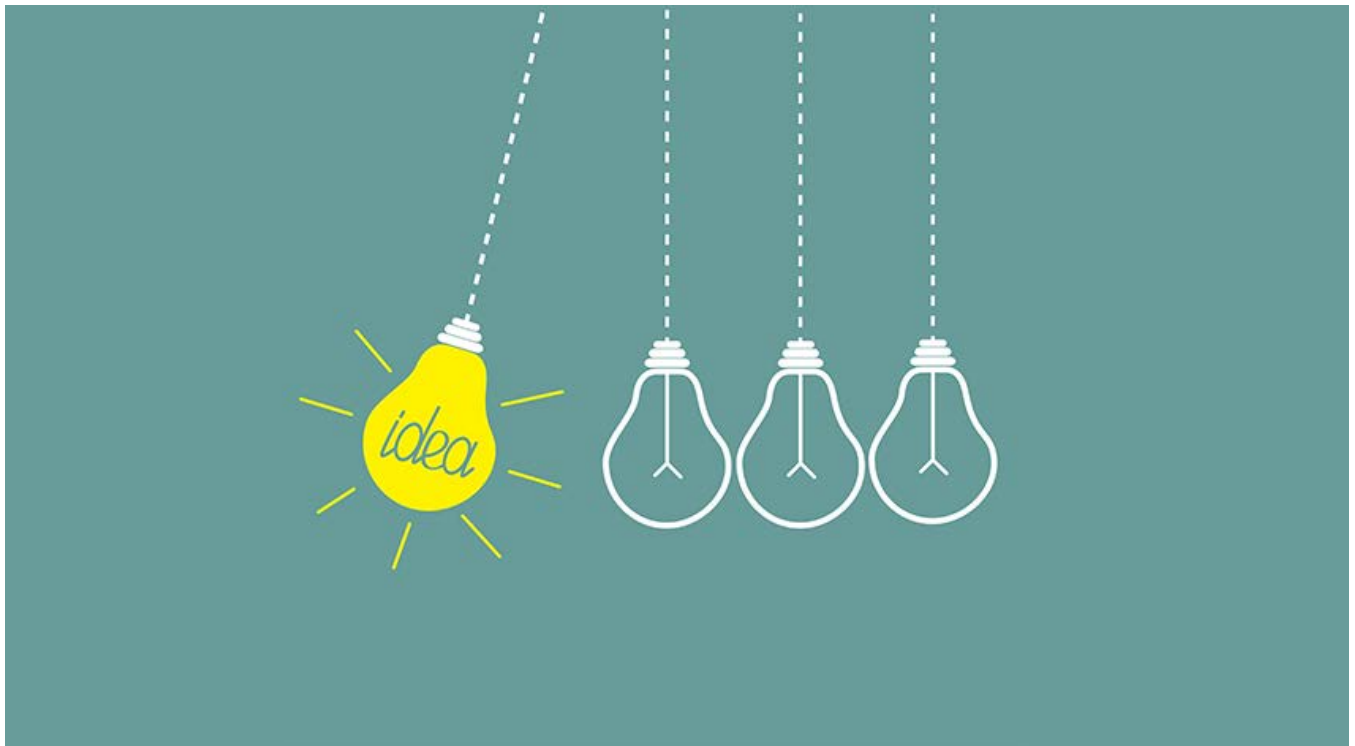


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# Forming a Nonprofit Tax-Exempt Corporation in Texas





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We welcome your questions, comments and suggestions for improvement to this Guide.

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## Forming a Tax-Exempt, Nonprofit Corporation in Texas

The purpose of this guide is to help you to decide whether to form a tax-exempt, nonprofit corporation. It also explains the basic steps to form a Texas nonprofit corporation and to secure federal tax-exempt status under Chapter 501(c)(3) of the Internal Revenue Code. [This guide contains general legal information only, and is not intended as a substitute for the advice of an attorney.](#)

### Will the organization serve an unmet need?

The threshold question in forming a tax-exempt, nonprofit corporation is whether it will serve an unmet need in the community. It is important for an organization to answer this question honestly before starting the formation and exemption process, as the answer directly affects the organization's financial sustainability. Donors, foundations and other grant-making entities are unlikely to provide funding to a "new" organization unless they see a need for its programs. Before you get started, answer the following questions:

- ◆ What is the primary purpose to be served by the new nonprofit?
- ◆ What community or group does the nonprofit intend to serve?
- ◆ Does this community or group have the specific need that you intend to meet? Ask the community you intend to serve rather than making assumptions about what you think they need.
- ◆ What competing organizations are already providing the same or similar services to this community or group?
- ◆ Is there a strong commitment from the organizers and participants of the organization to build the nonprofit?
- ◆ Is there an adequate source of funds to support the nonprofit? Explore potential funding sources before you go through the time, energy and expense of starting down the path to incorporation and federal tax-exempt status.

