

LEGAL STATUS OF CHAPTERS: QUESTIONS AND ANSWERS

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INTRODUCTION

The relationship between non-profit associations and their chapters is typically not one which engenders much discussion from the association's board or staff until a problem arises. When the problem hits, it is not uncommon for an association to find that the legal status of its chapters is murky. Sometimes the board and staff do not even know whether chapters are part of the same legal entity as the parent association or consist of separate legal entities. The chapters may have been established decades ago, long before the current board and staff were in place.

The event which sends the staff to find out in a hurry just what their chapters are is typically a visit from the IRS, or the naming of the parent association in a law suit asking recompense for a tort or debt of a chapter. The purpose of this booklet is to engender discussion among board members and staff about the legal relationship between the parent association and its chapters before a problem arises.

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1. WHAT IS A LEGAL ENTITY?

A legal entity is something that can enter into contracts and sue or be sued in its own name. There are many types of legal entities, including corporations, partnerships, trusts and unincorporated associations. A legal entity is responsible for filing its own reports with state and federal authorities, including information and tax returns with the IRS.

2. ARE CHAPTERS SEPARATE LEGAL ENTITIES?

That depends. Some chapters are included in the same legal entity as the parent. In other associations, each chapter is a separate legal entity, and the parent is a separate legal entity. Some associations are hybrids, with some chapters being separate legal entities and some being included in the same legal entity as the parent.

It is not always easy to tell whether a chapter is or is not included in the same legal entity as the parent. If a chapter is separately incorporated, the question is easily answered. Incorporation always establishes a chapter as a separate legal entity.

If a chapter is not incorporated, however, the next place to look for a clue is on the parent association's annual information return filed with the IRS. Are the items of income and expense attributable to the chapters included with the items of income and expense attributable to the parent? If they are, and if the information return is not filed on a "consolidated" basis, then the parent association is treating the chapters as being included in the same legal entity as the parent.

If the items of income and expense of the chapters are not included in the parent's information return, then the parent is treating the chapters for tax purposes as separate legal entities. This treatment will not necessarily be dispositive in a court of law if a parent is sued for the debt of a chapter. Nor will it even be dispositive with the IRS, if the IRS determines the chapters are, indeed, part of the same legal entity as the parent, and the parent simply neglected to include the income and expense items attributable to the chapters on its annual information reports.

The next place to look for a clue is in the chapter charter. Many parent associations have granted charters to their chapters, which are really a form of legal contract under which the chapter has the right to call itself an affiliate of the parent organization. A charter may state that the chapter shall exist as a legal entity separate from the parent. Most modern charters will include specific language

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to this effect, to avoid any confusion. This type of language is not common in many older charters.

Sometimes the by-laws of a parent association will contain language which bears on the identity of a chapter. If a parent association has chapters, there is frequently a section of the by-laws which gives the Board of Directors the authority to establish the chapters and may set terms and conditions under which the chapters can be established. The by-laws may contain a statement to the effect that all chapters shall be established as separate legal entities. The mere grant of authority to the board to establish chapters is not conclusive as to whether the chapters are separate from, or a part of, the same legal entity as the parent.

3. WHAT ARE THE LEGAL RAMIFICATIONS OF SEPARATENESS OR INCLUSION?

If a chapter is a separate legal entity, it is primarily responsible for its own debts and other obligations. A parent association can sometimes be held liable for the debts and other obligations of its chapter, as discussed below, but the claimant will have a much harder case to make if the parent association can clearly establish that the chapter is a separate legal entity.

On the other hand, if a chapter is not a separate legal entity, then the parent is absolutely liable for the debts or other legal obligations of the chapter. To analogize to the for-profit world, a chapter which is included in the same legal entity as the parent is much like a division of a for-profit corporation. The assets of all divisions of a for-profit corporation are liable for any debts or other obligations of any one division. Similarly, if chapters are included in the same legal entity as the parent, the parent association and all chapters are responsible for the debts and other obligations of any one chapter, and all chapters are responsible for the debts and other obligations of the parent.

4. WHAT ARE THE ADVANTAGES OF ESTABLISHING CHAPTERS AS SEPARATE LEGAL ENTITIES?

There are two main advantages to establishing chapters as separate legal entities. First, establishing chapters as separate legal entities provides the parent - and the other chapters - with a first line of defense against any claim that the parent or the other chapters are liable for the debts or other obligations of any one chapter.

