

## THE CLOSE NONPROFIT CORPORATION

Let us assume two new public benefit exempt organizations.<sup>1</sup> The first is Save the Double-Breasted Seersucker (SDS), an environmental organization whose mission is to preserve the habitat of this and other rare birds. SDS is funded through contributions from the Warbucks Foundation and a few other wealthy bird watchers and environmentalists. It incorporates as a New York not-for-profit corporation, files its 1023, and commences a broad-based fundraising campaign. Approximately eight months later it receives recognition of exemption, files with the New York Charities Registration Bureau, registers with the Office of Charitable Solicitation,<sup>2</sup> and meets all other filing requirements. Within two years of its founding it has an annual budget of \$1.5 million and offices in New York and Seattle. It has commenced the sale and distribution of SDS tee-shirts, bird whistles, and other commercial activities.

The second organization, Ballet Folklorica de Battery Park, performs traditional dances of lower Manhattan. It is formed by Manny, Moe, and Jack, three unemployed investment bankers who desire to pursue new directions in their lives. These three principals plus two of their girlfriends comprise the board. As with SDS they incorporate as a New York not-for-profit corporation, and obtain recognition of tax exempt status under I.R.C. § 501(c)(3).

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<sup>1</sup> Corporations which have § 501(c)(3) or 501(c)(4) status under the Internal Revenue Code are termed public benefit corporations. These organizations can be defined as a group serving what may loosely be called a public or charitable purpose - to do good works, benefit society or improve the human condition. Members have no ownership interests in public benefit corporations.

<sup>2</sup> As of this writing it is unknown whether these two functions will be combined in the Attorney General's Office or where.

The dance company will be the three principals' sole means of support. They hope to obtain grants from the National Endowment for the Arts, New York State Council on the Arts, New York City Department of Cultural Affairs, foundations and anyone else who might be a patron as well as revenue from admissions fees to performances. Virtually all funds raised go towards their salaries. While their primary artistic mission is to make Ballet Folklorica an integral part of the New York City dance scene, no less important an objective is to support themselves through their company or to hold the company together long enough to qualify for unemployment compensation.<sup>3</sup> Ballet Folklorica muddles along for three years. In two of the years the company's dance season is long enough to qualify for unemployment compensation for the principals who are listed as employees. In the third year it is not, and the principals took odd jobs that year.

The company's rental of rehearsal space, purchase of costumes and rental of lofts for performances required personal guarantees from the principals. They could afford no insurance. Board meetings were never held as the three considered themselves partners and made all decisions jointly. The two girlfriends were dummy directors. Manny, Moe and Jack hadn't heard from their lawyer since they received their recognition of exemption letter. They did not file an annual report with the IRS but did prepare a simple budget for funding sources which exaggerated their income to show that they were a substantial company. Three years after the company's founding when mergers and acquisitions again boomed, the principals left Ballet

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<sup>3</sup> In New York unemployment compensation is available after twenty weeks of work.

Folklorica to return to their former professions. The company has not been dissolved according to the procedures of the N-PCL.

The same legal regime governs both of these public benefit organizations. Though nonprofits may receive recognition of exemption if they are organized as unincorporated associations, the corporate form because of its advantage of limited liability<sup>4</sup> and the fact it is most familiar to counsel and the most common form of nonprofit organization makes it the entity of choice.<sup>5</sup> Though the dance company may be able to file simplified returns, its corporate structure and the legal formalities that adhere to it will be the same as the more substantial SDS. As a profit-seeking enterprise, Ballet Folklorica could be either a partnership, a close corporation, or a limited liability company. This essay suggests that a special category of close nonprofit corporations be created for smaller nonprofit organizations. My proposal would lower the transaction costs of forming and maintaining smaller organizations, and would also reduce agency costs<sup>6</sup> of monitoring them by state and federal authorities.

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<sup>4</sup> Limited liability for such small organizations is only meaningful against tort claimants. The principals will have to give personal guarantees for contracts.

<sup>5</sup> Henry Hansmann, Reforming Nonprofit Corporation Law, 129 U. Pa. L. Rev. 497, 501 (1981) [hereinafter Reforming]. Many aspects of the CNPC resemble the unincorporated association, but that has not been favored. Section 6 The Uniform Unincorporated Nonprofit Association Act offers limited liability but this Uniform Act has not been adopted in more than a few states. The nonprofit corporation will remain the dominant organizational form if for no other reason than custom and familiarity.

<sup>6</sup> The use of such academic jargon may risk expulsion from the group. Some just may be thankful they are practicing law. An agency relationship is a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit

## The Economic Structure of Smaller Nonprofits

From an economic perspective the types of nonprofit organizations discussed in this paper, particularly our dance company, resemble commercial entrepreneurial nonprofits in the Hansmann typology. The primary source of income for commercial nonprofits is from payments received from fees, goods and services.<sup>7</sup> In the case of our dance company sources of funds would include grants to perform new ballets or to perform at particular places, admission charges, and contributions from patrons and donors. Under Hansmann's governance typology, the dance company and similar nonprofits would be termed "entrepreneurial" because they are controlled by their managers rather than patrons and are self-perpetuating.<sup>8</sup> While Hansmann's categories are ideal typologies and my dance company is another, one should not underestimate the number of organizations that fit this category: small struggling nonprofits in which control

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the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship. This latter cost is the "residual loss." Thus, *agency costs* are the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditure by the agent, (3) the residual loss. Jensen & Meckling, *Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305, 308 (1976). In our example the principals would be the governmental and private patrons. The agent would be the organization and those who run it. The service provided is some benefit to the public - in our example promoting dance. The agency costs are those costs of the government in monitoring Manny, Moe and Jack and Ballet Folklorica and of the organization in filing the myriad forms and reports and registration statements; the use of attorneys and accountants to adhere to the requirements. In plain English, I am proposing to lower these costs of the organization and governments.

<sup>7</sup> Reforming, *supra* note 5 at 502-03; Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L. J.* 835, 840-42 (1980) [hereinafter *Role*].

