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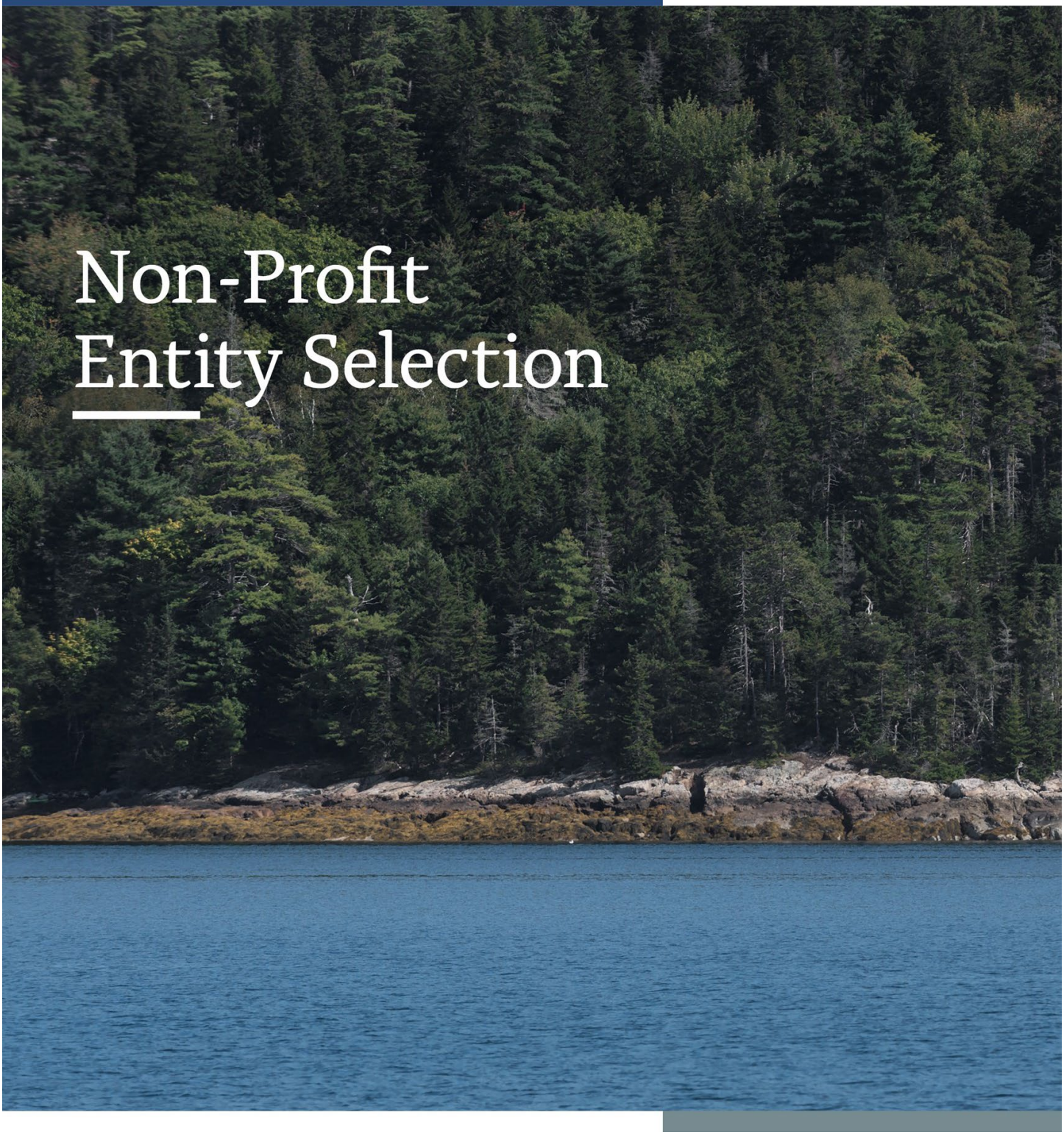

Non-Profit Entity Selection

If a decision is made to form a non-profit organization, the initial consideration is what type of charitable entity will be created. The following list includes the four basic types of entities that generally will qualify for tax-exempt status.

