CHAPTER 1

Nonprofit Organizations Law Generally

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A lawyer representing nonprofit colleges, universities, and other nonprofit organizations faces, on a daily basis, a barrage of questions about the rules governing the organizations' formation, administration, operation, management, and compliance with federal and state laws, including the tax laws. More frequently than nonlawyers might suspect, there is little or no law on a particular point.

These questions may require answers from an accountant, a fundraiser, an appraiser, or a management consultant rather than a lawyer. For example, a lawyer is not professionally competent to answer questions such as: "How much can I be paid?" or "How much is this gift property worth?" Even regarding matters that are within the lawyer's province, however—legal standards—the law is often vague. Much of the applicable nonprofit law is at the state level, so there can be varied answers to questions. Yet federal law on the subject of nonprofit law is building, and not just in the tax law arena; the best case in point is governance (Chapter 5).

Here are the questions most frequently asked about general operations of a nonprofit organization, including private colleges and universities—and the answers to them.

NONPROFIT LAW BASICS

1.1 What is a *nonprofit organization*?

The term *nonprofit organization* is somewhat misleading; regrettably, the English language lacks a better one. It does not mean an organization that cannot earn a profit. Many nonprofit organizations are realizing profits, in the sense of revenues

exceeding expenses. Colleges and universities exemplify this point. Using data for institutions' tax years ending in 2006, the average amount of net revenue received by small colleges and universities (2.34) was $11 million, by medium-size institutions (2.35) was $33 million, and by large institutions (2.36) was $87 million (2.50). An entity of any type cannot long exist without revenues that at least equal expenses.

The easiest way to define a nonprofit organization is to first define its counterpart, the for-profit organization. A *for-profit organization* exists to operate a business and to generate profits (revenue in excess of costs) from that business for those who own the enterprise. As an example, the owners of a for-profit corporation are stockholders, who take their profits in the form of dividends. Thus, when the term *for-profit* is used, it refers to profits acquired by the owners of the business, not by the business itself. The law, therefore, differentiates between profits at the entity level and profits at the ownership level.

Both for-profit and nonprofit organizations are allowed by the law to earn profits at the entity level. But only for-profit organizations are permitted profits at the ownership level. Nonprofit organizations rarely have owners; these organizations are not permitted to pass along profits (net earnings) to those who control them.

Profits permitted to for-profit entities but not nonprofit entities are forms of private inurement (see Chapter 6). That is, private inurement refers to ways of transferring an organization's net earnings to persons in their private capacity. The purpose of a for-profit organization is to engage in private inurement. By contrast, nonprofit organizations are forbidden to engage in acts of private inurement. (Economists call this fundamental standard the *nondistribution constraint*.) Nonprofit organizations are required to use their profits for their program activities. In the case of tax-exempt nonprofit organizations, these activities are termed their *exempt functions*. For colleges and universities, the principal exempt function is the education of students; collateral functions include sports programs, research, and community service activities.

Consequently, the doctrine of private inurement is the essential dividing line, in the law, between nonprofit and for-profit organizations.

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1.2 Sometimes the term *not-for-profit organization* is used instead of *nonprofit organization*. Are the terms synonymous?

As a matter of law, the terms *not-for-profit* and *nonprofit* do not mean the same. The two terms are often used interchangeably, but the proper legal term in this context is nonprofit organization (1.1).

The law employs the term *not-for-profit* to apply to an activity rather than to an entity. For example, the federal tax law denies business expense deductions for expenditures that are for a not-for-profit activity.[1] Basically, this type of activity is not engaged in with a business or commercial motive; a not-for-profit activity is essentially a hobby.

The term *not-for-profit* often is applied in the nonprofit context by those who do not understand or appreciate the difference between profit at the entity level and profit at the ownership level (1.1).

1.3 What are the types of nonprofit organizations?

The principal type of nonprofit organization is the nonprofit corporation. Private colleges and universities, and organizations related to them (such as a development foundation (2.68)), usually are organized as nonprofit corporations; some may be chartered directly by a state. The other types of nonprofit organizations are trusts, unincorporated associations, and limited liability companies.

1.4 What is the appropriate form of nonprofit organization?

Many factors need to be taken into account in determining the appropriate form of a nonprofit organization. One of the reasons the corporate form is prevalent is that nearly every state has a nonprofit corporation act that provides law underlying most aspects of the corporation's operations. Also, the corporate form offers directors and officers protection against personal liability in connection with their involvement in the organization's affairs. This is why just about every private college and university, and related entities, are structured as nonprofit corporations. (Public colleges and universities are established pursuant to a state constitution or statute.)

To be a corporation, however, the entity must file articles of incorporation with the appropriate state (1.11). Annual reports most likely also are required. These are public documents. Thus, those forming an entity that want more privacy for it may steer away from the corporate form.

Small organizations, less concerned with issues of liability and formality of organization, may be content with the unincorporated association form. In some instances, the appropriate form is dictated by law, such as employee plans (which are usually trusts) and planned giving vehicles (which also are often trusts, most notably the charitable remainder trust (12.62)).

1.5 How is a nonprofit organization started?

Generally, a nonprofit organization is formed in adherence to the law of the appropriate state (or District of Columbia). (A few nonprofit organizations are

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chartered by Congress. As noted (1.4), public colleges and universities are formed in accordance with a constitution or statute, being governmental instrumentalities or agencies.) In general, a nonprofit organization is formed by the filing or execution of a set of *articles of organization.*[2]

Thus, if the organization is to be a corporation, it commences its existence by filing articles of incorporation with a state (1.6). If the entity is a trust, it is formed by executing a declaration of trust or a trust agreement (1.14). An unincorporated association is established by execution of a constitution (1.15). A limited liability company is formed by execution of articles of organization (followed by adoption of an operating agreement governing operations, relationships among members, distributions, sharing of income and losses, and the like).