<sup>8</sup> *Role*, *supra* note 7 at 841, Reforming, *supra* note 5 at 503.

is concentrated in only a few managers. These controlling managers are founders, board members, and employees or performers whose economic welfare correlates directly with that of the organization. It is virtually impossible to gain a dependable statistical sense of the size of this grouping.<sup>9</sup> It is substantial in size. In 1989 over 70% of nonprofits excluding religious organizations and foundations had total revenue below \$25,000 and therefore did not have to file an annual report with the Internal Revenue Service. The majority of organizations reporting financial data had annual expenditures less than \$100,000 and median assets of \$ 158,000.<sup>10</sup>

Though our dance company is organized as a nonprofit, for all practical purposes its principals - the three dancers - are engaged in commercial activity differing little from managers of for-profit firms save for the source of some of their funds.<sup>11</sup> While there has been research on the blurring of the nonprofit and for-profit sectors, it usually has applied to competition within a sector of the economy such as health care and has involved larger organizations than those that are the subject of this paper.<sup>12</sup> The principals of our dance company are

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<sup>9</sup> "The independent sector is dominated by a large number of small organizations about which little is known." Virginia A. Hodgkinson et al. *Nonprofit Almanac 1992-1993: Dimensions of the Independent Sector* 11 (1992).

<sup>10</sup> Evelyn Alicia Lewis, *When Entrepreneurs of Commercial Nonprofits Divorce: Is it Anybody's Business? A Perspective on Individual Property Rights in Nonprofits*, 73 N.C.L. Rev. 1761, 1774 (1995) [hereinafter Lewis].

<sup>11</sup> Normally dance is not an area where nonprofits compete with profit-seeking counterparts. One of the few for-profit competitors might be the Rockettes of Radio City Music Hall, but the dancers have no ownership interest nor control of the company.

<sup>12</sup> See J.M. Ferris & E. Graddy, *Fading Distinctions Among the Nonprofit, Government, and For-Profit Sectors*, in *The Future of the Nonprofit Sector*, ch. 8 (Virginia A. Hodgkinson & Richard W. Lyman eds., 1989); David C. Hammack & Dennis R. Young, eds. *Nonprofit Organizations in a Market Economy* (1993).

entrepreneurs, defined as persons who organize, manage, and assume responsibility for a business or other enterprise.<sup>13</sup> While the phrase "nonprofit entrepreneur" might seem an oxymoron, such individuals today are found in all reaches of the nonprofit sector.<sup>14</sup>

I do not mean to suggest that entrepreneurial motives are inappropriate or to use the phrase in a pejorative sense. In these parlous economic times for all nonprofits, nonprofit entrepreneurs may make the difference between survival or dissolution. As Judge Posner has noted "...the adoption of the nonprofit form does not change human nature. ...Nonprofit status affects the method of financing the enterprise (substituting a combination of gift and debt financing for equity and debt financing) and the form in which profits are distributed."<sup>15</sup> All organizations must cover the costs of their operations eventually. The entrepreneur generates new sources of revenue that benefit the organizations they serve and themselves. The existence of additional for-profit goals does not mean that quantity and quality will be fatally compromised. A sacrifice of qualitative goals in the pursuit of entrepreneurial ones would lead to a loss of grants and patron support.

### **Control, Managerial Style, and the Disregard of Corporate Norms**

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<sup>13</sup> The Random House Dictionary 291 (1978).

<sup>14</sup> Edward Skloot, ed. *The Nonprofit Entrepreneur - Creating Ventures to Earn Income* 2 (1988); Lewis, *supra* note 10 at 1774.

<sup>15</sup> *Hospital Corp. of Amer. v. FTC*, 807 F.2d 1381, 1390 (7th Cir. 1986).

As in the case of our dance company, many small nonprofit organizations are operated and controlled by their founders, all of whom are employees. Commercial activity is every much as part of the mission as the eleemosynary goals. Control is crucial to the nonprofit's managers. In our example the principals have invested their human capital in the firm, have foregone other opportunities in less risky endeavors, and believe they can achieve their artistic and economic missions most efficiently though self-perpetuating control.

To the extent this is true, the corporate veil may become easily pierced. w/ limited liability, the argument for corporate need or knowledge of normal corporate procedures such as board meetings, annual meetings, minutes, election of directors or officers, and other corporate rituals. Financial records may be kept at the instance of patrons, but registration and filing requirements on the state level are often overlooked out of ignorance, inattention, or the small amount of patronage funds raised.<sup>16</sup> Decisions are made by equal principals or by the founder or leader of the organization away from the corporate board model of consensus after discussion. The managers are directors. Outside directors as in the case of our dance company are window dressing, usually discarded after the certificate has been filed.<sup>17</sup> In their management style these organizations function

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<sup>16</sup> A larger number of nonprofits are below the filing minimums at the state and federal level and are break even operations at best. Avner Ben-Ner & Theresa Van Hoomissen concluded from a study of 8,010 nonprofits in New York State in 1985 that "most nonprofit organizations' revenues exceed expenditures, but only by a minute margin", A Portrait of the Nonprofit Sector in the Mixed Economy, in THE NONPROFIT SECTOR IN THE MIXED ECONOMY, 243 263-264 (Avner Ben-Ner & Bernedetto Gui eds. 1993).

<sup>17</sup> This use of outside directors was exemplified in a recent article on the troubles of the Ridiculous Theatre Company, an organization too large to be a close nonprofit corporation: "The board rarely monitored expenditures. Its sole requirements for membership: a love of the Ridiculous and a \$2,500 yearly contribution. 'Charles [Ludlam] and I never wanted a board that would fire us or tell us what sort of work to produce,' said Mr. [Everett] Quinton [Artistic Director]". Bob Ickes,

more like partnerships or sole proprietorships, a fact that nonprofit corporate law ignores.

