<td></td>
<td>Summary</td>
<td>252</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 12</th>
<th>Governance Principles and Liability</th>
<th>253</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basics of Corporate Governance Principles</td>
<td>253</td>
</tr>
<tr>
<td></td>
<td>Emerging Concepts</td>
<td>254</td>
</tr>
<tr>
<td></td>
<td>Board Member Responsibilities</td>
<td>256</td>
</tr>
<tr>
<td></td>
<td>Lawsuits against Nonprofit Organizations</td>
<td>259</td>
</tr>
<tr>
<td></td>
<td>Individuals as Defendants</td>
<td>260</td>
</tr>
<tr>
<td></td>
<td>Protection against Personal Liability</td>
<td>261</td>
</tr>
<tr>
<td></td>
<td>Management Companies Revisited</td>
<td>266</td>
</tr>
<tr>
<td></td>
<td>Watchdog Agencies</td>
<td>267</td>
</tr>
<tr>
<td></td>
<td>Summary</td>
<td>270</td>
</tr>
</tbody>
</table>

| Index                |                             | 271 |
Preface

My editor, Susan McDermott, asked me to write this book. That fact is not entirely unique; that also happened recently (650 Essential Nonprofit Law Questions Answered (2005)). Indeed, previous editors at Wiley have requested—or at least suggested—books. (My response to each of these requests has been consistent and swift: yes.)

This book, however, is unique in another respect: it blatantly mimics another Wiley book, titled Not-for-Profit Accounting Made Easy. Lawyers and accountants in the nonprofit realm populate overlapping universes, so this companion volume is a natural. Susan wanted a law book to accompany this accounting book; here it is.

I have never discussed this accounting book with its author, Warren Ruppel. I cannot imagine, however, that he extracted as much enjoyment from the process as I did. After years of writing technical and long books about various aspects of nonprofit law, writing this one was pure fun. The biggest challenge, not surprisingly, was what to include and (the painful part) what to leave out. This book thus reflects my take on what constitutes the fundamentals of the law of nonprofit organizations. (The title of my book also reflects my ongoing disagreement with the accounting profession and others over the use of not-for-profit rather than nonprofit.)

In any event, I had an easier time of it than Mr. Ruppel did. He had to create his book; I had merely to imitate it. The substance obviously is different but the format is unabashedly copied. Consequently, the book is about the same length, there also are a dozen chapters, each chapter opens with an inventory of what is coming and ends with a chapter summary, and there are no footnotes. Both books share a similar jacket design. So, Mr. Ruppel and Wiley designed the vessel; I poured my descriptions of the law into it.
Back to this matter of what to include and what to exclude. I included the absolute basics (such as the private inurement doctrine, the lobbying rules, the unrelated business rules, and planned giving) but I wanted to include more, so I toyed with some emerging concepts.

Nonprofit law is as dynamic as law can get; capturing what appears to be the “basics” at a point in time can be elusive. For example, as this book goes to press, nonprofit corporate governance principles are rapidly developing. Congress (the 109th, meeting 2005-2006) seems poised to enact major tax-exempt organizations legislation, the IRS has ambitious regulations and rulings projects, and the courts are certain to contribute their share of new law. I have tried to inject references to the prospects of this and other coming law among the summaries of the basics.

As a non-accountant in the nonprofit field, I am glad to have Not-for-Profit Accounting Made Easy as a guide to the basics of the accounting principles and rules. I have tried to emulate Mr. Ruppel’s work, to provide an equally valuable volume for the non-lawyer who wants a grounding in nonprofit law.

Bruce R. Hopkins

2005
The purpose of this chapter is to provide basic information about the law concerning the formation of nonprofit organizations. This will serve as a basis for understanding much of the law summarized in the subsequent chapters. Specifically, this chapter will:

- Provide a nonprofit organizations philosophical framework
- Define the term *nonprofit organization*
- Address the matter of the organization’s *purposes*
- Explain the selection of the *form* of the organization
- Explain where to *locate* the organization
- Focus on the composition of the organization’s *governing body*
- Address the matter of the organization’s *officers* and *key employees*

**A PHILOSOPHICAL FRAMEWORK**

Before delving into the law of nonprofit organizations, one may ask: Why are there nonprofit organizations in the United States?