The federal tax law also will, assuming the nonprofit organization is to become a tax-exempt organization, require and encourage various provisions of the articles of organization. The law in this context is termed the *organizational test* (1.35).[3]

Most nonprofit organizations also have a set of bylaws—the rules by which they are operated. Some organizations have additional rules, such as codes of ethics, manuals of operation, and employee handbooks as well as a variety of policies and procedures (5.29–5.37).

Following the creation (and, if necessary, the filing) of the articles of organization, the newly formed entity should have an organizational meeting of the initial board of directors. At that meeting, the directors should adopt a set of bylaws, elect the officers, pass one or more resolutions to open bank and investment accounts, and attend to whatever other initial business there may be.

1.6 How does a nonprofit organization incorporate?

A nonprofit organization incorporates by filing a document with the appropriate state (1.11), usually termed *articles of incorporation.* State law likely will dictate some of the contents of these articles. At a minimum, the articles of incorporation will state the corporation's name, describe its corporate purposes, list the names and addresses of the directors, name a registered agent (1.7), and recite the names and perhaps the addresses of the incorporators (1.10).

The articles of incorporation likely will be filed with the secretary of state's office in the state. If that office determines that the articles qualify under the law, the state will issue a certificate of incorporation. The entity becomes a corporate as of the date on the certificate.

1.7 What is a *registered agent*?

Typically, the *registered agent* must be either an individual who is a resident of the state or a company that is licensed by the state to be a commercial registered agent.

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1.8 What does the registered agent do?

The registered agent functions as the corporation's point of communication to the outside world. Any formal communication for the corporation as a whole is sent to the registered agent. Thus, if the state authorities want to communicate with the corporation, they do so by contacting the agent. If someone wants to sue the corporation, the agent is served with the papers.

1.9 Does the registered agent have any liability for the corporation's affairs?

No. The registered agent, as such, is not a director or officer of the corporation. Thus, the agent has no exposure to liability for the corporation's activities. The agent would be held liable for his or her own offenses, such as breach of contract.

1.10 Who are the *incorporators*?

The *incorporators* are the individuals who technically create a corporation. (They may or may not be the corporation's true founders.) They execute the articles of incorporation. Under the typical legal requirement around the country, anyone who is 18 years of age and a U.S. citizen can incorporate a nonprofit corporation. Each state's law should be confirmed on this point, however. Many states require at least three incorporators.

An incorporator, as such, does not have a subsequent role with respect to the corporation. Once the corporation comes into being, the function of the incorporators terminates. An individual who serves as an incorporator can, and often does, serve as a trustee, director, officer, and/or employee of the corporation.

Some entities are quite sensitive to the matter of who is listed as an incorporator. They see the articles of incorporation as being of great significance to the organization—a document to be preserved and treasured for posterity. Thus, often, the initial board members are the incorporators. Others prefer to let the lawyers working on the case be the incorporators. No particular legal significance is attached to service as an incorporator.

1.11 How does a nonprofit organization decide in which state to incorporate?

The decision as to the state of incorporation is usually straightforward: It will be the state in which the organization will be primarily conducting its business—the state where its headquarters are to be located. Most frequently, this is the state

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in which those who are forming the entity and who will be operating it are residents and/or maintain their offices. There may, however, be one or more attributes of a state's law that are attractive to the founders, in which case the organization would incorporate pursuant to that state's law, then qualify the corporation as a foreign corporation in the state where its principal operations will be (1.12). A corporation that does business in more than one state will be incorporated in its "home" (domestic) jurisdiction and qualified as a foreign corporation to engage in business in the other states in which it has operations.

1.12 How does a nonprofit organization qualify to do business in another state?

To qualify to do business in another state, an organization files, with the state's secretary of state, an application for a certificate of authority to do business as a foreign entity in each state in which it conducts operations, other than its domestic state (1.11). The secretary of state will, assuming the application is properly prepared and the organization qualifies to do business in the state, issue a certificate of authority to do business in the state. This certificate may have to be updated annually; this classification may entail annual reports.

The process of obtaining this certificate is much like incorporating in a state. Also, the entity is required to have a registered agent in each state in which it is certified to do business (as well as in the domestic state).

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1.13 What constitutes *doing business* in a state?

Traditionally, the concept of *doing business* in a state requires some physical presence of the organization in the state, such as maintenance of an office or other active conduct of operations by employees or agents. A few states have expanded the concept by statute. For example, a state may legislate that fundraising in a state, even when done only by mail or telephone, constitutes doing business in a state.

1.14 How is a nonprofit trust started?

A nonprofit organization is formed as a trust when one of two documents is executed: a trust agreement or a declaration of trust. A *trust agreement* is a contract between or among two or more parties forming the entity, while a *declaration of trust* is statement, often by only one party, that a trust has been created. Those forming a trust are termed *trustors*. State law likely will dictate some of the contents of these documents. The federal tax law also will, assuming the nonprofit

trust is to be a tax-exempt organization, require and encourage various provisions of the trust document (1.35). The trust document usually does not have to be filed with the state as part of the formation process, although that may be required pursuant to the state's charitable solicitation act (Chapter 13) or other filing process. The entity becomes a trust as of the date the trust agreement or declaration of trust is executed.

