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### Recommended Citation

Thomas J. Russell, *Some Problems in Representing a Not-for-Profit Organization*, 15 DePaul L. Rev. 276 (1966)

Available at: <https://via.library.depaul.edu/law-review/vol15/iss2/2>

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## SOME PROBLEMS IN REPRESENTING A NOT-FOR-PROFIT ORGANIZATION

THOMAS J. RUSSELL\*

AMERICA has become a nation of "joiners." Nearly everyone today belongs to one or more civic, patriotic, religious, educational, charitable, fraternal, social, business league or labor organizations. All these associations or groups are referred to as "not-for-profit," since any income earned by the organization is not distributed to the members. However, little has been written about the various legal problems confronting these not-for-profit associations in their daily activities. It is the purpose of this article to discuss briefly some of the more common of these problems.

### INCORPORATION AND PERSONAL LIABILITY

Most of the larger not-for-profit organizations are incorporated.<sup>1</sup> Some have received special charters from the United States Government,<sup>2</sup> while others have been specially incorporated by private laws in the State of Illinois.<sup>3</sup>

Incorporation of a not-for-profit association protects the individual members from personal liability in the event of any adverse claims filed against the organization. On the other hand, an unincorporated association, which is not a subordinate body of a larger organization,

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<sup>1</sup> In recent years, a majority of states have adopted statutes setting out the procedure for incorporation of a not-for-profit corporation. In Illinois, prior to 1872, special charters were granted most not-for-profit corporations. From 1872 to 1944, only five sections of the Corporation Act covered not-for-profit corporations. At present, Illinois has a detailed General Not-For-Profit Corporation Act, containing over 100 separate sections. ILL. REV. STAT. ch. 32, §§ 163 (a) (1)–163 (a) (100) (1965).

<sup>2</sup> Those which have received their charters from the United States Congress include the American Red Cross, 36 U.S.C. § 1 (1964); the Daughters of the American Revolution, 36 U.S.C. § 18 (1964); the Boy Scouts of America, 36 U.S.C. § 21 (1964); the Girl Scouts of America, 36 U.S.C. § 31 (1964); and certain national veterans' organizations.

<sup>3</sup> Two of the many institutions specially chartered by the State of Illinois are Northwestern University (Private Laws, 1861) and The Chicago Law Institute (Private Laws, 1857).

has no legal recognition separate from its members.<sup>4</sup> If such an association were to be sued, each member would be personally liable for payment of any judgment entered against the group.<sup>5</sup> Furthermore, this unincorporated association has no standing to sue at law or be sued in its own name, but any action must be in the name of all members comprising it, however numerous they may be.<sup>6</sup>

This presents a problem for a local Parent-Teachers' Association, a suburban bowling league, or any other small group who may hold a dinner or other social affair for its members and their guests. If someone is injured at the affair, each member of the group can be held personally liable for payment of the damages. The risk becomes greater if alcoholic beverages are served at the affair, since the provisions of the Dram Shop Act then apply.<sup>7</sup>

Accordingly, any organization which engages in activities which could result in adverse claims should incorporate in order to avoid the risk of liability otherwise imposed upon each member.<sup>8</sup>

#### INCOME TAX

Most not-for-profit associations, whether incorporated or not, are entitled to an exemption from payment of federal income taxes on funds received by the association.<sup>9</sup> However, the mere fact that an organization is not for profit does not automatically entitle it to an exemption. It must submit proof of its right to an exemption. Until a

<sup>4</sup> *Chicago Grain Trimmers Ass'n. v. Murphy*, 389 Ill. 102, 58 N.E. 906 (1945). Subsequent to this decision, the legislature authorized unincorporated lodges or subordinate bodies of any society, or order, duly chartered by its grand lodge or body, to own real estate and sue and defend in its own name. ILL. REV. STAT. ch. 30, § 183-185 (1965). This, however, does not relieve the individual members from liability.

<sup>5</sup> *Hodgson v. Boldrum*, 65 Ill. 532 (1872).

<sup>6</sup> *Sutherland v. Copeland*, 350 Ill. App. 313, 112 N.E.2d 733 (1953); *Cox v. Shupe*, 41 Ill. App. 2d 413, 191 N.E.2d 250 (1963). See also, Fins, *Re-examination of Jurisdiction in Light of New Illinois Judicial Article*, 53 ILL. B.J. 12 (1964), wherein the author states that unincorporated associations can now be sued at law under the new judicial article, ILL. CONST. art VI, § 9.