The answer is that the United States was founded on several principles, with one of the chief ones being distrust of the state—that is, government. Consequently, there has been heavy reliance on nonprofit organizations in our society since the birth of the nation. From the beginning, the U.S nonprofit sector has served as an alternative to the governmental sector as a means for addressing society’s problems.
This, then, is a matter of political philosophy. The emergence and role of nonprofit organizations was not stimulated by the tax law. The key concept underlying this philosophy is pluralism; more specifically, the pluralism of institutions, which features competition among various institutions in the three sectors of U.S. society (nonprofit entities, governmental agencies, and for-profit businesses). In this context, the competition is between the nonprofit and governmental sectors. This philosophy is embodied in the writings of philosophers such as John Stuart Mill and Alexis de Tocqueville. The latter wrote that Americans were constantly forming associations and societies, rather than turning to government for solutions to problems.

Much literature exists on this subject. This philosophy is well articulated in, for example, the Report of the Commission on Private Philanthropy and Public Needs (1975). The Secretary of the Treasury told the House Committee on Ways and Means that charities are an “important influence for diversity and a bulwark against overreliance on big government” (1973). John Gardner wrote that the “private pursuit of public purpose is an honored tradition in American life” (1979). Max Lerner wrote that the “associative impulse is strong in American life.” Richard C. Cornuelle wrote that “[w]e have been unique because another sector, clearly distinct from the other two, has, in the past, borne a heavy load of public responsibility.” John D. Rockefeller III wrote that the “third sector is . . . the seedbed for organized efforts to deal with social problems.”

This conflict and tension among the sectors—a sorting out of the appropriate role of government and nonprofit organizations—is, in a healthy society, a never-ending process, ebbing and flowing with the sentiments and politics of the day. Indeed, it is because of this tension that there is a healthy society to begin with—which is to say, a free society.

The federal income tax exemption for nonprofit organizations thus is a reflection of and is in furtherance of the American way of life. The exemption is a manifestation of a free society. It is based on the previously expressed view that many of society’s problems can be solved by means other than the intervention of governmental agencies. Individuals can rarely act alone in this regard; they must function collectively, which means either through nonprofit organizations or governmental bodies. The American bias, based on distrust of government, is to favor the former.
The policy rationale for tax exemption is thus rested on this political philosophy, rather than tax policy. When a constitutional income tax came into existence in 1913, Congress created tax exemption for charitable organizations but did not leave any legislative history on the subject. It is generally assumed that Congress, back then, viewed tax exemption for charitable organizations as the only way to consistently correlate tax policy to political theory on the point, and saw the exemption of charities as an extension of comparable practice throughout the whole of history. One observer stated that the “history of mankind reflects that our early legislators were not setting precedent by exempting religious or charitable organizations” from income tax.

The charitable contribution deductions (in the income, gift, and estate tax law) are likewise part of the federal tax law because of the belief of Congress that the services provided by charitable organizations are valuable to U.S. society and that the existence of these organizations is inherently a significant part of the American social order. These deductions are in the law to stimulate contributions to charitable organizations. The charitable deduction is based on the same philosophical premise as the tax exemption. The Supreme Court wrote, in 1983, that, in enacting both the exemption and deduction provisions, “Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind.”

One of the issues of the day is whether tax exemption and the charitable deductions amount to government subsidies. Those who argue that they are assert that tax exemption is merely a subsidy provided by government to the nonprofit sector. Likewise, this view has it that the charitable deduction is a subsidy of a donor that is provided either by the government or by all other taxpayers. This view is based on the fact that, absent the workings of the deduction, more funds would flow to the U.S. treasury. The contrary view is that the subsidy rationale is misguided because it is based on the assumption (almost always unstated) that the subsidy is of funds to which the government is initially entitled. Yet, the rationale for the exemption and deduction make it clear that tax exemptions are beneficial to the social order, to promote pluralism.

The government generally leaves the nonprofit sector alone
when it comes to taxation. The money flowing to the sector does not belong to the government to begin with; thus, there cannot be a subsidy. The practical problem, obviously, is that, like any tax preference, tax exemptions and deductions shrink the tax base involved, so that one can (superficially) argue that they constitute subsidies. But, in the realm of charity, this approach takes the exemptions and deductions out of context, and—in an example of an analytical approach that the Supreme Court on occasion has labeled *wooden, unthinking,* and *crabbed*—ignores the philosophical construct. To paraphrase the Supreme Court, to treat exemptions and deductions as government subsidies is to “tear them from their roots.”