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Second, establishment of chapters as separate legal entities will make the individual chapters responsible for the filing of reports with governmental authorities, including fees or taxes associated with the reports. Of primary importance is the fact that a parent association need not include on its annual information report filed with the IRS the income and expenses of its chapters. Many parent associations find it impossible to obtain accurate information from their chapters with respect to income and expenses. Establishing the chapters as separate legal entities relieves the parent association of the obligation of making an accurate report of these items of income and expense to the IRS.

Another important reason for establishing chapters as separate legal entities is to protect the tax-exempt status of the parent association. If a chapter is included in the same legal entity as the parent, then its activities will be aggregated with those of the parent to determine whether, taken as a whole, the entity is entitled to retain tax-exempt status.

For example, the chapters may be engaged in a substantial level of unrelated business activity which, if aggregated with the parent's activities, could cause the parent to fail the IRS test for retention of tax-exempt status. A chapter could also be engaged in impermissible political activity. If the parent association is a Section 501(c)(3) organization (a charitable, educational, or religious organization), any amount of electioneering is grounds for revocation of its tax-exempt status. This means that a favorable article about a candidate for public office written in the newsletter of a chapter, if that chapter is included in the same legal entity as the parent, could cause the parent and all the chapters to lose tax-exempt status.

5. WHAT ARE THE DISADVANTAGES OF ESTABLISHING CHAPTERS AS SEPARATE LEGAL ENTITIES?

The primary disadvantage of establishing chapters as separate legal entities is loss of control. A separate legal entity can enter into contracts and file legal actions in its own name. It can undertake activities in its own name. Unless the parent organization enters into a tightly worded charter agreement with the chapter, the chapter will enjoy much greater freedom and the parent will enjoy much less control.

A second disadvantage is that chapters which exist as separate legal entities must file their own reports with governmental authorities. If the parent association undertakes to file all of these reports on behalf of the chapters, the mound of paperwork can be daunting. If the parent does not

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so undertake on behalf of the chapters, the chapters must file these reports on their own and this may mean the retention of their own accountants or attorneys. Many chapters do not have the in-house sophistication to properly file governmental reports on their own, or the financial resources to retain professionals to do so.

6. IF A CHAPTER IS A SEPARATE LEGAL ENTITY, SHOULD IT BE INCORPORATED?

If a chapter is a separate legal entity but is not incorporated, it is known as an “unincorporated association.” An unincorporated association is a type of legal entity that can enter into contracts in its own name, and sue and be sued in its own name. It is responsible for filing its own reports with governmental authorities.

The main difference between an unincorporated association and an incorporated chapter is that of ultimate liability of the members of the chapter for any debts or other legal obligations of the chapter. In an unincorporated association, the members are personally liable for the debts and other legal obligations of the chapter. In an incorporated chapter, the members are not personally liable for the debts and other legal obligations of the chapter. This is an extremely important distinction. A plaintiff suing an unincorporated association will also name each of the members individually and, if the plaintiff wins, the plaintiff will be entitled to look to the personal assets (houses, cars, bank accounts, etc.) of the individual members for recompense. Many knowledgeable people decline to become members of unincorporated associations for this reason.

The liability for which members can be responsible includes more than contractual liability. Members could also be liable for tort liability and dram shop liability. This means that if someone slips and falls at a chapter meeting, or if too much alcohol is served and an accident ensues, the injured party could sue the unincorporated association and obtain a judgment which would be collectible from the individual members if the chapter has insufficient assets or if insurance coverage is not in place.

7. WILL INCORPORATION OF A CHAPTER PROTECT A PARENT FROM LIABILITY?

Not necessarily, but it provides a good second line of defense. The parent’s first line of defense against a liability of the chapter is that the chapter constitutes a separate legal entity. If the chapter constitutes a separate legal entity but is also separately incorporated, the legal separateness of the

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two entities is easier to prove.

A parent may still face a claim for liability of its separately incorporated chapter. The issue is usually one of control. The more control a parent exercises over the chapter, the greater are the chances of the parent being found legally responsible for debts and other obligations of the chapter.

Control can be exercised organizationally or operationally. Sometimes organizational documents, such as chapter charters, establish a high degree of control of the parent over the chapter. If a chapter must seek approval of a parent before undertaking an action, this fact would give a plaintiff an argument that the parent exercised control over the action and should be jointly liable with the chapter for the result of the action. Operational control exists if the parent, in fact, exercises control over the activities of the chapter, even if the right to control is not included in the organizational documents.