<sup>7</sup> ILL. REV. STAT. ch. 43, § 135 (1965), under which any person who either *sells* or *gives away* alcoholic liquor causing intoxication is liable to a person who is injured as a result of acts of the intoxicated person.

<sup>8</sup> See Comment, 37 ILL. L. REV. 70 (1942).

<sup>9</sup> INT. REV. CODE OF 1954, §§ 401(a) and 501(c)(d), lists the organizations which are exempt from taxation. The major types exempted include nonprofit corporations, such as religious, educational and charitable institutions; civic and business leagues; and labor, social and fraternal associations. Also included in section 501 are trusts created by an employer for the exclusive benefits of his employees, under section 401(a).

determination letter or revenue ruling establishes an exemption, an income tax return must be filed.<sup>10</sup>

Even after exemption is granted, most organizations must thereafter file an annual information return with the Internal Revenue Service in order to continue to enjoy the exemption.<sup>11</sup> In addition, all exempt organizations are required to withhold taxes from their employees in the same manner as any taxable employer.<sup>12</sup>

Furthermore, the exemption does not apply to all income received by the organization. If it operates a business enterprise which is unrelated to its exempt purpose, it will be required to pay tax on all income derived from "unrelated trade or business."<sup>13</sup>

However, churches are exempt from the tax imposed on unrelated business income. This exemption is strictly construed and is applicable only to organizations fulfilling the technical definition of a "church" as defined in Regulation 1.511-2(3) (i) and (ii). The Christian Brothers were denied an exemption from income taxes on earnings of their world-famous wine making operations because they were found not to qualify as a "church."<sup>14</sup> The court held that even though the Christian Brothers were a religious order, organized under the auspices of the Roman Catholic Church, engaged in operation of parochial schools and novitiates, they did not constitute a "church" within the purview of the income tax law.

The scope and extent of the exemption is dependent upon the source of the income as well as the use made of the funds by the organization. For example, a social club is entitled to an exemption from federal income taxes if its income is primarily derived from membership fees, dues and assessments. If the organization derives a substantial part of its income from public patronage of its facilities, it will lose its exemption.<sup>15</sup>

Even after an exemption has been granted, an organization may lose its exempt status if it enters into any "prohibited transaction,"<sup>16</sup> or accumulates an unreasonable amount of income.<sup>17</sup> A "prohibited

<sup>10</sup> Treas. Reg. § 1.501(a)(1) (1959).

<sup>11</sup> INT. REV. CODE OF 1954, § 6033.

<sup>12</sup> Treas. Reg. § 31.3401(d)-1(d) (1957).

<sup>13</sup> INT. REV. CODE OF 1954, § 513(a).

<sup>14</sup> *De LaSalle Institute v. United States*, 195 F.Supp. 891 (N.D. Calif. 1961).

<sup>15</sup> Treas. Reg. § 1.501(c) 7-1 (1958).

<sup>16</sup> INT. REV. CODE OF 1954, § 503(c).

<sup>17</sup> INT. REV. CODE OF 1954, § 504.

transaction" is one in which an organization lends any part of its income or corpus without adequate security, pays unreasonable compensation for services rendered, makes its services available on a preferential basis, purchases or sells its securities for an inadequate consideration or engages in any transaction resulting in a substantial diversion of its income or corpus to the creator of the organization.

Some not-for-profit organizations receive all, or a substantial part, of their income from a profit-making organization. Sometimes this occurs because the not-for-profit organization owns stock in the organization carrying on the business for profit. However, the fact that the income is turned over to a tax-exempt organization does not entitle the profit-making organization to an exemption from income taxes. If the organization carries on a commercial enterprise, its income is taxable despite the fact that the parent organization may be tax-exempt. Such organizations are called "feeder organizations."<sup>18</sup>

#### PROPERTY AND SALES TAXES

The obligations of a not-for-profit organization to pay real estate, sales and other local taxes depends entirely upon the constitution and statutes of each state where either the property or organization, or both, are located. In Illinois, the constitution authorizes the legislature to exempt from taxation property "used exclusively for agricultural and horticultural societies, for school, religious, cemetery and charitable purposes."<sup>19</sup> Pursuant to this authority, the legislature has granted a number of exemptions from property taxes.<sup>20</sup> These statutes are strictly construed, and all debatable questions are resolved in favor of taxation.<sup>21</sup>

In addition, the courts have held that property which is owned by

<sup>18</sup> Treas. Reg. § 1.502-1 (1963).