The defining brake on nonprofit entrepreneurship, the nondistribution constraint,<sup>18</sup> is not relevant in the context of the organizations that are the focus of this paper. Unlike SDS which will use the profits from tee-shirts and other entrepreneurial activities to expand the organization or to fulfill its mission, after expenses for operation, all of the revenues raised by Ballet Folklorica are used for existing salaries and basic expenses. There never is anything left to distribute.<sup>19</sup> Because of the low salary levels we assume no problems of inurement or private benefit.<sup>20</sup> One could argue that all of these small commercial entrepreneurial nonprofits

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"An Empty Stocking, A Seasonal Tale," N.Y. Times, Dec. 24, 1995 at II, 5.

<sup>18</sup> The nondistribution constraint provides that no part of the net earnings of a nonprofit organization may inure to the benefit of any private shareholder or individual. I.R.C. § 501(c)(3), Treas. Reg. § 1.501(c)(3), N.Y. Not-for-Profit Corp. L. § 102 (a)(10),(5).

<sup>19</sup> Despite the annual publicity of the compensation largess major charities and foundations grant to their executives, Chronicle of Philanthropy, Sept. 1995 at 1; Karen W. Arenson, Large Charities Pay Well, Survey Finds, N.Y. Times, Sept. 5, 1995 at 12; the reality of the broader nonprofit sector is that most salaries are low by for-profit or government standards. A 1992 survey of 1300 New York City nonprofits by the Nonprofit Coordinating Committee and the Fund for the City of New York found that the average salary of an executive director of a New York City was \$30,000. The NPCC survey included many smaller organizations of the type discussed in this paper. Other surveys of larger organizations have found higher average and median salaries, but levels substantially below that of executives of for-profit companies. Sharon McDonnell, Many Nonprofit Leaders Don't Profit, Crains N.Y. Bus., May 9, 1994, at 29.

<sup>20</sup> In fact these organizations all raise the spectre of violation of the private inurement and private benefit proscriptions. Private inurement applies to an exempt organization's insiders, that is, individuals whose special relationship offers them an opportunity to benefit economically from the organization's income or assets. The Service has developed the related concept of "private benefit" which is founded on the principle that a § 501(c)(3) organization must serve public rather than private interests. The organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests. Treas. Reg. § 1.501(c)(3)-1(d)(1). The private benefit proscription applies to anyone outside of the intended charitable class, whether or not they are insiders. See, Gen. Couns. Mem. 39862 (Dec. 2, 1991).



violate the private benefit prohibition,<sup>21</sup> but the Service either has ignored or not focused upon the problem.

Nonprofit Law has not reflected the very different managerial and governance ethos of these smaller organizations. Nonprofit corporate law treats large and small nonprofits identically, assuming that entrepreneurship is collateral to the organization's exempt mission. The legal rituals and formalities that drive corporate governance and practice are absent from the smaller nonprofit. Recognition of the differing legal needs and goals of the small, commercial nonprofit is important for framing appropriate legal norms for this part of the nonprofit universe.<sup>22</sup> Business corporate developments provide a useful analogue and starting point.

### Organizational Vehicles for Profit-Seeking Counterparts

The use of the nonprofit form is a means to an entrepreneurial end. Entrepreneurs select the not-for-profit rather than the more appropriate for-profit form only because nonprofit status provides access to exempt organizations or donors for financing, particularly if the entrepreneur lacks the means or if there is a market failure to finance the for-profit entity.<sup>23</sup> The closely

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<sup>21</sup> I.R.C. § 501(c)(3). Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

<sup>22</sup> Cf. Lewis, *supra* note 4 at 1787.

<sup>23</sup> Lewis, *supra* note 8 at 1799. As described by Lewis, *id.* at 1806-07, sector straddling is undertaken by associated public and private partnerships in certain industries such as film making. A for-profit close corporation is founded and managed by a film maker who also creates a nonprofit intermediary to channel grants. An organization might make a grant for contribution to a qualifying nonprofit entity for a specific project. The nonprofit then contracts out the production of the goods and services to the for-profit firm which actually initiated and completes the project. The

held nature of the nonprofit firm permits the entrepreneur to maintain the necessary control.

### The Close Corporation Analogue

As corporate law developed in the twentieth century corporate law norms accommodated the operational needs of publicly held corporations with a substantial number of shareholders and a separation of ownership and of control. Under the classical model of the corporate structure shareholders were owners, the board of directors oversaw the firm monitoring officers and managing policy, and the managers were agents of the board responsible for the day to day operations.<sup>24</sup>

However, the vast majority of business corporations, nearly 94%, have ten or fewer shareholders.<sup>25</sup> Their structure and modus operandi are quite different as are the expectations of shareholders. This vast mass of smaller corporations has been called "close corporations". While there is no single accepted definition of the term, there are certain common characteristics used to describe them. They are corporations with a small number of individual shareholders

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shareholders of the for-profit firm are connected to the entrepreneurs in the nonprofit. The nonprofit pays contract fees to the profit seeking firm, using grant monies received from project funders. Barney and Friends was funded in this way. In Lewis's example the nonprofit essentially is a means to launder grant money. In our hypothetical the nonprofit is the means and end to obtain funds from nonprofit patrons. These funds are diverted to entrepreneurial use. Other industries, including publishing, computer software, daycare, and home health care, use this technique. Id. at 1808 n. 212

<sup>24</sup> Berle and Means noted the separation of ownership and control where the managers actually dominated the corporation and its governance. There is an academic cottage industry describing the recent emergence of shareholder power by the institutional investor.

<sup>25</sup> William L. Carey and Melvin A. Eisenberg, Cases and Materials on Corporations, 243 (7th ed. 1995). Data is from the 1970s.

whose shares are not traded on a recognized securities exchange or on the over-the-counter market.<sup>26</sup> Other characteristics include an integration of ownership and control, that is, the shareholders actually manage and direct the organization. Through agreement shareholders will negate free transferability of ownership interests through share transfer restriction agreements.

