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The Law of Tax-Exempt Organizations: Eight Edition

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SECTION: CHAPTER 1**LENGTH:** 12689 words**HEADLINE:** Philosophy Underlying and Rationales for Tax-Exempt Organizations**BYLINE:** BRUCE R. HOPKINS**BODY:**

Nearly all of federal and state law pertains, directly or indirectly, to tax-exempt organizations; there are few areas of law that have no bearing whatsoever on these entities. The fields of federal law that directly apply to exempt organizations include tax exemption and charitable giving requirements, and the laws concerning antitrust, contracts, employee benefits, the environment, estate planning, health care, labor, the postal system, securities, and fundraising for charitable and political purposes. The aspects of state law concerning exempt organizations are much the same as the federal ones, along with laws pertaining to the formation and operation of corporations and trusts, and charitable solicitation acts. Both levels of government have much constitutional and administrative law directly applicable to exempt organizations. A vast array of other civil and criminal laws likewise apply. The principal focus of this book is the federal tax law as it applies to nonprofit organizations, although other laws applicable to exempt organizations are referenced throughout.

§ 1.1 NONPROFIT ORGANIZATIONS

A tax-exempt organization is a unique entity; among its features is the fact that it is (with few exceptions) a nonprofit organization. Most of the laws that pertain to the concept and creation of a nonprofit organization originate at the state level, while most laws concerning tax exemption are generated at the federal level. Although almost every nonprofit entity is incorporated or otherwise formed under state law, a few nonprofit organizations are chartered by federal statute. The non-profit organizations that are the chief focus from a federal tax law standpoint are corporations, trusts, and unincorporated associations. There may, however, be increasing use of limited liability companies in this regard.

A nonprofit organization is not necessarily a tax-exempt organization. To be exempt, a nonprofit organization must meet certain criteria. As noted, most of these criteria are established under federal law. State law, however, may embody additional criteria; those rules can differ in relation to the tax from which exemption is sought (such as taxes on income, sales of goods or services, use of property, tangible personal property, intangible personal property, or real property).ⁿ¹ Thus, there are nonprofit organizations that are taxable entities, under both federal and state law.

ⁿ¹ In establishing its criteria for tax exemption, however, a state may not develop rules that are discriminatory to the extent that they unconstitutionally burden interstate commerce (*Camps Newfound/Owatonna, Inc. v. Town of Harrison*, et al., 520 U.S. 564 (1997)). In general, Brody, "Hocking the Halo: Implications of the Charities' Winning Briefs in *Camps Newfound/Owatonna, Inc.*," 20 *Exempt Org. Tax Rev.* (No. 1) 31 (1998).

(a) Definition of Nonprofit Organization

The term *nonprofit organization* does not refer to an organization that is prohibited by law from earning a *profit* (that is, an excess of earnings 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 or otherwise received. This fundamental element is found in the doctrine of *private inurement*.ⁿ²

ⁿ² The doctrine states that the entity be organized and operated so that "no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual" (e.g., Internal Revenue Code of 1986, as amended, section (IRC §) 501(c)(3)). The technical aspects of the private inurement doctrine are the subject of Chapter 19.

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The legal concept of a nonprofit organization is best understood through a comparison with a *for-profit* organization. The essential difference between nonprofit and for-profit organizations is reflected in the private inurement doctrine. n3 Nonetheless, the characteristics of the two categories of organizations are often identical, in that both mandate a legal form, n4 one or more directors or trustees, and usually officers, and both of these types of entities can have employees (and thus pay compensation), face essentially the same expenses, make investments, enter into contracts, sue and be sued, produce goods and/or services, and, as noted, generate profits.

n3 The word *nonprofit* should not be confused with the term *not-for-profit* (although it often is). The former describes a type of organization; the latter describes a type of activity. For example, in the federal income tax setting, expenses associated with a not-for-profit activity (namely, one conducted without the requisite profit motive) are not deductible as business expenses (IRC § 183).

n4 See § 4.1.

A fundamental distinction between the two entities is that the for-profit organization has owners that hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the benefit of its 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 that is designed to generate a profit for its owners. The transfer of the profits from the organization to its owners is the inurement of net earnings to them in their private capacity.

By contrast, the nonprofit organization generally is not permitted to distribute its profits (net earnings) to those who control it (such as directors and officers). n5 (A nonprofit organization rarely has owners. n6) Simply stated, a nonprofit organization is one that cannot engage in private inurement. Consequently, the private inurement doctrine is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit organizations for purposes of the federal tax law.

n5 The U.S. Supreme Court wrote that a "nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it 'is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees' " (Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al., *supra* note 1 at 585, quoting from Hansmann, "The Role of Nonprofit Enterprise," 89 *Yale L. J.* 835, 838 (1980)).

n6 A few states allow nonprofit organizations to issue stock. This is done as an ownership (and control) mechanism only; this type of stock does not carry with it any rights to earnings (such as dividends).

To reiterate: Both nonprofit and for-profit organizations are legally able to generate a profit. Yet, as the comparison between the two types of organizations indicates, there are two categories of profit: one at the *entity level* and one at the *ownership level*. Both can yield the former type of profit; the distinction between the two types of entities pivots on the latter category of profit. n7 The for-profit organization endeavors to produce a profit for its owners—what one commentator called its "residual claimants." n8 For-profit organizations are supposed to engage in private inurement; nonprofit entities may not do so. Indeed, the nonprofit organization often seeks to devote its profit to ends that are beneficial to society.

n7 One commentator stated that charitable and other nonprofit organizations "are not restricted in the amount of profit they may make; restrictions apply only to what they may do with the profits" (Weisbrod, "The Complexities of Income Generation for Nonprofits," Chapter 7, Hodgkinson, Lyman, and Assocs., *The Future of the Nonprofit Sector* (Jossey-Bass, Inc., 1989)).

n8 Norwitz, " 'The Metaphysics of Time': A Radical Corporate Vision," 46 *Bus. Law* (No. 2) 377 (Feb. 1991).