In one of its first pronouncements on the point, the U.S. Supreme Court (albeit somewhat hesitantly) concluded, soon after enactment of the constitutional income tax in 1913, that the foregoing rationalization was the basis for the federal tax exemption for charitable entities. The Court wrote in 1924 that “[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain.” In 1970, the Court wrote that the state “has an affirmative policy that considers these groups [that is, tax-exempt charities] as beneficial and stabilizing influences in community life and finds this classification useful, desirable, and in the public interest.”

In 1983, the Court wrote (this time without hesitancy) that “[c]haritable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues.” In this opinion, the Court added that tax exemptions “for certain institutions thought beneficial to the social order of the country as a whole, or to a particular community, are deeply rooted in our history, as in that of England. The origins of such exemptions lie in the special privileges that have long been extended to charitable trusts.” The Court reviewed case law and concluded that “[t]hese statements clearly reveal the legal background against which Congress enacted the first charitable exemption statute in 1894: charities were to be given preferential treatment because they provide a benefit to society.”
The Court has viewed tax exemption and the charitable contribution deductions as subsidies provided by government. It first indicated its view in this regard in 1983, when it observed: “When the Government grants exemptions or allows deductions all taxpayers are affected; the very fact of the exemption or deduction for the donor means that other taxpayers can be said to be indirect and vicarious ‘donors.’”

Oddly, this was not the original view of the Court. In 1970, it conceded that granting tax exemption “necessarily operates to afford an indirect economic benefit.” But it also observed that the “grant of a tax exemption is not sponsorship [that is, not a subsidy] since the government does not transfer part of its revenue” to exempt organizations.

The current federal and state governments’ crackdown on charitable and other nonprofit organizations shows that the governmental sector can become intolerant of the nonprofit sector. Tax exemption and the charitable contribution deductions are not protected by constitutional law principles. Thus, the nonprofit sector is always open to government regulation. The sector is dependent on restraint by government as to regulation of it, so as to preserve pluralism. It is always a perilous position for the sector to be in.

**Note** Most of the law discussed in this book is federal tax law as administered and enforced by the Internal Revenue Service (IRS), a component of the Department of the Treasury. Appropriate state law should also be consulted, such as a state’s nonprofit corporation act and the states’ charitable solicitation act. Other federal, state, and local law may be applicable, however (see Chapter 12).

**DEFINING NONPROFIT ORGANIZATION**

The term nonprofit organization consistently generates confusion. For one thing, the term does not refer to an organization that is prohibited by law from earning a profit (that is, an excess of revenue over expenses). In fact, it is quite common for nonprofit organizations to generate profits. Rather, the definition of nonprofit organization essentially relates to requirements as to what must be done with the profits earned.
A nonprofit organization may be contrasted with a for-profit organization. The for-profit organization has owners that hold equity in the enterprise, such as stockholders of a corporation. For-profit entities are operated for the benefit of their owners: the profits of the business undertaking are passed through to them, such as by the payment of dividends on shares of stock. That is what is meant by the term for-profit organization: It is one designed and operated to generate a profit for its owners. The transfer of profits through the organization to its owners is known as private inurement.

By contrast, nonprofit organizations are not supposed to engage in private inurement. They are expected to devote their profits to their nonprofit purposes and activities. Consequently, the doctrine of private inurement is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit entities.

Another source of confusion is use of the term tax-exempt organization. The two terms do not mean the same, although there is considerable overlap. An organization can be a nonprofit one without being tax-exempt. Nearly all tax-exempt organizations, however, are nonprofit entities. State law usually determines whether an organization is a nonprofit entity. The federal tax law generally is the basis for an organization’s tax-exempt status (if any).

A third source of confusion is the term charitable organization. Just as all nonprofit organizations are not tax-exempt, not all tax-exempt organizations are charitable in nature. The term charitable, while it certainly has its technical elements, generally embraces organizations that are educational, scientific, religious, and the like. The Supreme Court held that all of these organizations must meet “certain common law standards of charity—namely, that an institution seeking tax-exempt status [as a charitable entity] must serve a public purpose and not be contrary to established public policy.” Further, contributions to these entities are generally eligible for the charitable contribution deduction.