1.15 How is a nonprofit unincorporated association started?

A nonprofit organization is formed as an unincorporated association when a constitution is executed. A constitution looks much the same as a set of articles of incorporation (1.6). State law likely will dictate some of the contents of this document. The federal tax law also will, assuming the nonprofit unincorporated association is to be a tax-exempt organization, require and encourage various provisions of the constitution (1.35). A constitution usually does not have to be filed with the state as part of the formation process, although that may be required pursuant to the state's charitable solicitation act (Chapter 13) or other filing process. The entity becomes an unincorporated association as of the date the constitution is executed.

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1.16 Who owns a nonprofit organization?

For the most part, a nonprofit organization does not have owners who would be comparable to stockholders of a for-profit corporation or general partners in a partnership. There are some exceptions; a few states allow nonprofit corporations to be established with the authority to issue stock.

Stock in a nonprofit organization is used solely for purposes of ownership. Any person (an individual, a business entity, or another nonprofit organization) can be a shareholder under this arrangement.

Thus, at least in the nongovernmental, nonprofit context, no one owns a school, college, or university. In a sense, the governmental institutions of higher education (2.16) are owned by their respective governments. There are, of course, owners of for-profit educational institutions.

1.17 Who controls a nonprofit organization?

The nature of control of a nonprofit organization depends on the nature of the entity. Usually control of a nonprofit organization is vested in its governing body, frequently termed a *board of directors* or *board of trustees*. Actual control may lie elsewhere—with the officers or key employees, for example. It is unlikely that

control of a large-membership organization would be with the membership, because that element of power is too dissipated. In a small-membership entity, such as a coalition, control may well be with the membership. The foregoing is particularly the case with respect to corporations and unincorporated associations. Control of a trust lies with its trustees.

1.18 How many directors must a nonprofit organization have?

The number of directors (or trustees) a nonprofit organization must have is generally a matter of state law. This is particularly the case for corporations, where state law generally mandates at least three directors. In a few states, however, it is permissible for a nonprofit corporation to have only one director. By dint of the nature of an unincorporated association, it is likely to have several directors. By contrast, it is common for a trust to have only one trustee.

For some nonprofit organizations, the size (and composition) of the board is dictated not by law but by other considerations, such as a range of expertise, a need to be reflective of the community, diversity, or concentration of a particular profession or other field on the board. Certainly, a tax-exempt college or university is not likely to have a mere smattering of directors or trustees; these institutions tend to be guided by a much larger governing board, in the range of 20–40 individuals. In the case of some governmental colleges and universities (2.16), the members of the board of regents of a university system are elected by the public.

With the advent of federal law and regulation focusing on governance (Chapter 5), however, the size of a nonprofit organization's board of directors is becoming a federal law factor. This is particularly the case for public charities. The Internal Revenue Service (IRS) has issued several private letter rulings holding that an organization cannot qualify as a public charity, at least in part, where it has only one or two directors; this entails an application (albeit strained) of the private benefit doctrine (6.1). Indeed, one court decision holds that a corporation with only one director (albeit allowable under state law) cannot qualify under the federal tax law as a public charity.[4] These considerations are of little concern to colleges and universities, however, inasmuch as they tend to have sizable governing boards as a matter of practice, although this matter of board size may be pertinent to related organizations.

1.19 Can the same individuals serve as the directors, officers, and incorporators?

Generally, an individual can serve as a director (or trustee), officer, and incorporator of a corporation. For example, the chancellor or president of a private,

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incorporated college can serve simultaneously on the institution's board of trustees. The law of the appropriate state should be reviewed as to this point. For example, under the laws of some states, the same individual cannot be president and secretary of a corporation simultaneously; this is because other state law may require that a document must be executed by two individuals, the entity's president and secretary.

1.20 Can the same individual serve as a director, officer, incorporator, and registered agent?

Yes, with respect to a corporation, an individual may serve as a director, officer, incorporator, and registered agent, unless state law forbids such a multirole status, which is unlikely. The registered agent—if an individual—must be a resident of the state in which the entity is functioning (1.11), but the requirement of residency is not applicable to the other roles.

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1.21 What is the legal standard by which a nonprofit organization should be operated?

The legal standard by which a nonprofit organization should be operated depends on the type of organization. If the nonprofit organization is not tax-exempt, the standard is nearly the same as that for a for-profit entity. If the nonprofit organization is tax-exempt but is not a charitable organization, the standard is somewhat higher. The legal standard is highest for a tax-exempt charitable organization (1.40). In general, the standard is easy to articulate but often difficult to implement.

1.22 What is the legal standard for an organization that is tax-exempt and charitable?

The legal standard by which all aspects of operations of the organization should be tested requires reasonableness and prudence. Everything the organization does should be undertaken in a reasonable manner and to a reasonable end. Also, those working for or otherwise serving the charitable organization should act in a way that is prudent. Tax-exempt charitable (including educational) organizations are required to satisfy an operational test (1.36).

The federal tax exemption granted to charitable and certain other forms of tax-exempt organizations can be revoked if the organization makes an expenditure or engages in some other activity that is deemed to be not reasonable. The same is likely true at the state level: Unreasonable behavior may cause the attorney general to investigate the organization.

1.23 What is the rationale for this standard for charities?

The principles underlying the laws concerning charitable organizations, both federal and state, are taken from English common law, principally those portions pertaining to trusts and property. The standards formulated by English law hundreds of years ago for the administration of charitable trusts were very sound and very effective, and they underpin the laws today. The heart of these standards is the fiduciary relationship.