*ambiguous* → These corporations may not have perpetual duration. Because of a dearth of assets, the shareholders may not be able to obtain limited liability. Owner participation has blurred traditional roles. Precepts of centralized management may be adjusted toward shared responsibility. It has been widely noted that the close corporation resembles a partnership. Many close corporations are "really partnerships, between two or three people who contribute their capital, skills, experience and labor."<sup>27</sup>

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At first the same law applied to all corporations. But caselaw and later statutory developments took cognizance of the special needs of these small corporations. Because the participants in close corporation ventures are working closely together, often have all of their capital invested in the firm, and their employment is their livelihood, minority shareholders in such organizations have been particularly vulnerable to oppression. As a result the law developed a heightened fiduciary duty towards these minority "partners".<sup>28</sup>

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<sup>26</sup> Robert Charles Clark, Corporate Law § 1.3 (1986). This seems to be the definition under the New York Business Corporation Law §§ 620(b); 1104(a).

<sup>27</sup> Kruger v. Gerth, 16 N.Y. 2d 802, 805 (1965), Desmond C.J. dissenting.

<sup>28</sup> See Donahue v. Rodd, 367 Mass. 578, 328 N.E.2d 505 (1975).

States have used differing strategies in their approaches to the close corporation.<sup>29</sup> Normally they are chartered under the general corporate law. Some states have no special provisions for close corporations but modify traditional statutory norms so that they will meet the particular needs of close corporations. New York and the Model Business Corporation Act adopt a unified approach but add a few provisions applicable only to the corporations with defined shareholder characteristics, namely that no shares are listed on the national securities exchange or regularly quoted on an over-the-counter market.<sup>30</sup> Other jurisdictions including Delaware and California, follow the unified approach to a point with provisions that modify statutory norms providing flexibility. These jurisdictions also have an integrated set of provisions which are applicable only to corporations that qualify for and elect close corporation status.<sup>31</sup> Corporations must elect close corporation status and if they do can structure themselves as an incorporated partnership.

No matter what statutory approach has been utilized the purpose of the close corporation concept has been to recognize that certain corporations deserve special treatment. Usually, the corporation must elect to receive such privilege. Data indicates<sup>g</sup> that only a fraction of eligible corporations elect, so the effectiveness of these options are minimal. As a result smaller corporations and their shareholders continue to look to courts for relief and recognition of their

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<sup>29</sup> Carey & Eisenberg, *supra* note 24 at 399, 400.

<sup>30</sup> N.Y.B.C.L. § 620(c); M.B.C.A. § 7.32

<sup>31</sup> Del. Code tit. 9 §§ 341-356. Eligibility for close corporation status under Delaware law requires shares are not held by more than thirty persons, there must be a share transfer restriction, and the corporation can make no offering of its stock. *Id.* § 342.

special needs.

As I've suggested, close corporations resemble partnerships in management approach. Many nonprofits such as our dance company are comparable to partnerships<sup>32</sup> in the way they are run. The general partnership form is not available to nonprofits.<sup>33</sup> Though I am suggesting a new state law category, clearly, the Code will have to be changed or the Service will have to interpret "corporation" to include a partnership and perhaps even an individual for my proposal to work.<sup>34</sup>

NO!  
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### The Limited Liability Company

A more recent form of business organization is the limited liability company (LLC), which also offers assistance in meeting the needs of smaller firms.<sup>35</sup> First utilized in this country in Wyoming of all places in 1977, a limited liability company is a hybrid entity which combines corporate-like limited liability and the opportunity for federal and state partnership

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<sup>32</sup> A partnership is an association of two or more persons to carry on as co-owners a business for profit. U.P.A. § 6(1); R.U.P.A. § 202(a).

cert denied 385 US 822 (1966)

<sup>33</sup> Emerson Inst. v. U.S., 356 F.2d 824 (D.C. Cir. 1966). Section 501(c)(3) refers to a "corporation, community chest, fund or foundation".

add point →

<sup>34</sup> According to the I.R.S. Exempt Orgs. Handbook, § 321.1 it is not possible to operate an exempt organization as an individual.

<sup>35</sup> Two foreign entities with limited liability attributes are the "Limitada" from the civil law system and the German "GmbH".

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taxation treatment. The LLC avoids the strict qualification rules of the S corporation.<sup>36</sup>

The LLC is formed by filing articles of organization with the secretary of state. The owners are called members, who govern the organization or may delegate governance responsibilities to managers who need not be members. The principal governing document is the "operating agreement" which resembles a partnership agreement, by-laws, or a shareholders agreement. The LLC has the same powers as the corporate form. It is a useful vehicle for small businesses with few active members. Like the partnership, limited liability companies lack the corporate characteristic of free transferability of interests.

#### Attributes of the Close Nonprofit Corporation

I envision the Close Nonprofit Corporation having special attributes including: a maximum of seven years duration; governance by manager-principals instead of directors; a recognition of the lack of centralized management; and a maximum annual income or revenues from all sources of \$150,000 before regular corporate and reporting standards would trigger. Manager-principal status would not be transferrable absent a refiling of the certificate of incorporation. To organize a prospective organization would file a certificate of CNPC status with the appropriate official in the state of incorporation. Thereafter, the organization would file annually simple revenue and expenditures forms. Unless a new certificate of CNPC status was filed at the end of the seven years, the organization would dissolve automatically. The

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<sup>36</sup> S corporations may have only one class of stock, no more than thirty-five shareholders, may not own more than 80% or more of another corporation, may not have other corporations nor non-resident aliens as shareholders.

Yes but... see Rev. Rul. 94-93, 1994-2 CB 198, revoking Rev. Rul. 77-220, 1977-1 CB 263.