**PURPOSE OF ORGANIZATION**

One of the fundamental first steps a nonprofit organization must necessarily take is identification of its purposes. This is not just dictated by the law; each organization simply, as a practical matter,
must state its purpose or purposes for existence in writing. An organization’s purposes are different than an organization’s activities. Activities are undertaken to effectuate purposes.

An organization’s statement of purposes must first be written to comport with the applicable state’s nonprofit law. This usually is not too difficult to achieve, as long as the statement does not empower the organization to engage in substantial commercial activities.

Second, the statement of purposes needs to be prepared properly to enable the organization to qualify for tax-exempt status (assuming that classification is available and desired). This statement must be in the organization’s articles of organization, which is the document creating the entity (and is discussed later in this chapter). The contents of this aspect of the statement are dependent on the type of tax-exempt organization the nonprofit entity intends to be.

The types of tax-exempt organizations are reviewed in Chapter 2. Generally, however, the choice will be one of the following:

- Charitable organization
- Social welfare (e.g., advocacy) organization
- Labor organization
- Business league (association)
- Social club
- Employee benefit fund
- Fraternal society
- Political organization

The organization’s statement of purposes needs to be written so as to bring the entity into conformity with the appropriate category of exempt organization. The purposes of an organization may partake of more than one of these categories. Tax-exempt status will be dependent on which of the types of purposes is primary—this is the primary purpose rule.

The federal tax law on this point is the most refined in the case of charitable organizations. These organizations must adhere to a formal organizational test. Other types of tax-exempt organizations may, however, extrapolate appropriate elements from this test. Organizations need not expressly make reference to the specific Internal Revenue Code section that is the basis for the exemption where the statement of purposes is confined
to those that are inherently exempt. Otherwise, the statement of purposes must state that the organization will not engage in any activities outside the scope of the selected category of exemption.

**Note** The length and level of detail of an organization’s statement of purposes will vary. The statement can be brief, such as “shall be operated for charitable and educational purposes” or “shall operate a social club.” Conversely, the statement can entail considerable detail. This is largely a matter of judgment in each case; a balance needs to be struck between the big picture and specificity. Constant amendment of articles of organization should be avoided. The bylaws (discussed later) can be more effusive as long as the statement in them is not broader than that in the articles of organization.

The organizational test for charitable organizations, in addition to requiring a suitable statement of purposes, mandates a *dissolution clause*. This is a provision in the organizing document that dictates where the organization’s net income and assets (if any) will be distributed should the organization liquidate or otherwise dissolve. Permissible recipients are one or more other charitable organizations or governmental agencies. No other type of tax-exempt organization is required by federal law to have a dissolution clause in its articles of organization.

**Tip** Some nonprofit, tax-exempt organizations have additional operational tests to satisfy. These include supporting organizations and private foundations (see Chapter 3).

**Note** Tax-exempt, charitable organizations must also comply with an *operational test*. This test concerns whether the organization is in fact operated for exempt purposes. Generally, defects in an entity’s articles of organization cannot be cured by complete adherence to the operational test.
LOCATION OF ORGANIZATION

Those planning a nonprofit organization must ascertain its state of formation. That is, under which state’s law should the organization be created? (In a rare situation, the entity is established by federal or state statute, or a local government’s ordinance.) The state selected may or may not be the state in which the organization will conduct its operations.

The starting assumption is that the jurisdiction in which the organization is to be formed is the state in which the organization will be located. That is the state in which it will have its principal (usually sole) office, conduct its programs, and otherwise function. There may be, however, one or more compelling features of another state’s law or administration of it, unavailable under the law of the home state, that dictate formation elsewhere. These are just a few of the possibilities:

- The intensity or type of regulation in the home state (with California and New York at the top of the high-regulation list)
- The form of the organization
- The number of directors or trustees required
- Whether state law permits the nonprofit organization to be formed as a stock-based corporation
- The element of appearances, in that those forming the organization may believe that it must be formed under the law of a particular state, such as New York (in the case of an internationally focused organization) or the District of Columbia (in the case of a public policy organization)

The difficulty with forming a nonprofit organization in a state different than the one in which the entity will operate is that the organization will have to comply with elements of the law of both states. The state in which the organization is formed is the domestic one; the state in which the organization is to operate (if different) is the foreign jurisdiction. The organization must qualify to do business in the foreign state.