1.24 What does the term *fiduciary* mean?

A *fiduciary* is a person who has special responsibilities in connection with the administration, investment, and distribution of property, where the property belongs to someone else. This range of duties is termed *fiduciary responsibility*. For example, guardians, executors, receivers, and the like are fiduciaries. Trustees of charitable trusts are fiduciaries. Today, a director or officer of a charitable organization is a fiduciary.

Indeed, the law can make anyone a fiduciary. As an illustration of the broad reach of this term, in a few states, professional fundraisers (13.42) are deemed, by statute, fiduciaries of the charitable gifts raised during the campaigns in which they are involved.

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1.25 What is the legal standard underlying fiduciary responsibility?

In a word, prudence: a fiduciary is expected to act, with respect to the income and assets involved, in a way that is prudent. This standard of behavior is known as the prudent person rule. This rule means that fiduciaries are charged with acting with the same degree of judgment—prudence—in administering the affairs of the organization as they would in their personal affairs. Originally devised to apply in the context of investments, this rule today applies to all categories of behavior—both commissions and omissions—undertaken in relation to the organization being served.

1.26 What is the meaning of the term *reasonable*?

The word *reasonable* is much more difficult to define than prudence. A judge, attorney general, IRS agent, and the like will say that the word is applied on a case-by-case basis. In other words, the term describes one of those things that one "knows when one sees it."

The term *reasonable* is basically synonymous with *rational*. A faculty of the mind enables individuals to distinguish truth from falsehood and good from evil by deducing inferences from facts. Other words that often can be substituted for *reasonable* are *appropriate*, *proper*, *suitable*, *equitable*, and *moderate*. Whatever term is used, an individual in this setting is expected to use this faculty and act in an appropriate and rational manner.

1.27 Who are the fiduciaries of a charitable organization?

The principal fiduciaries of a charitable organization are the directors. The officers are also fiduciaries. Other fiduciaries may include an employee who has responsibilities similar to those of an officer, such as a chief executive officer or a chief financial officer who is not officially a director or officer. Outsiders, such as people who are hired to administer an endowment fund or pension plan, are fiduciaries with respect to the organization. Each of these individuals has what is known as fiduciary responsibility (1.25), which includes the responsibility of acting reasonably (1.26) under the circumstances.

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1.28 What does the term *ex officio* mean?

The Latin term *ex officio* basically means "by reason of an office." It is used in the nonprofit law context to mean an individual who is a member of a board of trustees or board of directors of an organization by virtue of holding another position. This other position may be an officer of the organization. For example, the individual who is president of a college or university automatically may be a member of the college's board of trustees. Alternatively, the other position may be a position with another organization. For example, the president of a college or university automatically may be a member of the board of directors of the college's fundraising foundation (2.68). These are known as ex officio positions.

The concept of ex officio board members has nothing to do with whether they are voting members. Some assume that those who serve on boards by reason of ex officio status cannot vote; this is an incorrect assumption. Unless a governing instrument provides that an ex officio board member does not have the right to vote, that board member is entitled to vote.

1.29 What does the term *ultra vires act* mean?

The Latin term *ultra vires* means "in excess of powers." Thus, an ultra vires act is an act that is beyond, or outside of, the scope of powers authorized for an organization. For example, an action of a corporation (1.6) that is beyond the powers

conferred on it by its articles of incorporation, or perhaps a state's nonprofit corporation act pursuant to which it was formed, is an ultra vires act.

The commission of an ultra vires act may cause a corporation to lose its corporate status and, if it is a tax-exempt organization, may result in revocation of its exempt status and/or its public charity status (4.1). For example, a college or university that began operating a museum as its primary activity would be engaging in an ultra vires act. Adverse consequences in law can be averted by revising the corporate charter and achieving tax-exempt status on that basis. However, a college or university in this circumstance would lose its classification as an operating educational institution (2.14) and thus its public charity status as a school (4.13).

1.30 What are the rules regarding the development of chapters?

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There is very little law on this topic. A nonprofit organization that wants to have chapters is free to do so. The principal legal question for an organization with chapters is whether the chapters are separate legal entities or are part of the "parent" organization.

Thus, the rules as to chapters are likely to be confined to those the principal organization devises. A good practice for the main organization is to develop criteria for the chapters and then "charter" them according to the criteria. Some parent organizations execute a contract with their chapters, to be in a position to enforce the criteria. To some extent, then, the proper process for the creation and maintenance of a chapter program is akin to franchising in the for-profit setting.

There are no rules—other than those that an organization devises for itself—regarding the jurisdiction of chapters. A chapter can encompass a state, a segment of a state, or several states. There is no legal need for uniformity on this point; chapters can be allocated on the basis of population.

1.31 Do chapters have to be incorporated?

No, there is no legal requirement that chapters be incorporated. (Basically, there is little law mandating that any nonprofit organization be incorporated.) It is a good practice to cause the chapters to be corporations, however, so as to minimize the likelihood of liability for the parent organization and the boards of directors of the chapters.

This reference to the corporate form pertains to the question of whether the chapters are separate legal entities (1.32). A chapter can be a separate legal entity without being incorporated; for example, a chapter can be an unincorporated

association. (It is not likely that the chapter would be in trust form (1:14).) In most instances, chapters are separate legal entities. This means, among other elements, that they must have their own identification number (they should not use the parent organization's number) and pursue their own tax exemption determination letter (unless they are going to rely on the group exemption).

1.32 Is the concept of chapters relevant in the higher education context?

The concept of chapters is somewhat relevant in the higher education context. Obviously, a college or university itself does not have chapters. Nonetheless, tax-exempt colleges and universities inevitably are involved in associations, professional societies, and similar organizations that have chapters.

