Nonprofit Formation: Choosing the Vehicle

BY DARREN MOORE

Once the decision has been made to operate in the nonprofit form, the next decision is the proper organizational vehicle. For nonprofit organizations that will ultimately seek tax-exempt status as organizations described under Section 501(c)(3) of the Internal Revenue Code, the options are charitable trust, unincorporated association, nonprofit corporation, and limited liability company. The choice of vehicle largely depends upon the aims of the organizers and anticipated operations of the organization. It is also largely a decision based upon state law concerns (with a few exceptions). This blog post will discuss the decision in the context of Texas law.

Charitable trusts are the oldest form of nonprofit "entity," tracing their roots back to the Statute of Charitable Uses of 1601. At its simplest, a charitable trust is a fiduciary relationship with respect to property whereby property is held in trust for charitable purposes. Texas law defines a charitable trust as "a charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift to a charitable entity." Tex. Prop. Code §123.001(2). 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. This creates the fiduciary relationship though it is often referred to as an entity.

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 the vehicle. 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 (though the same fiduciary duties) in performing his or her duties than directors of nonprofit corporations. 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. In Texas, 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.

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. See Tex. Bus. Orgs. Code Ann. § 252.001 et seq. 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 (and will be required to have such documents to seek tax exemption).

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, 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.

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.

Perhaps the most commonly used entity for exemption under Section 501(c) is a nonprofit corporation. Nonprofit corporations in Texas are governed by Chapter 22 of the BOC. 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. 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. 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). 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.

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 though 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.

Should a single member LLC wish to apply for exemption (as opposed to being 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 certain additional conditions in its organizational documents.

The choice of vehicle should be made with careful consideration. If you'd like to consult on this decision, please give me a call at 817-877-1088.