### Does the organization have the capacity to carry out its mission and purpose?

Another important aspect of creating a tax-exempt nonprofit corporation is organizational capacity. If the founder is the only one investing time and energy, the organization will not grow or outlive its founder. Consider the following:

- ◆ Is there an active involved group of founders or just one person? A nonprofit corporation is created to exist in perpetuity, beyond the life of the founder. If the passion for the organization is dependent on one person's energy, it is not likely to continue without that person.
- ◆ Does the founder have the goal of creating a paying job for him or herself? Does the founder want to maintain control? Founders must understand that the nonprofit will be governed by a board of directors, not an individual. The board has the power to hire and fire executive director, and to vote officers and directors, including the President, on and off the board.
- ◆ Does the founder have any expertise in the activities in which the organization will engage? For example, if the organization will provide affordable housing for veterans, do any board members know how to put together financing or construct housing?

- ◆ Has the organization considered how it will be financially viable in the long term? Is there a proposed budget or business plan?

## Who owns a nonprofit corporation?

In for-profit corporations, shareholders own the corporation. In a nonprofit corporation, no person owns the nonprofit or its property. Texas law defines a nonprofit corporation as one in which no part of its income is distributable to a member, director or officer of the corporation. It can be organized in Texas for any lawful purpose unless expressly prohibited by the Texas Business Organizations Code. A nonprofit corporation may also apply for state and federal tax-exemption. It can be a membership organization, but unlike “members” of for-profit entities, like an LLC, nonprofit members have no financial in the nonprofit. Management of the nonprofit can be vested in its members or, as is more often the case, in a board of directors. Nonprofits also operate in a stricter regulatory environment than for-profit entities, with special laws governing financial accountability, transparency, conflicts of interest and other safeguards. If the nonprofit dissolves, its assets must be used for an exempt purpose.<sup>1</sup> As a practical matter, the remaining assets of the failed nonprofit will be directed to another nonprofit.

One benefit of incorporation as a nonprofit is access a wider variety of funding sources reserved for nonprofit corporations, such as government or community development loans and grants. Another primary benefit is protection from personal liability for the corporation’s members and directors. To maintain this protection, a nonprofit board must act in good faith, with ordinary care, and in the best interest of the nonprofit. Tex.Bus.Org.Code [§22.221](#). Certain insider deals, undisclosed conflicts of interest, and other actions or decisions made to benefit an individual instead of the nonprofit can pierce through this protection and expose board members to individual liability.

## What is a 501(c)(3) nonprofit?

The Internal Revenue Service (“IRS”) recognizes 28 types of tax-exempt nonprofit organizations under Section 501(c)(3) of the Internal Revenue Code (“IRC”). While all 501(c) organizations are exempt from federal income taxes, only 501(c)(3) contributions are tax-deductible to the to the donor. Other types of Section 501(c) organizations, such as 501(c)(4) civic leagues or 501(c)(7) sports organizations, are beyond of the scope of this publication.

To qualify for federal tax-exemption under Section 501(c)(3), a nonprofit must be organized and operated exclusively for one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, or the prevention of cruelty to children or animals. It cannot be organized for the purpose of financial profit for its members or directors, although they can be paid a reasonable compensation for their work. Section 501(c)(3) nonprofit organizations are absolutely precluded from engaging in partisan political campaign activities. Certain lobbying activities are permissible but regulated.<sup>2</sup>

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<sup>1</sup> [IRS suggested language](#) for dissolution clause: Upon the dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose. See [IRS Publication 557, Tax-Exempt Status for Your Organization](#).

<sup>2</sup>For information on permissible advocacy activities for nonprofits, including [Texas-specific](#) resources, visit [Bolder Advocacy](#), a special initiative of the [Alliance for Justice](#), or the National Council of Nonprofits resource pages on [Everyday Advocacy Resources](#).

## What constitutes charitable, educational, or literary purposes?

**Charitable Purposes** — Charitable purposes under the Internal Revenue Code are broadly defined as services that are beneficial to the public interest and may encompass some of the other specifically enumerated 501(c)(3) purposes (such as religious or educational). The organization must serve an open class of people and not limit its activities to specific individuals. For example, a charitable organization established to provide food to the homeless in the community would be a charitable organization, but an organization established to provide food to a designated set of low-income families would not be. The beneficiary class needs to be open and unspecified, but does not have to be large. An organization established to feed the hungry in a certain two-block area would qualify as a charitable organization. Examples of charitable purposes include relief of the poor, distressed, or underprivileged; advancement of education or science; erection or maintenance of public buildings or monuments; lessening the burdens of government; elimination of prejudice and discrimination; promotion and development of the arts; and defense of human and civil rights secured by law.

**Educational Purposes** — Educational purposes under the IRC include instruction of the public on subjects useful to individuals for the benefit of the community and for self-development. The Internal Revenue Service (“IRS”) generally will find that a curriculum is educational if, when presenting particular viewpoints, it provides a sufficiently full and fair exposition of pertinent facts to permit an individual or the public to form an independent opinion or conclusion. However, mere presentation of unsupported opinion is not considered educational. Some examples of educational purposes include: publishing public interest educational materials that do not conflict with the requirements above; conducting public discussion groups, forums, panels, lectures, or workshops; offering a remote learning course; operating a museum, zoo, planetarium, symphony orchestra, or other performance groups; serving an educational institution, such as a college bookstore, alumni association, or athletic organization; and publishing educational newsletters, pamphlets, books, or other material.