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FEDERAL TAX LAW BASICS

1.33 What is the *organizational test*?

The two most significant aspects of the organizational test are the requirements for a suitable statement of purposes[5] and a dissolution clause that determines where the organization's net income and assets will be distributed should the organization dissolve or liquidate.[6] It is also common practice to recite the organization's compliance with the applicable tax law rules. For example, the articles of organization of a public charity (4.1), which includes colleges and universities, often will state that the organization will not violate the private inurement doctrine (Chapter 6), will not engage in significant attempts to influence legislation (Chapter 8), and will not participate or intervene in political campaigns involving candidates for public office (Chapter 9). The federal tax law includes additional organizational tests for supporting organizations (4.18) and private foundations (4.2).

1.34 What is the *operational test*?

Basically, the operational test requires a tax-exempt charitable organization to, if it is to remain exempt, engage primarily (1.35) in activities that accomplish one or more of its exempt purposes.[7] For example, exempt charitable organizations are not permitted to distribute their net earnings for the benefit of persons in their private capacity[8] (Chapter 6) or function as advocacy—or action—organizations[9] (Chapters 8, 9).

1.35 What does the term *primarily* mean?

The word *primarily* does not mean *exclusively*. Thus, a tax-exempt charitable organization may engage in some nonexempt activity as long as it is insubstantial. Thus, if nonexempt activities exceed this threshold of insubstantiality, the organization cannot be exempt as a charitable, educational, or like entity.[10] As the U.S. Supreme Court wrote, the "presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."[11] A federal court of appeals held that nonexempt activity will not result in loss or denial of exemption where it is "only incidental and less than substantial" and that a "slight and comparatively unimportant deviation from the narrow furrow of tax approved activity is not fatal."[12] In the words of the IRS, the rules applicable to charitable organizations in general have been "construed as requiring all the resources of the organization [other than an insubstantial part] to be applied to the pursuit of one or more of the exempt purposes therein specified."[13] Consequently, the existence of one or more authentic exempt purposes of an organization will not be productive of tax exemption as a charitable or other entity if a substantial nonexempt purpose is present in its operations.

It is the use of the term *primarily* rather than *exclusively* (in its literal sense) that, among other aspects of the law, enables tax-exempt colleges, universities, and other organizations to engage in unrelated business activity (Chapters 14, 15) and remain exempt.

1.36 What is the *commensurate test*?

The commensurate test, which is somewhat related to the operational test (1.34), is applied by the IRS to assess whether a charitable organization is maintaining program activities that are commensurate in scope with its financial resources. The IRS wrote (in an unnumbered technical advice memorandum published in 1991) that this test "requires that organizations have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial." Therefore, the IRS added, an organization that "raises funds for charitable purposes but consistently uses virtually all its income for administrative and promotional expenses with little or no direct charitable accomplishments cannot reasonably argue that its charitable program is commensurate with its financial resources and capabilities."

Few instances of application of this test are recorded. It was first applied in connection with an organization that derived most of its financial support in the form of rental income, yet successfully preserved its tax-exempt status because it satisfied the test, in that it was engaging in an adequate amount of charitable

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activity.[14] In the case of the organization that was the subject of the foregoing technical advice memorandum, the IRS concluded that the test was transgressed because of its finding that the charity involved expended, during the years examined, only about 1 percent of its revenue for charitable purposes; the rest was allegedly spent for fundraising and administration.

The commensurate test and the primary purpose test (1.35) have an awkward coexistence. For example, a charitable organization was allowed to retain its tax-exempt status while receiving 98 percent of its financial support from passive unrelated business income (14.29) inasmuch as 41 percent of the organization's activities were charitable programs.[15] Another organization remained an exempt charitable entity, even though two-thirds of its activities were unrelated business, because the net unrelated revenue was used in furtherance of its charitable activity.[16] Yet a public charity had its tax exemption revoked, by application of this test, where, in the two years under examination, although its bingo game gross income was 73 percent and 92 percent of its total gross income, only a small amount of this money was distributed for charitable purposes.[17]

Despite infrequent application of the commensurate test by the IRS (and never by a court), the IRS recently reincarnated the test as the *charitable spending initiative*, making the use of it one of the agency's top priorities in the exempt organizations area. In 2009, the IRS announced this initiative, characterizing it as a "long-range study to learn more about sources and uses of funds in the charitable sector and their impact on the accomplishment of charitable purposes."[18] In late 2010, the IRS announced that it is examining exempt charitable organizations with high levels of fundraising expenses, organizations reporting unrelated business activity with relatively low levels of program service expenditures, organizations with high levels of officer compensation in comparison with program service expenditures, and organizations with low levels of program service expenditures in comparison to their total revenue.[19]

1.37 What is the *commerciality doctrine*?

The *commerciality doctrine*, which is a body of law the courts have grafted onto the statutory and regulatory rules for tax exemption for charitable entities, posits that an organization is engaged in a nonexempt activity when that activity is undertaken in a manner that is commercial in nature. An activity is considered to be *commercial* if it has a direct counterpart in, or is conducted in the same manner as is the case in, the realm of for-profit organizations.