With the dual-state approach, the organization may have to maintain a registered agent in both jurisdictions. Both states may require an annual report and an annual filing fee. Overall (including legal fees), it is usually more costly to form a nonprofit organization in one state and function in another. There are,
therefore, financial and efficiency issues associated with the two-state approach. In the case of nearly all nonprofit entities, one state will do.

SELECTION OF ORGANIZATION FORM

Once the home state has been determined, the legal form of the nonprofit organization must be considered. This is, as noted, basically a matter of state law. (Again, this assumes that the organization is not formed by statute or ordinance.)

Tax-exempt, nonprofit organizations generally are of three types:

1. Corporation
2. Unincorporated association
3. Trust

There are other forms of tax-exempt organizations, such as a limited liability company or a professional corporation. These forms are, however, rare in the nonprofit world.

Generically, the document by which a tax-exempt organization is created is known, in the parlance of the federal tax law, as articles of organization. There usually is a separate document containing rules by which the organization conducts its affairs; this document is most often termed bylaws. The organization may develop other documents governing its operations, such as various policies and procedures, an employee handbook, a conflict-of-interest policy (although that may be part of the bylaws), and/or a code of ethics.

There are several types of articles of organization for each of the principal types of tax-exempt, nonprofit organizations:

- Corporation: articles of incorporation
- Unincorporated association: constitution
- Trust: declaration of trust or trust agreement

The contents of a set of articles of organization should include the following:

- The name of the organization (discussed in the next section)
- A statement of its purposes (previously discussed)
The name(s) and address(es) of its initial directors or trustees
The name and address of the registered agent (if a corporation)
The name(s) and address(es) of its incorporator(s) (if a corporation)
A statement as to whether the entity has members
A statement as to whether the entity can issue stock (if a corporation)
Provisions reflecting any other state law requirements
Provisions reflecting any other federal tax law requirements
A dissolution clause

The bylaws of a nonprofit organization (if any) will usually include provisions with respect to the following:

The organization’s purposes
The origins (e.g., election) and duties of its directors
The origins and duties of its officers
The role of its members (if any)
Meetings of members and directors, including dates, notice, quorum, and voting
The role of executive and other committees
The role of its chapters (if any)
The organization’s fiscal year
A conflict-of-interest policy (if not separately stated)
Reference to (any) affiliated entities
Restatement of the federal tax law requirements

Several factors need to be considered in deciding which form a nonprofit organization should select, particularly if tax-exempt status is desired. Generally, the pivotal factor concerns the personal liability of the organization’s trustees, directors, and officers. The corporate form is the only form that provides the advantage of shielding board members and officers (and perhaps key employees) from most types of personal liability. With the corporation, liability, if any, is generally confined to the corporation; that is, it does not normally extend to those who manage it.

Another factor is that the law of a state usually provides answers to many of the questions that inevitably arise when forming and operating a nonprofit organization. These answers are most likely found in the state’s nonprofit corporation act.
A third factor is privacy. In exchange for the grant of corporate status, the state usually expects certain forms of compliance by the organization, such as adherence to rules of operations, an initial filing fee, annual reports, annual fees, and public disclosure requirements. There rarely are comparable filing requirements for trusts and unincorporated associations. Although articles of incorporation are public documents, trust documents and unincorporated association constitutions often are not.

In most cases, federal tax law is silent as to the form of tax-exempt organizations; most of them can select from among the three types. In a few instances, however, a specific form of organization is required to qualify under federal law as a tax-exempt organization.

Note  This choice of form is not immutable. A tax-exempt organization can change its form. (As a matter of state law, trusts are likely to be the most difficult of entities to change.) A common instance is conversion of an unincorporated association to a nonprofit corporation. (It is rare for a nonprofit corporation to unincorporate.) When this type of conversion is made, however, a new legal entity is created. This may require another filing with the IRS to procure a determination letter for the successor organization. (See Chapter 2.)

NAME OF ORGANIZATION

Those forming a nonprofit organization—particularly one that is to be tax-exempt—should give serious consideration to the entity’s name. This is not a matter of law; it is an element of appearance. Certainly, the organizational test (discussed under the section “Purpose of Organization”) is silent on the point.