<sup>19</sup> ILL. CONST. art. IX, § 3.

<sup>20</sup> ILL. REV. STAT. ch. 120, §§ 500.1-500.20 (1965), which contains a description of the various properties entitled to exemption. Included are burial grounds, school property, property of charitable institutions used for charitable purposes, and property used exclusively for religious purposes.

<sup>21</sup> Rotary International v. Paschen, 14 Ill. 2d 480, 153 N.E.2d 4 (1958), wherein the court denied an exemption to the administrative headquarters of the Rotary International on the grounds that the organization was not "charitable" within the meaning of the law. It defined charitable as follows: "An organization is charitable only when it exists to carry out a purpose recognized in law as charitable, and the law recognizes as charitable only those purposes which, if carried out, will benefit the public in such a way that there is a consequent relief, to some extent, of the burden upon the State to care for and advance the interests of its citizens." (*Id.* at 488, 153 N.E.2d at 9).

an exempt institution will not be entitled to an exemption unless the property itself is *used* for exempt purposes.<sup>22</sup> This applies even though the income received from the property is devoted to the exempt purposes of the organization.<sup>23</sup> It is now generally recognized that not only must the property be *used* for an exempt purpose, but it must also be *owned* by an exempt organization.<sup>24</sup>

Recently, the legislature imposed a duty on owners of exempt property located in Cook County to file with the County Assessor, annually, a certificate to the effect that there has been no change in either the ownership or use of the exempt property as of January 1st of that year. Failure to file such certificate can result in loss of exemption.<sup>25</sup>

Until August 1, 1961, most not-for-profit associations enjoyed an exemption from the obligation to pay retailer's occupation tax on any sales made to its members and guests.<sup>26</sup> This was changed by legislative amendment in 1961, and the only exemption granted at present is with respect to sales by charitable, religious and educational institutions of items specially made for their members, such as uniforms, insignia, choir robes and isolated non-competitive sales by church and educational groups, such as the annual Scout cookie sales, church rummage and cake sales, and meals prepared by church workers.<sup>27</sup> The present law even requires schools and universities to pay a retailer's occupation tax on proceeds of sales of school books to students.<sup>28</sup>

This change in sales tax status of not-for-profit organizations has now imposed a duty on officers of these associations to prepare and file

<sup>22</sup> *People v. Trustees of Schools*, 364 Ill. 131, 4 N.E.2d 16 (1936), wherein property owned by a public school district in Evanston was denied an exemption because the property was leased for commercial purposes at an annual rental of \$22,500.

<sup>23</sup> *Turnverein "Lincoln" v. Board of Appeals*, 358 Ill. 135, 192 N.E. 16 (1934).

<sup>24</sup> *Coyne Electrical School v. Paschen*, 12 Ill. 2d 387, 146 N.E.2d 73 (1957).

<sup>25</sup> ILL. REV. STAT. ch. 120, § 500 (1965).

<sup>26</sup> *Svithiod Singing Club v. McKibbin*, 381 Ill. 194, 44 N.E.2d 904 (1942), wherein the court held that the Retailer's Occupation Tax Act, ILL. REV. STAT. ch. 120, § 440 (1965), applied only to persons engaged in the business of selling at retail, and not-for-profit associations were not engaged in "business."

<sup>27</sup> Retailer's Occupation Tax Act, ILL. REV. STAT. ch. 120, § 440 (1965). See also, Illinois Dep't of Revenue, Rules and Regulations, Rule 38.