Thus, this matter of commerciality surfaces where there are similar organizations in the for-profit sector, as is the case, for example, with tax-exempt hospitals and credit unions and organizations providing food services and conference

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facilities. It is beginning to manifest itself in the higher education setting, with the emergence of for-profit colleges and universities. Other fields with counterpart functions are publishing, consulting, and retreat facilities. As an illustration, a nonprofit adoption agency was denied exemption as a charitable entity, being cast as operating in a manner not "distinguishable from a commercial adoption agency," because it generated substantial profits, accumulated capital, was funded entirely by fees, lacked plans to solicit contributions, and had a paid staff.[20]

A federal court of appeals stated the factors to be applied in determining commerciality: (1) the organization sells goods and/or services to the public (this element alone was said to make the operations "presumptively commercial"), (2) the organization is in "direct competition" with for-profit counterparts, (3) the prices set by the organization are based on pricing formulas common in the comparable for-profit industry, (4) the organization utilizes promotional materials and "commercial catch phrases" to enhance sales, (5) the organization is advertising its services and/or goods, (6) the organization's hours of operation are basically the same as for-profit enterprises, (7) the guidelines by which the organization operates require that its management have "business ability" and training, (8) the organization does not utilize volunteers but pays salaries, and (9) the organization does not engage in charitable fundraising.[21] These criteria are being applied by other courts, such as denial of exemption to an organization the principal purpose of which was operation of a conference center,[22] and by the IRS, such as denial of exemption to a nonprofit restaurant.[23]

In addition to its impact on tax exemption issues, the commerciality doctrine is emerging as a significant force in determining what is an unrelated trade or business (Chapters 14, 15).

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1.38 What are the categories of charitable organizations?

The federal tax regulations[24] reference nine categories of charitable entities[25]—those that:

1. Provide relief for the poor
2. Provide relief for the distressed
3. Provide relief for the underprivileged
4. Advance religion
5. Advance education (3.6)
6. Advance science
7. Erect or maintain public buildings, monuments, or works
8. Lessen the burdens of government
9. Promote social welfare

In addition, the federal tax statutory law provides tax exemption as charitable entities for:

1. Cooperative hospital service organizations[26]
2. Cooperative educational service organizations[27]
3. Charitable risk pools[28]

Also, court opinions and IRS rulings identify ten other categories of charitable organizations—those that:

1. Promote health
2. Promote the arts
3. Promote sports for youth
4. Protect the environment
5. Promote patriotism
6. Engage in local economic development
7. Provide care for orphans
8. Facilitate cultural exchanges
9. Improve the administration of justice
10. Engage in the practice of law in the public interest

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1.39 What are the other categories of tax-exempt organizations?

There are seven categories of organizations that are tax-exempt pursuant to the same provision for exemption as charitable entities:

1. Educational organizations
2. Religious organizations
3. Scientific organizations
4. Literary organizations
5. Organizations that foster national or international sports competition
6. Organizations that prevent cruelty to children or animals
7. Organizations that test for public safety

The federal tax law provides tax exemption for many other categories of nonprofit organizations, including these eight:

1. Social welfare organizations[29]
2. Business leagues (associations)[30]
3. Labor unions and similar organizations[31]
4. Social clubs[32]
5. Political organizations[33]
6. Title-holding companies (single-parent and multiparent)[34]

7. Fraternal organizations[35]
8. Credit unions[36]
7. Veterans' organizations[37]
8. Prepaid tuition plans[38]

1.40 What is a *governmental unit*?

An entity is a *governmental unit* if it is (1) a state or local governmental unit as defined in the rules providing an exclusion from gross income for interest earned on bonds issued by these units,[39] (2) entitled to receive deductible charitable contributions as a unit of government,[40] or (3) an Indian tribal government or a political subdivision of this type of government.[41] The second of these categories encompasses the states, possessions of the United States, political subdivisions of the foregoing, the United States, and the District of Columbia.

A college or university may be a form of governmental unit (2.16).

1.41 Can a nonprofit organization be affiliated with a governmental unit?

Yes. The federal tax law recognizes the concept of an *affiliate of a governmental unit*. This type of entity is a tax-exempt organization that meets one of two sets of requirements (1.44).[42]

1.42 How is this type of *affiliation* established?

As noted (1.41), there are two ways in which an entity may be treated as an affiliate of a governmental unit. One of these sets of requirements is that the organization has a ruling (1.45) or a determination letter (1.46) from the IRS that (1) its income, derived from activities constituting the basis for its exemption, is excluded from gross income under the rules for political subdivisions and the like,[43] (2) it is entitled to receive deductible charitable contributions on the basis that contributions to it are for the use of governmental units, or (3) it is a wholly owned instrumentality of a state or political subdivision of a state for employment tax purposes.

The other set of requirements is available for an entity that does not have a ruling or determination letter from the IRS but (1) it is either operated, supervised, or controlled by governmental units, or by organizations that are affiliates of governmental units, or the members of the organization's governing body are elected by the public, pursuant to local statute or ordinance; (2) it possesses two or more of certain affiliation factors; and (3) its filing of an annual information

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return (Chapter 17) is not otherwise necessary to the efficient administration of the internal revenue laws.

An organization can (but is not required to) request a determination letter (3.19) or ruling (3.20) from the IRS that it is an affiliate of a governmental unit.

1.43 What are the federal tax law consequences for a nonprofit organization that is affiliated with a governmental unit?

The federal tax law consequences for a nonprofit that is affiliated with a governmental unit can be significant. It depends on the basis for the tax exemption. For example, in the case of an organization that is "tax-exempt" solely by reason of the fact that its revenue is excluded from gross income[44]—the situation for most governmentally owned colleges and universities (2.16)—most of the federal tax law that applies to conventional exempt organizations is inapplicable. That is, these bodies of law, otherwise applicable to public charities, do not apply: the private inurement doctrine (Chapter 6), the private benefit doctrine (*id.*), the intermediate sanctions rules (*id.*), the limitations on allowable lobbying (Chapter 8), the prohibition on political campaign activity (Chapter 9), and the requirement that annual information returns be filed with the IRS (Chapter 17) (except for supporting organizations).