The organization’s name sets a tone that overshadows the evaluation that is accorded the entity, whether it is by the IRS, a court, the media, or the general public. Thus, the name should do more than convey what the entity’s purposes and programs are about—it should be appropriate for a tax-exempt organization and, if applicable, an exempt charitable organization. Particularly in an instance of a putative charitable entity, as a matter of sheer presentation, and of imbuing the exemption application
process with a positive start (from the applicant’s viewpoint), more than passing thought should be given to this matter of the nonprofit organization’s name.

A name can be clever and yet only provide a court with a basis for concluding that the undertaking was something less than serious, thereby tainting the entire cause; an example of this is Salvation Navy. If an organization is trying to qualify for tax exemption but probably is not entitled to it, it is not a good idea to select a name that conveys the individuals’ true intentions in forming the entity (such as attempting to qualify an organization as a religious one because it conducts “worship services” on a yacht while floating around in a large bay); an example is the Southern Church of Universal Brotherhood Assembled (the acronym being SCUBA).

By contrast, one of the finest names ever assigned to a tax-exempt, nonprofit organization is this: the Vigilant Hose Company. The organization is a volunteer fire company.

**COMPOSITION OF GOVERNING BODY**

A nonprofit organization—irrespective of form—must have a governing body. These individuals generally are termed *trustees* or *directors*. State law will determine the minimum number of board members; the law typically mandates at least three of these individuals, particularly in the case of nonprofit corporations. Some states require only one. (The federal tax law is silent on this point.)

Some nonprofit organizations have large governing boards, often to the extent of being unwieldy. (State law does not set a maximum number of directors of nonprofit organizations.) The optimum size of a governing board of a nonprofit organization is dependent on many factors, including the type of organization, the extent of its program activities, the nature and size of the organization’s constituency, the way in which directors are elected, and the role and effectiveness of an executive committee.

**Nomenclature**

State law generally refers to those who serve on the governing board of a nonprofit organization as *directors*. Some tax-exempt organizations use other terms, such as *trustees* or *governors*. Gener-
ally, organizations are free to use the terminology they want. Nonetheless, applicable state law should be reviewed.

The choice of term in this context usually is not a matter of law. Some organizations prefer to refer to their governing board as the board of trustees because it sounds more impressive. This is particularly the case with charitable entities (such as private foundations) and educational institutions (such as schools, colleges, and universities). (Technically, only a member of the governing board of a trust can be a trustee, but that formality has long disappeared.)

Where there are related organizations, this terminology can be employed to reduce confusion. For example, in an instance of a tax-exempt association and its related foundation, the board of the former may be termed the board of directors and the board of the latter the board of trustees.

Scope of Authority

The directors of a nonprofit organization are those who set policy for the organization and oversee its affairs. Implementation of plans and programs, and day-to-day management, are the functions of officers and employees. The foregoing is conceptual; in reality, it is difficult to mark precisely where the scope of authority of a particular board of directors stops and the authority of other managers begins. (In the parlance of the tax law, trustees, directors, officers, and key employees are managers of the organization.)

Frequently, authority of this nature (or territory or turf) is resolved in the political arena, not the legal one. It may vary, from time to time, as the culture of the entity changes. In some organizations, the directors do not have the time or do not want to take the time to micromanage. Others restrain themselves from doing so—and still others do not. Often, the matter comes down to the sheer force of personalities. In some organizations, the most dominant manager is the executive director rather than the president or chair of the board. Still, in the end, the principle of law is that the board of a nonprofit organization has the ultimate authority over the affairs of the organization, unless there is a voting membership, in which case the ultimate authority is vested in the larger group.

Emerging governance principles for nonprofit organizations are placing more emphasis on an active, participating governing
board (see Chapter 12). The days of the passive, often-absent board member may be over. Emphasis is now on standards of fiduciary responsibility. Under evolving guidelines, board members are expected to be knowledgeable, involved, and making decisions as the full body, rather than deferring to the officers, an executive committee, or other smaller group.