CNPC would retain corporate concepts of limited liability.<sup>37</sup>

### The Tax Treatment of Close Nonprofit Corporations

Though the close nonprofit corporation is a corporate entity, I suggest that for purposes of federal taxation it would not be treated as a separate entity but as an aggregation of its managers-principals. At the federal level the CNPC would resemble a partnership or limited liability company, and any tax burdens or benefits would pass through to the individual manager-principals. In a partnership income is attributable to the partners who are subject to a tax on that income in their separate or individual capacities.<sup>38</sup> Because of this "pass-through" treatment, a partnership pays no tax though it must file a partnership tax return.<sup>39</sup> Corporations other than S corporations, pay tax on their net income.<sup>40</sup> The S corporation offers pass-through advantages combined with rigid eligibility requirements.<sup>41</sup> If it demonstrates certain non-corporate characteristics, the limited liability company will receive pass-through treatment.<sup>42</sup> As the CNPC is not formed to carry on a business for profit, it would not be taxed as a

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<sup>37</sup> See N-PCL § 517.

<sup>38</sup> I.R.C. § 5701.

<sup>39</sup> I.R.C. § 6031.

<sup>40</sup> I.R.C. § 11.

<sup>41</sup> I.R.C. subchapter S, §§ 1361(b)-1363.

<sup>42</sup> Rev. Proc. 95-10, 1995-3 I.R.B. 21.

corporation. However, the CNPC would not have the remaining corporate characteristics either.<sup>43</sup>

check the box

As we shall see the close nonprofit corporations will lack by virtue of definition all of the characteristics the Service has attributed to associations. The vast majority of small nonprofits pay most of their revenue in the form of salaries, so there is little income in any case after expenses. So in a tax sense many nonprofits already are like partnerships.

Though completing the 1023 form can be a daunting process,<sup>44</sup> the overwhelming number of applications - one figure I've heard is 95-99% - eventually get approved. We may want to examine CNPC's more closely because of the possibilities of abuse or inexperience. When the organization submitted its 1023, it would indicate that it was seeking recognition of CNPC status. A panel of individuals, knowledgeable in the particular area would determine

<sup>43</sup> The Code defines a corporation as including "associations, joint-stock companies, and insurance companies". IRC § 7701(a)(3). Thus, certain unincorporated entities, associations, may be treated as corporations for federal tax purposes, as well as corporations routinely organized under state law. "Associations" have been defined in terms of their corporate characteristics. *Morrissey v. Comm'r*, 296 U.S. 344 (1935). The regulations set forth six characteristics of a "pure corporation" which distinguish it from other business organizations: 1) associates; 2) an objective to carry on a business and divide the profits; 3) continuity of life; 4) centralization of management; 5) liability for debts limited to corporate property, and 6) free transferability of interests. Treas. Reg. § 301.7701-2(a)(3). The determination of whether an organization is classified as an association is made by taking into account these and any other relevant factors. Except in the case of a corporation owned by a single shareholder, the absence of either of the first two characteristics will prevent an organization from being classified as an association. An organization will be classified as an association and taxed as a corporation only if it has three of the four remaining corporate characteristics. Treas. Reg. 301.7701-2(a)(3).

NO

<sup>44</sup> The instructions for Form 1023 inform us that the estimated time to complete Parts I to IV will be 55 hours and 14 minutes for recordkeeping, learning about the law 4 hours 37 minutes, preparing and sending the form to the IRS 8 hours 7 minutes plus additional time for the schedules. Where do these figures come from?



whether the individuals involved as manager-principals and the proposed organization were likely to comply with the charitable standards expected of § 501(c)(3) organizations and evaluate the organization's purposes. An objection might be, do we want IRS to be making decisions over the cultural or charitable worth of prospective institutions or qualitative questions? There are precedents for governmental determinations of such status.

I proceed under the assumption that exemption is a kind of subsidy<sup>45</sup> though in the case of the CNPC, the subsidy portion is probably small because most revenues go to salaries which are taxed at the individual level. Though this "vetting" is not required of regular applications, it seems to me that the creation of this non-profit limited liability entity should require a closer scrutiny because exemption is passing through a few individuals and the normal fiduciary standards will be mitigated. There is precedent for citizen review of status eligibility.

New York City and a few other municipalities have designated certain districts as suitable for living working spaces by professional artists. In New York City "professional artists"<sup>46</sup> who wish to be eligible to live and work in loft housing in designated areas of the city must submit an application with a resume, samples of work, and references to an Artist's Certification Committee which reviews and makes recommendations regarding certification to the New York

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<sup>45</sup> See, *Regan v. Taxation With Representation*, 461 U.S. 540, 544 (1983) ["Deductible contributions are similar to cash grants of the amount of a portion of the individual's contributions.].

<sup>46</sup> "Artist" is defined as someone "regularly engaged in the fine arts...on a professional basis." N.Y. Mult. Dwell. L. § 276.

City Commissioner of Cultural Affairs who makes the actual decision.<sup>47</sup> Consideration of these applications involves subjective, qualitative factors as would the review of applications of individuals who propose to carry on charitable activities.<sup>48</sup>

The Internal Revenue Service has used panels of experts, and has proposed the use of a panel to appraise in advance works of art donated for charitable purposes. It has proposed a revenue procedure that would allow a taxpayer to obtain from the Service in return for a \$3,000 user fee a statement of value for use in taking a deduction under § 170 for art contributed to a qualified organization.<sup>49</sup> Statements of Value would be issued in advance of the return due date by the I.R.S. Art Advisory Panel, a group of twenty-five art experts, engaged by the Service to evaluate works of art for tax purposes.<sup>50</sup>

Perhaps most analogous is the review of the cultural and artistic merit of works of art by Ireland's Revenue Commissioners which may result in tax exemption. Income earned by

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<sup>47</sup> New York City Administrative Code, Title 58/1, § 1-01-§ 1-09 (1991).

<sup>48</sup> The criteria for consideration include the artist is regularly engaged in and demonstrates a serious consistent commitment to his or her art form or art occupation; the applicant is engaged in an art form or art occupation which can be considered and is pursued by the applicant as a "fine art". To demonstrate such pursuit of such art form as a fine art the application must evidence a "substantial element of independent esthetic judgment and self-directed work by the applicant, i.e. the production of work solely on a commercial, industrial or work-for-hire basis ...is not sufficient;...the application should warrant a finding that others in the field recognize the applicant as a 'professional' with regard to his or her art form or occupation. The word professional" in this context does not necessarily refer to the amount of financial remuneration..." Id. at § 1.05

<sup>49</sup> I.R.S. Notice 95-1, 94 TNT 250-1 (Release Date dec. 21, 1994).