Some organizations and institutions that have their tax exemption rested on the gross income exclusion rule also have a ruling from the IRS that they are exempt by reason of being charitable, educational, and the like.[45] This dual status can pose special problems, such as for governmentally owned colleges and universities.

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1.44 When can a college or university that is operated by a government qualify under the conventional rules for tax exemption?

In general, a wholly owned instrumentality of a state or municipal government that is a separate legal entity can qualify for tax exemption as a charitable, educational, and like entity if it is a *clear counterpart* of a charitable or like organization. The test established by the IRS is based on the scope of the organization's purposes and powers; the entity cannot qualify under the conventional exemption if its purposes and powers are beyond those permitted for charitable organizations. Thus, the government itself cannot qualify as a charitable organization, inasmuch as its purposes are not exclusively those inherent in charities, nor can an integral component of the government.

An otherwise qualified instrumentality satisfying the *counterpart* requirement, such as a college or university, can be deemed a charitable organization for purposes of federal tax exemption. If, however, an instrumentality is clothed with

powers other than those described in the federal tax rules for charitable organizations, such as enforcement or regulatory powers, it cannot constitute a clear counterpart organization.

Two IRS rulings illustrate this contrast. In one ruling, a public housing authority was denied tax exemption as a charitable organization, even though its purpose was to provide safe and sanitary dwelling accommodations for low-income families in a municipality. The statute under which it was incorporated conferred on it the power to conduct investigations, administer oaths, issue subpoenas, and make its findings and recommendations available to appropriate agencies; these powers were ruled to be regulatory or enforcement powers.[46] By contrast, a public library organized under a statute was ruled to be a counterpart to a charitable organization and hence exempt. The organization had the power to determine the tax rate necessary to support its operations within specified maximum and minimum rates; since the organization lacked the power to impose or levy taxes, its tax rate determination power was deemed to not be regulatory or enforcement in nature.[47]

1.45 Can a state college or university be considered a *political subdivision* for federal tax law purposes?

A state college or university cannot be treated as a political subdivision for purposes of the federal tax law. This is because these institutions do not possess the right to exercise part of the sovereign power of the state.

For tax-exempt bond purposes, a *political subdivision* is defined as "any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit."[48] The attributes of a sovereign are the power to tax, the power of eminent domain, and the police power.[49]

State colleges and universities do not have these powers. The argument that, since a state institution of higher education benefits from the state's power to tax through legislative appropriation of funds, there is a delegation of the tax power to the institution, has been rejected by a court.[50] State colleges and universities do not have the power of eminent domain; the power to condemn property is always vested elsewhere in the state's government. The existence of a campus police force is not sufficient to enable a state college or university to claim successfully that it has the police power. Indeed, the campus police are authorized to enforce laws enacted by the state, not by the state college or university, and charges must be brought before state judicial officers, not school authorities. Thus, even assuming that a state college's or university's function of providing higher education is the performance of a government, public function, such an institution is not a political subdivision of a governmental unit. The IRS has so ruled.[51]

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1.46 How is the IRS structured in connection with its oversight of tax-exempt organizations?

The IRS is a component of the Department of the Treasury, which has as two of its functions the assessment and collection of federal income and other taxes. This department is authorized to conduct examinations, serve summonses, and generally enforce the internal revenue laws. The tax assessment and collection functions largely have been assigned to the IRS, which is an agency of the department. The mission of the IRS, according to its Web site, is to "provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

The IRS is headquartered in Washington, D.C.; its operations there are housed in its National Office. An Internal Revenue Service Oversight Board is responsible for overseeing the agency in its administration, conduct, direction, and supervision of the execution and application of the nation's internal revenue laws. The head of the IRS is the Commissioner of Internal Revenue.

The IRS is organized into four operating divisions; this structure is reflected in the IRS's regional offices. One of these divisions is the Tax Exempt and Government Entities Division (TE/GE Division), headed by the commissioner of the TE/GE Division. Within the TE/GE Division is the Exempt Organizations Division, which develops policy concerning and administers the law of tax-exempt organizations; this division is administered by a director, who is responsible for planning, managing, and executing nationwide activities in the realm of exempt organizations (including, of course, colleges and universities). The director of the Exempt Organizations Division also supervises and is responsible for the programs of the offices of Customer Education and Outreach, Examinations, and Rulings and Agreements.

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Applications for recognition of exemption (Chapter 3) generally are sent to the IRS service center in Cincinnati, Ohio. Annual information returns (Chapter 17) are filed with the IRS center in Ogden, Utah. The exempt organizations examinations function is headquartered in Dallas, Texas. The Exempt Organizations Division issues annual reports that summarize how the TE/GE Division is applying its resources in support of the IRS's major strategies and priorities in the exempt organizations area.

1.47 Does the IRS communicate what its efforts and priorities are in connection with its administration of the law of tax-exempt organizations?

Yes. The IRS provides this type of disclosure in many ways. Annually, the IRS Exempt Organizations Division (1.50) publishes an annual report, including a

work plan, summarizing its efforts for the fiscal year involved and sketching its enforcement and regulatory priorities for the following fiscal year.[52] The division maintains a Web site[53] and has a monthly newsletter.[54] The IRS publishes many "plain-language" publications concerning tax-exempt organizations law topics, and its personnel participate in a variety of exempt organizations law seminars and conferences.