Corporation

The most popular form of non-profit entity is a non-profit (or not-for-profit) corporation. The non-profit corporation is so popular because it is relatively simple to form. Typically, all that is necessary to form a non-profit corporation is to file Articles of Organization (or Articles of Incorporation) with any one of the United States. Corporations are created pursuant to state law, so strict adherence to state statutes and regulations regarding incorporation is critical. Upon completion of the incorporation process, directors and officers are appointed to manage the non-profit corporation. Thereafter, a non-profit corporation will adopt bylaws, which are specific expressions of how the non-profit corporation will be governed, although the bylaws may not contradict the state statutes governing non-profit corporations.

If a non-profit corporation is properly managed and operated, then a greater degree of personal liability protection can be provided to its directors and officers, which is a significant advantage over other forms of charitable entities. This protection is referred to in legal parlance as the "corporate veil" and serves to shelter directors and officers from the liabilities of the non-profit corporation, as long as those officers and directors are meeting their fiduciary duties of due care, good faith and loyalty. This liability protection, however, is not absolute; therefore, prudence suggests that non-profit corporations also should purchase liability insurance for its directors and officers.

Charitable trust

Generally, a charitable trust is formed when a "grantor" (also referred to as "donor" or "settlor" or "trustor") transfers assets to an individual or entity (or both) called a "trustee" with clear instructions that the trustee will use the assets contributed in furtherance of a specific charitable purpose expressly set forth in the terms of the charitable trust. A significant advantage to forming a charitable trust is one of privacy as generally a charitable trust can be created without obtaining governmental permission, although registration with some government authority is likely for tracking whether the charitable purpose is met. A significant disadvantage to forming a charitable trust is that a trustee does not have the protection of the business judgment rule applicable to corporate directors, and therefore, are at much greater risk of being held personally liable for trust liabilities. In such a circumstance, however, the charitable trust can indemnify the trustee so long as such indemnification language appears within the charitable trust or a state statute governing the conduct of a charitable trust, and assuming the charitable trust has sufficient assets to cover potential liabilities. Another disadvantage to forming a charitable trust is the agreement of trust must be drafted with much greater care because charitable trusts are governed by both trust case law and statutory law.

Limited liability company

A limited liability company (LLC) is formed by filing articles of organization with one of the United States. Governance of LLC activity is typically expressed within an "operating agreement" created at the same time as filing such articles of organization. Every state has its own laws regarding operation of an LLC, so it is important to review the law in the jurisdiction where the non-profit LLC will be located. Some states, for example, specifically authorize a non-profit LLC, while other states require that an LLC must have a business purpose.

One downside to choosing an LLC as an organizational structure is that the Internal Revenue Service has, to date, made very few rulings regarding non-profit LLCs. An LLC can be recognized as a tax-exempt entity but there exists a trap for those persons unaware of tax law. Specifically, an LLC with individual "members" holding "units" of ownership will not qualify for tax-exempt status, as tax-exempt organizations cannot be privately owned. Only an LLC whose members are other Internal Revenue Code §501(c)(3) organizations can qualify as tax-exempt.

Unincorporated association

An unincorporated association consists of not less than two individuals who wish to join together to accomplish a common charitable purpose. To recognize an unincorporated association, the IRS will require some written document evidencing this intended common charitable purpose. No governmental permission or registration, however, is required. An unincorporated association is not likely to be able to protect its individuals from personal liability as there is a significant question whether the unincorporated association is a legal entity distinct and separate from its individuals who come together to accomplish the association's charitable purpose. Some states have passed laws providing liability protection to individuals who are associated with an unincorporated association. Many states, however, provide little or no protection for such individuals associate with an unincorporated association. Therefore, such individuals risk being held personally liable for association liabilities, and furthermore, the actions of one such individual could make all individuals associated with the unincorporated association subject to liability.

A critical understanding of the personal liability risk is necessary if consideration is given to operating as an unincorporated association. Such unincorporated associations are typically selected by small groups of like-minded individuals who desire a minimum of government reporting.

Summary

While there are many choices available to individuals and entities interested in creating charitable organizations, non-profit corporations are the most accepted structure for non-profit organizations to choose. However, IRC §501(c)(3) organizations looking to form subsidiary organizations may find creating a limited liability company to be a more suitable. Whatever form the non-profit will take, hiring an attorney to research state laws regarding non-profit formation is a necessary first-step.

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