



2201 Post Road, Suite 104, Austin, Texas 78704
tel. 512/447-7707, ext. 370 • fax. 512/447-3940 •
www.texasbar.org • info@texasbar.org

by Anna Maria Mendez

Nonprofit Unincorporated Associations vs. Nonprofit Corporations Choosing the Right Corporate Structure

Although many of the differences between nonprofit unincorporated associations and nonprofit corporations have been addressed by the Texas Uniform Unincorporated Nonprofit Association Act, there are still various factors to consider when choosing between an unincorporated association and incorporation.

Generally, one major benefit of unincorporated associations is the lack of the strict organizational, reporting, and registration requirements imposed upon nonprofit corporations. However, the benefit of informality is lost if the association desires tax-exemption status. Formal documentation and organizational requirements, in addition to helping the organization apply for exemption status, may also help to refine and focus the goals of the organization itself.¹ Unless the organization is small, does not plan on receiving much money, and basically limits itself to internal activities or limited transactions with outside parties, incorporation is probably the best decision.

Here are certain aspects of both nonprofit corporations and unincorporated associations and some differences between the two:

Tax Exempt Status:

Both nonprofit associations as well as nonprofit corporations may apply for and receive recognition of tax-exempt status from the IRS. The same tests apply to any organization (whether a trust, corporation, or association) seeking exemption under IRC §501(c)(3). Each organization must: submit a form 1023 application, send articles of organization (and bylaws if a corporation), financial data, a description of activities, purpose, standards, and procedures, have an Employee Identification Number, and have an exempt purpose. In order for an organization to qualify for this exemption, the articles of association or incorporation must contain certain language as suggested in IRS Publication 557. Churches and other organizations having gross annual receipts of \$5,000 or less do not have to apply to be considered tax-exempt organizations.

Even though an organization may be recognized as tax-exempt by the IRS it may have to pay unrelated business taxes. For nonprofit corporations as well as nonprofit associations, earnings that are unrelated to the exempt purpose will be taxed at corporate income tax rates.

Liability:

Since the nonprofit corporation is a legal entity in itself, members of the corporation and its Board of Directors are protected in those roles from personal liability for the corporation's

¹ Weblocator, *Texas Associations & Nonprofit Corporations Law* (2004),
<http://www.weblocator.com/attorney/tx/law/b09.html#tx6090000>.

breach of contract or tortious acts or omissions (though they may still be held liable for individual acts). The Texas Uniform Unincorporated Nonprofit Association Act provides similar protections for nonprofit associations: members are no longer liable for a breach of the association's contract or for a tortious act or omission *merely* because the person is a member.

The Nonprofit Corporation Act is detailed in its discussion of indemnification for directors of the nonprofit depending on the nature and outcome of the lawsuit. A nonprofit corporation *may not* indemnify a director that engaged in willful or intentional misconduct or that received an improper personal benefit. However, it *must* indemnify a director against reasonable expenses in a lawsuit filed against the director if he or she was successful in defending the lawsuit. The corporation *may* indemnify a director who is not wholly successful if the director acted in good faith and reasonably believed the conduct was within the best interests of the corporation. The nonprofit corporation *may* also indemnify a director in a criminal case if the director had no reason to believe his or her conduct was unlawful. There is no parallel indemnification provision in the Nonprofit Association Act for nonprofit associations, meaning the association must take affirmative steps to create and impose these rules.

The Charitable Liability and Immunity Act (Tex. Civ. Prac. & Rem. Code §84) grants volunteers that serve charitable organizations immunity from civil liability under certain circumstances. The Act defines "charitable organization" as any *corporation*, foundation, community chest, or fund that is exempt from federal income tax through IRC 501(c)(3) or (c)(4). However, if the organization is an association (or any type of organization other than those listed above), it must be a bona fide religious, charitable, educational, etc. organization, must not participate in any political campaign, and *must normally receive more than one-third of its support in any year from private or public gifts, grants, contributions, of membership fees*. In other words, unincorporated association volunteers may still be subject to personal liability if the association does not meet certain funding requirements.

Powers as a Legal Entity:

A corporation, by definition, is an organization formed by state law that acts as a "person" to carry on business or other activities. The corporation has the power to sue or be sued, purchase, lease, acquire, hold, and transfer property in its own name, make contracts, or be named as a beneficiary.

The Nonprofit Association Act gives nonprofit associations powers similar to those of corporations. A nonprofit association may sue or be sued, can acquire, hold, and transfer an estate or interest in real or personal property, and can be the beneficiary of trusts, contracts, or wills.

Formation, Records, and Reporting Requirements:

The Nonprofit Corporation Act governs the formation of nonprofit corporations. This Act sets forth requirements for the number of directors, voting rights of directors and member, meeting procedures, notice requirements for meetings, and officers and duties. Once the Articles of Incorporation are completed they must be filed with the Secretary of State. Due to the strict requirements for incorporation, it is recommended that the organization utilize an attorney to help create the nonprofit corporation.

In addition to formation requirements, Texas law also calls for record and reporting requirements for nonprofit corporations. The corporation must keep “correct and complete” books and account records and minutes of all board, committee, and member proceedings and must keep a record of the names and addresses of voting members (information to be available to members upon written demand). If the corporation raises more than \$10,000 a year it must maintain full and correct financial records for each transaction in accordance with generally accepted accounting practices, and the board must prepare an annual report of the corporation’s financial activity. Financial activity reports must be filed with the IRS at the close of each fiscal year unless the corporation has annual gross receipts less than \$25,000.

In contrast to incorporation, forming a nonprofit association has very few requirements. Texas law defines a nonprofit association as an “unincorporated organization...consisting of three or more members joined by mutual consent for a common, nonprofit purpose.” The Nonprofit Association Act sets out no requirements as to how the organization is established and the Articles of Association are not filed with the Secretary of State. The Act sets forth two *optional* filing requirements: a statement of authority to transfer an estate or interest in real property and to appoint an agent to receive service of process. There is no legal requirement for a written document of organization, though this is necessary if the association plans to apply for tax-exempt status.

Although the Texas Nonprofit Association Act does not mandate registration or organizational requirements, nonprofit associations *are* required to keep “correct and complete” account records for at least three years after the end of each fiscal year and must make that information available to the members of the association. If needed, the Attorney General is allowed to inspect and make copies of these records and other documents to determine if the association has violated state law.

Conclusions:

For most nonprofit organizations that need to raise money to operate, incorporation is the best choice. Most businesses, donors, as well as the IRS will be more familiar working with corporations (which can be bigger and more well known) as opposed to unincorporated associations.²

The greatest benefit of nonprofit unincorporated associations is the informality allowed in the formation and administration of the organization. Smaller local organizations (e.g. music or religious clubs) may prefer an unincorporated association status if they do not have the financial or human resources to obtain and maintain nonprofit incorporation requirements (e.g. meetings, voting, organizational and reporting requirements, etc.), have limited transactions with third parties, or if the organization brings in such a small amount of money that it does not have to even apply for tax-exempt status.

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² Glen A. Yale, *Am I Liable? Responsibilities & Liabilities of Texas Nonprofit Organization Directors*, 2d ed (San Antonio: Nonprofit Resource Center of Texas, 1999), 14.