1.48 What is the role of a lawyer who represents one or more nonprofit organizations?

Overall, the role of a lawyer for a nonprofit organization—sometimes termed a *nonprofit lawyer*—is no different from that of a lawyer for any other type of client. The tasks are to know the law (and avoid malpractice), represent the client in legal matters to the fullest extent of one's capabilities and energy, and otherwise zealously perform legal services without violating the law or breaching professional ethics.

The typical lawyer today is a specialist, and the nonprofit lawyer is no exception. Nonprofit law is unique and complex; the lawyer who dabbles in it does so at peril. A lawyer may be the best of experts on labor or securities law and know nothing about nonprofit law. The reverse is, of course, also true: The nonprofit lawyer is likely to know nothing about admiralty or domestic relations law.

The first task listed is "to know the law." That is literally impossible: No lawyer can know all of the law. The nonprofit lawyer, like any other lawyer, needs to be just as aware of what he or she does not know as of what is known. The nonprofit lawyer may be called in as a specialist to assist another lawyer, or, occasionally, a nonprofit lawyer may turn to a specialist in other fields that can pertain to nonprofit entities, such as environmental or bankruptcy law.

Some lawyers represent nonprofit organizations that have a significant involvement in a field that entails a considerable amount of federal and/or state regulation. This is particularly the case with trade, business, and professional organizations. These lawyers may know much about the regulatory law in a particular field yet know little about the law pertaining to nonprofit organizations as such.

1.49 What is the role of a lawyer who represents a nonprofit college or university?

A lawyer who represents a nonprofit college or university is indeed a specialist. He or she should know nonprofit law as well as higher education law. This will be a blend of state and federal law. Thus, a lawyer in this position should be facile in relation to, for example, the laws administered by the U.S. Department of

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Education, that department's state counterpart (if there is one), the tax exemption law (Chapter 3) and the public charity law (Chapter 4), state fundraising law (Chapter 13), and the federal tax rules pertaining to charitable giving (Chapter 12), unrelated business (Chapters 14, 15), and annual reporting (Chapter 17). Other fields of law of relevance to a lawyer representing a nonprofit college or university may include employee benefits, labor, intellectual property, and/or scientific research.

NOTES

1. Internal Revenue Code section (IRC §) 183.
2. Income Tax Regulations (Reg.) § 1.501(c)(3)-1(b)(2).
3. Reg. § 1.501(c)(3)-1(b)(1).
4. Ohio Disability Association v. Commissioner, 98 T.C.M. 462 (2009).
5. Reg. § 1.501(c)(3)-1(b)(1).
6. *Id.*
7. Reg. § 1.501(c)(3)-1(c)(1).
8. Reg. § 1.501(c)(3)-1(c)(2).
9. Reg. § 1.501(c)(3)-1(c)(3).
10. Reg. § 1.501(c)(3)-1(c)(1).
11. Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945).
12. St. Louis Union Trust Co. v. United States, 374 F.2d 427, 431–432 (8th Cir. 1967).
13. IRS Revenue Ruling (Rev. Rul.) 77-366, 1977-2 C.B. 192.
14. Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186.
15. IRS Technical Advice Memorandum (Tech. Adv. Mem.) 9711003.
16. Tech. Adv. Mem. 200021056.
17. IRS Private Letter Ruling (Priv. Ltr. Rul.), 200825046.
18. IRS Exempt Organizations Fiscal Year 2009 Annual Report.
19. IRS Exempt Organizations Fiscal Year 2010 Annual Report, including the fiscal year 2011 work plan.
20. Easter House v. United States, 846 F.2d 78 (Fed. Cir. 1988), *cert. den.*, 488 U.S. 907 (1988).
21. Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991).
22. Airlie Foundation v. Internal Revenue Service, 283 F. Supp. 2d 58 (D.D.C. 2003).
23. Priv. Ltr. Rul. 201046016.
24. Reg. § 1.501(c)(3)-1(d)(2).
25. That is, those that are charitable within the meaning of IRC § 501(c)(3).
26. IRC § 501(e).
27. IRC § 501(f).
28. IRC § 501(n)(1)(A).
29. These are organizations described in IRC § 501(c)(4).

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30. These are organizations described in IRC § 501(c)(6).
31. These are organizations described in IRC § 501(c)(5).
32. These are organizations described in IRC § 501(c)(7).
33. These are organizations described in IRC § 527.
34. These are organizations described in IRC § 501(c)(2) and (25), respectively.
35. These are organizations described in IRC § 501(c)(8) or (10).
36. These are organizations described in IRC § 501(c)(14).
37. These are organizations described in IRC § 501(c)(19).
38. These are plans described in IRC § 529.
39. IRC § 103.
40. IRC § 170(c)(1).
41. IRC §§ 7701(a)(40), 7871.
42. IRS Revenue Procedure (Rev. Proc.) 95-48, 1995-2 C.B. 418.
43. IRC § 115.
44. *Id.*
45. IRC § 501(c)(3).
46. Rev. Rul. 74-14, 1974-1 C.B. 125.
47. Rev. Rul. 74-15, 1974-1 C.B. 126.
48. Reg. § 1.103-1(b).
49. E.g., Commissioner v. Shamberg's Estate, 144 F.2d 998 (2nd Cir. 1944), *cert. den.*, 323 U.S. 792 (1945).
50. E.g., Philadelphia National Bank v. United States, 666 F.2d 834 (3rd Cir. 1981).
51. Rev. Rul. 77-165, 1977-1 C.B. 21.
52. See notes 18–19.
53. Rev. Rul. 77-165, 1977-1 C.B. 21.
54. See, e.g., note 19.

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