<sup>28</sup> See *Follett's Book and Supply Store v. Isaacs*, 27 Ill. 2d 600, 190 N.E.2d 324 (1963), wherein it was held that the legislature did not intend to exempt sales by schools which were in competition with profit-making establishments who had to pay a tax in connection with such sales.

returns with the Department of Revenue of the State of Illinois. The added costs involved in such matters has also placed an additional burden on the treasury of many organizations.<sup>29</sup>

#### WORKMEN'S COMPENSATION AND UNEMPLOYMENT COMPENSATION

The Workmen's Compensation Act provides that any "public service, eleemosynary, religious or charitable corporation or association who has any person in service or under any contract for hire, express or implied, oral or written . . ." may elect to become subject to the provisions of the Act.<sup>30</sup> Many persons working for and on behalf of not-for-profit associations are volunteers and not employees within the statutory definition.<sup>31</sup> However, what is the status of a student who received a reduced tuition and is injured while in the service of the school? In *Todd School for Boys v. Industrial Commission*,<sup>32</sup> the Illinois Supreme Court held that unless the reduction in tuition was compensation for the services of the student, he was not an employee within the meaning of the Act. Likewise, in *Athletic Association of the University of Illinois v. Industrial Commission*,<sup>33</sup> a student at the University of Illinois who was injured while performing at an event sponsored by the University was not considered an employee, since he received no payment for his services. Even though his work was under the direction of the University and resulted in financial benefits to the University, it did not in itself create a relationship of employer and employee.

Thus, it would seem that unless a volunteer worker or a student receives some direct compensation for his services, he is not an employee. However, an officer of an organization who receives a yearly stipend for his services would seem to qualify as an employee and create a duty on the organization to protect itself under the Workmen's Compensation Act.

The Federal Unemployment Tax Act<sup>34</sup> exempts certain organiza-

<sup>29</sup> See, e.g., *supra*, wherein it was stated that the annual volume of sales by college and university book stores to students in Illinois was \$4,791,350. This now requires colleges in Illinois to pay to the state approximately \$190,000 in sales tax each year.

<sup>30</sup> Workmen's Compensation Act, ILL. REV. STAT. ch. 48, § 138.1(a)(2) (1965).

<sup>31</sup> *Id.* at § 138.1(b)(2).

<sup>32</sup> 412 Ill. 453, 107 N.E.2d 745 (1952).

<sup>33</sup> 384 Ill. 208, 51 N.E.2d 157 (1943).

<sup>34</sup> 68A Stat. 447 (1954); 26 U.S.C. § 3306 (1964).

tions from the requirement of contributing to federal unemployment compensation for their employees.<sup>35</sup> Notably among them are services performed in the employ of religious, charitable, educational or other organizations described in the Internal Revenue Code,<sup>36</sup> which are exempt from federal income tax by the Code.<sup>37</sup> In addition, services performed for most not-for-profit organizations exempt from federal income tax will not be included if the remuneration for such service is less than \$50 in any calendar quarter.<sup>38</sup>

The State of Illinois Unemployment Compensation Act<sup>39</sup> is almost identical with the federal law with respect to exemptions for not-for-profit organizations. Both the above exemptions allowed by the federal act are recognized by the state.<sup>40</sup>

#### CONCLUSION

The above constitutes only a brief discussion of a few of the problems facing an attorney who may be called upon to represent a not-for-profit organization. The coverage is not comprehensive but only intended for the purpose of alerting legal counsel for a not-for-profit organization to certain areas of the law that may affect the operation of the organization. Since most attorneys belong to a number of such organizations, for social, civic and other reasons, they are called upon from time to time to advise the members regarding their legal obligations. The constitution, by-laws and Corporate Charter of the organization must be carefully reviewed before any opinion should be rendered by any attorney called upon to represent the organization.

Both the courts and tax officials place great weight on the purpose clauses and membership qualifications set forth in the constitution, by-laws and charter of the organization. In addition, the actual operations of the group are also scrutinized to determine its eligibility for exemption. Today, more than ever, as the need for taxes, both on the local and federal level, increases, not-for-profit organizations must strictly comply with the law in every respect before they will be entitled to exemption from taxes.

<sup>35</sup> 68A Stat. 447 (1954); 26 U.S.C. § 3306 (1964).

<sup>36</sup> INT. REV. CODE OF 1954, § 501(c).

<sup>37</sup> INT. REV. CODE OF 1954, § 501(a). See also, Federal Unemployment Tax Act, 68A Stat. 447 (1954); 26 U.S.C. § 3306(c) (8) (1964).

<sup>38</sup> 68A Stat. 447 (1954); 26 U.S.C. § 3306(c) (10) (1964).

<sup>39</sup> ILL. REV. STAT. ch. 48, §§ 300-820 (1965).

<sup>40</sup> *Id.* at §§ 331 and 333.