Origins

The board of directors of a nonprofit organization can be derived in several ways. Indeed, there can be a blend of these ways. The basic choices are as follows:

- Election by a membership (including a sole member)
- Election by the other directors (a self-perpetuating board)
- Selection by the membership of another organization
- Selection by the governing board of another organization
- Ex officio positions

If there are bona fide members of the organization (such as an association or a social club), it is likely that these members will elect some or all of the members of the governing board of the entity. This election may be conducted by mail ballot or voting at the annual meeting. It is possible, however, for a nonprofit organization with a membership to have a governing board that is not elected by that membership.

In the absence of a membership or if the membership lacks a vote on the matter, the governing board of a nonprofit organization may be a self-perpetuating board. With this model, the initial board members (often named in the articles of organization) continue with those the board elects and those elected by subsequent boards.

Some governing boards have one or more ex officio positions. This means that an individual is a board member by virtue of another position he or she holds, such as an officer position or a board position with a related organization. (This term does not mean that the individual lacks the right to vote.) These other positions may be confined to the organization involved or be those of another organization or a blend of the two approaches. For example, the governing board of a supporting organization (see Chapter 3) is likely to have at least its majority appointed by the governing board of one or more supported organizations.
In the case of many nonprofit organizations, the source of the membership of the board is preordained. Examples include the typical membership organization that elects the board (such as, as noted, an association or social club); a hospital, college, or museum that has a governing board generally reflective of the community; or a private foundation (see Chapter 3) that has one or more trustees who represent a particular family or corporation.

Control

With the rare exception of the stock-based nonprofit organization, no one “owns” a nonprofit organization. Control of a nonprofit organization, however, is another matter. Certainly, the governing board of a nonprofit organization generally controls the organization, even in an instance of a membership entity.

There are other manifestations of this matter of control of the affairs of a nonprofit organization. One is the situation where an individual or a close-knit group of individuals wants to control, on an ongoing basis, an organization. This can be of particular consequence in the case of a single-purpose organization that was founded by an individual or this type of a group. Those who launch a nonprofit organization understandably do not want to put their blood, sweat, tears, and dollars into formation and growth of the organization, only to helplessly watch others garner control over it and freeze them out of the organization’s affairs. Solutions to this dilemma include selection of a board the founders trust, long terms of office, formation of the entity in a state that allows only one or two directors, different classes of board members, the founders as sole members, the founders as stock owners of the organization, and use of an advisory committee rather than a large governing board. These techniques need to be tested against the rules of applicable state law.

The IRS is particularly suspicious about nonprofit organizations that have only members of one family as board members. The agency has said that, where an organization is totally controlled by its founder and his or her immediate family, the entity “bears a very heavy burden to be forthcoming and explicit about its plans for the use of [its] assets” for exempt purposes. Although the law does not preclude a closely controlled nonprofit organiza-
tion from being tax-exempt, the IRS is of the view that this structure lacks “institutional protections,” that is, a board of directors consisting of “active, disinterested persons.” (The term disinterested means not being predominantly concerned with furthering private ends, not having a lack of interest in the affairs of the organization.) Thus, this IRS rule: “Small, closely controlled exempt organizations—and especially those that are closely controlled by members of one family—require thorough examination to insure that the arrangements serve charitable purposes rather than private interests.”

Other Considerations

The board of directors of a nonprofit organization may decide to have a chair (designated chairperson, chairman, or chairwoman) of the board. This individual presides over board meetings. The chair position is not usually an officer position (although it can be made one). The position may (but need not) be authorized in the organization’s bylaws.

Some organizations find it useful to stagger the terms of office so that only a portion of the board is up for election or reelection at any one time, thereby providing some continuity of service and expertise. A tidy model in this regard is the nine-person board, with three-year terms for members; one-third of the board is elected annually. The organization’s bylaws should state the terms of the offices and address the matter of re-elections to office (including any term limits).

A board of directors of a tax-exempt organization usually acts by means of in-person meetings, where a quorum is present. Where state law allows, the members of the board can meet by means of conference call (a call where all participants can simultaneously hear each other) or by unanimous written consent. These alternative procedures should be authorized in the organization’s bylaws—indeed, that may be a requirement of state law. If there is to be one or more nonvoting directors, the bylaws should make that clear.

Unless there is authorization in the law (and there is not likely to be), the directors of a nonprofit organization may not vote by proxy, mail ballot, e-mail, or telephone call other than a qualified conference call.

Members of a nonprofit organization have more flexibility as