<sup>50</sup> The procedure would be available for works of art receiving a qualified appraisal of \$ 50,000 or more and only after an object had been donated.

artists, writers, composers and sculptors from the sale of their works is exempt from tax in Ireland in certain circumstances. Section 2 of the Finance Act of 1969 empowers the Revenue Commissioners to make a determination that the work has "cultural and artistic merit."<sup>51</sup> If such a determination is made, the income derived from such work is exempt from income tax. The exemption applies to original and creative works in a book or other writing, a play or musical composition, a parody or other visual media or a sculpture.<sup>52</sup> In deciding whether or not to make such a determination the Irish Revenue Commissioners may consult with an individual or organization for assistance in reaching such a decision. Though the Finance Act provides that claimants for artists' relief must be solely resident in Ireland, advance opinions can be given to claimants resident abroad when the claimant becomes resident in Ireland, formal determinations are then made. There is an appeal only if the Revenue Commissioners have not acted within six months.<sup>53</sup>

Though seeking a review by a panel of experts might seem cumbersome if not a

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<sup>51</sup> Recently revised guidelines attempt to define "art": A work has cultural merit if its contemplation enhances the quality of individual or social life by virtue of that work's intellectual, spiritual or aesthetic form and content. A work has artistic merit when its combined form and content enhances or intensifies the aesthetic apprehension of those who experience or contmplate it." Since its introduction in 1969 2,600 of nearly 5,000 applications were successful. In 1995 there were 132 approvals out of 289 applications. Additionally writers and artists can enjoy state financial assistance through Aosdána, a self-regulated state financed group of up to 200. Members are entitled to tax free payments of up to £ 8000 per year for full-time artists unable to support themselves on their artistic earnings.

<sup>52</sup> Some non-fiction works-art criticism, history, biography, and literary translation-can qualify, but excluded are music written for advertisements, textbooks and newspaper or magazine articles.

<sup>53</sup> Artists well known in his or her field merely have to fill out a short form informing the Revenue Commissioners that they have produced an original and creative work.

substantial delay in the process of receiving recognition of exemption, I believe it would work.

7. When the organization elects to have regular 501(c)(3) status, it should receive expedited review by the service so long as the individuals and CNPC returns have been filed. On the state level only a restated certificate of incorporation would need to be filed when the organization grew out of CNPC status.

### **Lack of Centralized Management**

CNPC's would lack centralized management as interpreted by the Service.<sup>54</sup> They would be governed or managed by manager-principals, rather than by a board of directors. This structure would resemble the management of a limited liability company, combining the benefits of limited liability with the sharing of control found in a partnership. The minimum number of manager-principals would be three as currently required of directors under the N-PCL.<sup>55</sup> In the absence of agreement to the contrary, each of the principals could bind the corporation. There would be no need for meetings of the board or the accompanying formalities which are largely ignored by smaller organizations anyway.

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<sup>54</sup> An organization has centralized management if any person or group (made up of less than all members) has continuing exclusive authority to make management decisions in the same manner as a board of directors of a corporation. Reg. § 301.7701-2(c)(1). Because a general partnership has a mutual agency relationship among the general partners, a general partnership formed under a statute corresponding to the Uniform Partnership Act cannot have centralized management. Reg. § 301.7701-2(c)(4). Limited partnerships generally do not have centralized management unless substantially all the interests in the partnership are owned by limited partners.

<sup>55</sup> N.Y. N-PCL § 702. There is no non-superficial reason why a CNPC could not have but one member save it presents an unseemly view to the outside. The Uniform Limited Liability Company Act permits one person to organize an LLC, § 202 but individuals are treated as sole proprietorships or S corporations and in fact 80% of S Corporations have one shareholder.

The close nonprofit corporation would be categorized as a Type B not-for-profit under the N.Y. N-PCL. While the existing statute grants Type B corporations the option of being membership or nonmembership corporations, I would prefer CNPCs to be nonmembership. This would eliminate the need for shareholders' meetings, election of directors, participation in organic changes and many of the other corporate-membership functions that require sophistication and legal counsel. Nonmembership status would be consistent with the goals of simplicity and erosion of corporate formalities of the CNPC structure.

### **Lack of Transferability of CNPC Status**

A federal tax indicium of corporate status is the free transferability of membership interests without consent of other members in a manner that substitutes the transferee for the member.<sup>56</sup> Though there are no shares in a nonprofit organization, members should not be able to transfer their special nonprofit status privilege to others. This would limit the organization's continuity of life and complement the limited duration of seven years. It would restrict the organization's ability to change its exempt purposes from that proposed by its founders. A restriction on free transferability of interests would also limit the use of the CNPC as a tax evasion or laundering device.

### **Duration**

As in our hypothetical dance company, many smaller nonprofits just cease operation and

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<sup>56</sup> Treas. Reg. § 301.7704-2(e).

walk away from the organization, leaving it to limbo. Members or directors treat such organizations as unincorporated associations. No steps are taken for dissolution, and there are few assets that remain. Though failure to file appropriate forms may lead to fines and revocation of corporate status<sup>57</sup> in fact there is little oversight of the many organizations that functionally cease to exist but remain legally alive. Dissolution is complex, expensive, time consuming, requires counsel, and a waste of resources at this level of size. According to Bowen little is known about the number of such organizations that dissolve.<sup>58</sup> Little is known about these organizations period.