Another situation in which a parent might be found liable for the actions of the chapter is when the parent jointly sponsors an event with the chapter. It is very common for parent organizations to jointly sponsor educational or social events with chapters. The mere fact that the chapter is assigned to make all the local arrangements will not protect the parent from liability arising from the local activities. The parent organization should make sure that its own insurance policy will cover all activities which it sponsors, whether that sponsorship is joint or sole.

A third instance in which a parent may find itself liable for its chapter's obligations, even though separately incorporated, is when the parent refers to the business or activities of the chapters as its own. Sometimes a parent organization claims credit for activities of its chapters, especially in documents distributed to the general public. A national charity might claim that it raised a certain level of funds, without clarifying that a portion of the funds were raised by chapters. A national scientific organization might refer to a paper presented at a symposium of one of its chapters as a presentation of its own. These kind of lax references could be just the kind of hook a plaintiff's lawyer is looking for with which to drag a parent organization into a lawsuit with respect to the chapter's activities.

8. WHAT HAPPENS WHEN A CHAPTER DISSOLVES?

If a chapter is part of the same legal entity as the parent, the assets of the chapter, for legal purposes, already belong to the parent. When the chapter dissolves, those assets remain with the parent.

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If a chapter is a separate legal entity, when it dissolves, its assets will be disposed of in accordance with state law and IRS rules, unless the parent organization has a specific written agreement with the chapter specifying disposition. Many organizations state in their chapter charter that, upon dissolution of the chapter, all assets of the chapter will be turned over to the parent organization.

Other parent organizations do not impose this requirement on chapters. Especially if a chapter is locally funded, local members might resist the concept of turning over any remaining assets to the parent organization upon dissolution of the chapter. There is not one right or wrong way, but the rules should be spelled out in writing in the chapter charter or in a written agreement between the chapter and the parent organization, to avoid fights over funds if a chapter dissolves.

9. WHAT IS THE FEDERAL TAX STATUS OF A CHAPTER?

If a chapter is included in the same legal entity as the parent, it is automatically covered by the parent's federal tax exemption. If the chapter is a separate legal entity, it must have its own tax status. It can obtain tax-exempt status in one of two ways. First, it can file its own Application For Recognition of Tax-Exempt Status with the IRS. Alternatively, a parent organization can file a group exemption request with the IRS to obtain tax-exempt status for all of its chapters.

10. WHAT IS A GROUP EXEMPTION?

A group exemption is a ruling or determination issued to a parent organization recognizing on a group basis the federal tax exemption of its chapters. To be included in a group exemption, the chapters need not be incorporated, but they must each have an organizing document, such as a chapter charter. Even if it is not incorporated, each chapter included in the group exemption must have its own employer identification number.

An application for group exemption consists of a letter signed by an officer of the parent association which confirms to the IRS that the chapters are affiliated with the parent, describes their purposes and activities, includes a sample copy of a uniform governing instrument, such as a charter or articles of incorporation, and includes several other items of information. The group exemption process is relatively simple compared to other IRS filings.

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Most importantly, a group exemption is separate from the parent's own tax exemption. This means that if the chapters engage in activity which results in the revocation of their own tax-exempt status, the tax-exempt status of the parent is not necessarily effected.

11. WHAT ARE THE PARENT'S CONTINUING OBLIGATIONS IF IT OBTAINS A GROUP EXEMPTION FOR ITS CHAPTERS?

To maintain a group exemption for its chapters, a parent organization must update the IRS once a year on any changes in the purposes, character, or method of operation of the chapters, and the names, addresses, and employer identification numbers of chapters that have been added or terminated during the year.

A parent organization may, but need not, file a group form of annual information return (Form 990) with the Internal Revenue Service for chapters included in the group exemption. The group return would be separate from, and in addition to, the parent's own annual information return. If the parent organization prefers, it can require each chapter to file its own information return. This means that, even if a parent organization obtains a group exemption for its chapters, it is under no obligation to gather and report information on chapter income and expenses to the IRS. Those chapters with gross receipts equal to or less than \$50,000 may file an abbreviated 990N, an "e-postcard", online with the IRS or the parent can file this form on behalf of the chapter. The chapter may also file its own annual information return with the IRS.

SUMMARY

The legal status of chapters is a complex issue. The boards and staff of parent associations face many choices in determining how chapters should be established or whether their current organizational structure needs revision. The questions and answers in this booklet will lead to more questions. Be sure to consult with an attorney knowledgeable in association law before proceeding with a course of action.