I am suggesting that the CNPC have a finite renewable existence of seven years. It seems that period would be sufficiently long for germination. After seven years an organization should be successful enough to seek the regular category of nonprofit corporate and 501(c)(3) status. For the organization that merely muddles along and wants to continue, there would be no problem so long as it has filed or files during the renewal process the simplified forms required by state and federal authorities and the individual's personal taxes are in order. If an organization grows beyond the \$150,000 level before the seven year duration, it would automatically become a regular nonprofit corporation in the succeeding year, and the full panoply of fiduciary and filing responsibilities would adhere.

### **The \$150,000 Income Limitation**

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<sup>57</sup> See E.P.T.L. 8.1-4; N.Y. N-PCL § 112; Rev. Model Nonprofit Corp. Act § 14.20.

<sup>58</sup> William G. Bowen et al., *The Charitable Nonprofits* 100-01 (1994).

I would raise significantly the minimum filing requirements at both the state and federal levels.<sup>59</sup> Though I would require the organizations to register to solicit funds, here too I would raise the trigger before serious financial disclosure forms are required. Thereafter, regular state and federal filing standards would apply. Below the trigger organizations would file simplified CNPC forms.

?? { It seems to me that we don't have an enforcement regime applicable to small nonprofits in any case, merely a registration requirement. I am willing to let it go at that. One cannot deny that there are abuses but the costs to monitor, the even were such resources available are not worth the efforts. The very real costs in terms of accounting fees and legal capital by small firms foolish enough to adhere to the filing requirements are inefficient and unnecessary. Besides, figures representing abuse of CNPC status should appear on the personal income tax form. There the consequences of improper or dilatory filing and the chances of being caught are exponentially higher. ?

### Fiduciary Obligations

Directors of nonprofit organizations are fiduciaries to their organization and to the public<sup>60</sup>. really?

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<sup>59</sup> At the state level simplified forms can be filed if gross receipts are less than \$25,000. At the federal level the annual information return, Form 990, have to be filed by non private foundations if gross receipts exceed \$25,000. Organizations whose gross receipts are \$25,000 to \$100,000 and who have total assets less than \$250,000, a short-form equivalent 990-EZ may be filed.

<sup>60</sup>The word "fiduciary" comes from the Latin word "fiducia," meaning trust. The term entered English law reports in the mid-nineteenth century, and was descriptive of relationships similar to that between a trustee and *cestui que trust* (beneficiary). "Fiduciary" replaced "trust" which in the same era came to have a precise technical meaning, namely that B had settled legal ownership of property on A to be used on behalf of B or others. "Trust" earlier meant more broadly or imprecisely, that B

Nonprofit fiduciaries are, in many different ways, obliged to act unselfishly and to offer their institutions the advantage of their knowledge and skill. The fiduciary obligation presupposes that persons subject to it are capable, at least in defined circumstances, of renouncing the immediate pursuit of self-interest. Fiduciary obligations are notably elusive as a concept<sup>61</sup>. Nevertheless in the traditional corporate structure they require at a minimum that directors exercise a duty of care<sup>62</sup>; a duty of loyalty to the corporation<sup>63</sup>; and a duty of obedience<sup>64</sup>

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reposed confidence in A. The fiduciary obligation came to have a life of its own in the English chancery courts which historically were a separate court system of equity. See, Deborah A. DeMott, *Fiduciary Obligation, Agency and Partnership* 12 (1991).

<sup>61</sup>The particular duties it imposes vary in different contexts, as does the justification for imposing the obligation itself. However illusory, the obligation unifies disparate types of legal relationships, including agency, intra-corporate, attorney-client relationships; relations between directors, officers and an organization's members or the public; and between employees, and managers and the organization. Because of the generality and imprecision of many fiduciary norms, the vulnerability of many beneficiaries to misconduct by fiduciaries, and the difficulty of applying such standards to concrete guides for behavior, judicial opinions interpreting and applying fiduciary rules sound like sermons. See, *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 564 (1928)(Cardozo,C.J.).

<sup>62</sup>The duty of care concerns the standard of conduct applied to directors in the discharge of their responsibilities. Directors must exercise their responsibilities in good faith and with a certain degree of diligence, attention, care, and skill. Broadly stated, a director can fail to discharge her duty in two ways: by failing to supervise the corporation (the duty of attention) or even if the director is disinterested, independent and acts in good faith, by failing to make an informed decision about a matter that comes before the board for action.

The significance of the duty of care and its complement, the business judgment rule, is that they relate to a process of decisionmaking. If a director acts in good faith, with the requisite degree of care, and within her authority, a court will not review the action, even if it proves disastrous to the organization. Thus, the duty of care focuses upon the manner in which directors exercise their responsibilities, rather than the correctness of the decision. N.Y. Not-for-Profit Corp. L. §§ 717, 719. Rev. Model Nonprofit Corp. Act §§ 8.30, 8.33, 8.41-42.

<sup>63</sup>Directors owe a duty of loyalty to the corporation on whose board they serve. This duty requires them to act in a manner that does not harm the corporation. It further requires directors to avoid using their position to obtain improperly a personal benefit or advantages which might more properly



Breaches of the traditional fiduciary obligations, conflicts of interest, divided loyalties, and transactions among directors, officers, and charitable corporations occur with frequency among the smaller nonprofits that are the subject of this paper. They are often a necessity of survival. Only through an interested transaction may there be access to resources unavailable from the market. The financial status of these small organizations may be so poor that market sources of credit, supplies, or services are unavailable. Loans of money, goods, or services may be obtainable only from the principals involved with the organization. These loans may involve substantial commingling of property or assets.

The normal governance process used to meet fiduciary responsibilities is ignored.

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belong to the corporation. The fact that a director had an interest in a transaction is less significant than whether it was fair to the corporation at the time the decision was made and whether the decision was reached in an impartial board environment. The duty of loyalty requires directors to place the interests of the corporation ahead of their personal gain. A director is expected to make decisions objectively, to refrain from participation, and to obtain approval from the corporation where there is a relationship which impairs the director's objectivity. American Law Institute, Principles of Corporate Governance: American Law Institute, Analysis and Recommendations § 5.02 (1994); N.Y. Not-for-Profit Corp. L. §§ 715-16; Rev. Model Nonprofit Corp. Act §§ 8.31, 8.32, 8.33. In a conflict of interest situation, directors receive more favorable financial benefits than they would gain in an open market or they enjoy priority over open market competitors.

<sup>64</sup>This is a somewhat less recognized duty of board members is to carry out the purposes of the organization as expressed in the articles of association or certificate of incorporation. The duty of obedience resembles the trustee's duty to administer a trust in a manner faithful to the wishes of the creator. IIA Scott on Trusts (William F. Fratcher, ed., 4th ed. 1986) § 164.1. Unless allowed by the law, nonprofit directors may not deviate in any substantial way from the duty to fulfill the particular purposes for which the organization was created. Daniel L. Kurtz, Board Liability 84-85 (1989). In a sense the duty of obedience requires the directors to refrain from transactions and activities that are *ultra vires*, i.e., beyond the corporation's powers and purposes as expressed in its certificate of incorporation. The *ultra vires* doctrine has been emasculated in corporate law, but a director may be subject to suit if a corporation has entered into or completed an *ultra vires* transaction. Rev. Model Nonprofit Corp. Act § 3.04(c). Thus, the director has a duty to follow the purposes and powers as expressed in the governing legal documents.

Formal board meetings are not held. Because of the nature of the organization informal modes of decisionmaking will not meet the deliberative model of the duty of care. It is difficult to separate the interests of the corporation from those of the principals. Conflicts of interest are not sanitized by the available statutory hoop<sup>65</sup>. The duty of obedience may give way to more immediate needs<sup>66</sup>.

The fiduciary model as applied to small nonprofits does not work. It should better organizational practices. I think the approach to fiduciary obligations of the Revised Uniform Partnership Act might be helpful.<sup>67</sup> I would scale back principals' fiduciary responsibilities. 711 77

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<sup>65</sup>See N.Y. Not-for-Profit Corp. L. §§ 715-16; Rev. Model Nonprofit Corp. Act §§ 8.31, 8.32, 8.33.

<sup>66</sup>Moreover, few of the principals know what is in the purposes clause of their organization's certificate of incorporation.

<sup>67</sup>Rev. U.P.A. § 404 General Standards of Partner's Conduct.

(a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c).

(b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:

(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property including the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

(c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing.

(e) A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.

(f) A partner may lend money to and transact other business with the partnership, and

→ The duty of care would be limited to avoidance of reckless conduct, intentional misconduct or knowing violation of the law<sup>68</sup>. Duty of loyalty obligations would include a prohibition on appropriating corporate opportunity and competing directly with the corporation. The principal would not violate her duty of loyalty if conduct furthered her own interests. Principals could transact business with a CNPC without requiring formal approval. A principal's duties to the corporation would be bounded by the obligations of good faith and fair dealing. I do not think that loosened fiduciary obligations will make much difference at all.

### Conclusion

The CNPC would bring an air of reality to the governance of small nonprofits. By reducing fiduciary, accountability, and monitoring responsibilities as well as compliance costs the CNPC offers positive economic benefits for small organizations and the government alike. For the nonprofit it will allow principals to focus upon their exempt activities rather than spending time and money on attorneys and accountants if they are responsible, or more likely - ignoring the formal internal governance requirements of state corporate statutes.

There are benefits for government as well under this proposal. There is general

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as to each loan or transaction the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law.

(g) This section applies to a person winding up the partnership business as the personal or legal representative of the last surviving partner as if the person were a partner.

<sup>68</sup>The standard of care usually applied is that of gross negligence as opposed to ordinary negligence. I for one have difficulty in drawing the line for the distinction. I agree with Baron Rolfe who once defined gross negligence as the same thing as ordinary negligence "with the addition of a vituperative epithet". *Williamson v. Brett*, 152 Eng. Rep. 737 (1843).

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agreement that the state's enforcement efforts are inadequate. At the state level, attorneys generally lack the resources to enforce breaches of fiduciary duties in all but the most egregious situations, for all practical purposes charities are self-regulated.<sup>69</sup> The Internal Revenue Service increasingly has become involved in enforcing breaches of fiduciary duty, historically a state corporate law matter and far afield from its primary enforcement focus which is to recapture lost revenues owed to the federal treasury.<sup>70</sup> Recent IRS efforts as well as the Intermediate Sanctions legislation<sup>71</sup> raise significant issues of federalism.<sup>72</sup> Apart from questions whether enforcement should move to the federal level, the Exempt Organizations Division is hardly a paragon of efficient enforcement. One estimate is that at its present rate and existing resources it would take 79 years for the Service to audit all exempt organizations. The CNPC model would move enforcement responsibilities away from its present fiduciary focus to that of raising revenue. It would transfer enforcement to departments and agencies responsible for individual tax collection, a more proper and efficient situs for enforcement.<sup>73</sup> 7

The Close Nonprofit Corporation would better serve the needs and practices of small nonprofits than the existing legal structure which is largely ignored, expensive to follow, and

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<sup>69</sup> Robert Abrams, *Regulating Charity - The State's Role*, 35 Rec. 481, 484 (1980).

<sup>70</sup> *Blumenfield v. U.S.*, 306 F.2d 892, 900 (19 ) ("The primary purpose of the revenue statutes is to obtain revenue").

<sup>71</sup> Also known as the Compensation Consultants Full Employment Act.

<sup>72</sup> The argument on the other side is that the IRS has assumed this responsibility by default.

<sup>73</sup> One can suggest several hypotheses for the effectiveness of personal income tax collection: better computers, more resources for the effort, and the perceived seriousness of tax fraud.

does not meet the needs of organizations or the public. Basically, CNPC's would exist below the radar screens of government. If CNPCs are successful they would become "major league" 501(c)(3)s. If not, they would quietly disappear. The nonprofit sector would be much smaller numerically as a result of this redefinition, but much richer because CNPCs could conduct their exempt activities unhampered.