**Literary Purposes** — Usually, nonprofit organizations fall under educational purposes when they involve publishing written materials. An organization that wants to publish materials geared to benefit the public interest may also qualify for tax-exempt status as long as it does not target commercial markets and sells the publications at a modest price. Some examples include publishing material on environmental preservation, highway safety, or drug and alcohol abuse.

## What is a community development organization?

An important category of charitable purposes is community development, such as job training, small business assistance, or affordable housing development. Although there is no established legal definition for a “community development organization”, it is characterized by its community-based leadership and its work primarily in the development of housing and job creation. There are essentially four independent bases for Federal tax-exemption for a nonprofit community development organization:

- ◆ relieving the poor and distressed,
- ◆ combating community deterioration,
- ◆ eliminating discrimination, and

- ◆ lessening the burdens of government.

**Relieving the Poor and Distressed** — The difficulty with this basis for exemption is determining whether an individual or family is “poor and distressed.” The IRS defines “poor and distressed” as the inability to afford the “necessities of life” without undue hardship. When the IRS grants federal tax-exempt status to a community development organization for its work to relieve the poor and distressed, it looks at the organization’s anticipated impact on families’ lack of adequate housing, chronic unemployment or underemployment, and whether the work will be performed in a geographic area identified as economically disadvantaged by a government agency.

**Combating Community Deterioration and Eliminating Discrimination** — Under this basis for exemption, a community development organization can seek a federal tax exemption based on social welfare activities without having to show that the population it serves is “poor and distressed.” Examples include organizations that erect or rebuild housing in a deteriorated area, sponsor efforts to promote racial integration, stabilize the neighborhood, and provide social services to area residents.

**Lessening the Burdens of Government** — To qualify under this basis for exemption, an organization must meet a two-part test: (1) the government must consider the activities the organization will perform to be the government’s responsibility, and (2) the activities must actually “lessen” the burden of the government. The best way to establish an activity as a government burden or duty is to find a law or a government rule or policy that applies to the particular activity (such as a local housing or economic development plan or policy). Other relevant factors to establish a government’s burden include a governmental unit’s prior involvement in an activity on a regular basis for a significant length of time; the funding of an organization’s activities by the government; or an activity which is one that could be performed directly by a governmental unit.

The second part of the two-part test is whether the organization’s activities will actually “lessen” the government’s burden when considering all of the circumstances as a whole. Basically, the organization’s activities must fairly directly address the burden. Providing affordable housing for low-income families is historically a governmental function (for example, the federal Department of Housing and Urban Development, or the Farmers’ Home Administration Program). Encouraging job creation and growth of small business is also a goal of government, so nonprofit economic development corporations have a strong claim that they lessen the government’s burden.

## What are some alternatives to incorporation?

**Unincorporated Association** – The simplest form for a new organization is an unincorporated association. Organizing as an unincorporated nonprofit association is informal, allows flexibility if goals or needs change, and it comes with little cost. It benefits organizations that are small, do not plan to receive much money or outside funds, whose activities are mostly internal, and whose transactions with outside parties are limited. nonprofit unincorporated associations are usually used to accomplish limited short-term goals, such as raising funds for a library, or a tenant’s association formed to make decisions regarding the community areas shared by an apartment complex.



There are no formal requirements to form the association. The organization is not a filing entity, meaning that it is not required to file incorporation or association documents with the Texas Secretary of State.<sup>3</sup> An unincorporated association *is* required to keep “correct and complete” account records for at least three years after the end of each fiscal year, and make that information available to the members of the association.

While bylaws are not required, most unincorporated associations adopt bylaws to define governance issues. If an unincorporated charitable nonprofit has less than \$5,000 in annual revenues, it may function as a 501(c)(3) without applying for IRS recognition of its status. This means that donations to the association will be tax-deductible to the donor without the need for incorporation and filing. However, an unincorporated nonprofit association has no separate legal existence apart from its members and no protection from individual liability for acts taken by the unincorporated association. As a practical matter, it may be difficult to obtain contributions without an IRS determination letter officially recognizing the nonprofit as a Section 501(c)(3) organization.<sup>4</sup>

**Fiscal Sponsorship** – A fiscal sponsorship occurs when an existing organization or program that is not yet tax-exempt partners with an established tax-exempt nonprofit organization. The activity or program is carried out under the control and tax-exempt status of the existing organization (the “fiscal sponsor”). This allows grants and contributions to be raised through the fiscal sponsor, which already has fiscal, accounting, personnel, and management systems in place. There are no incorporation costs, and the sponsor assumes the risk of liability. The downside of fiscal sponsorship is that the fiscal sponsor has ultimate authority over all decisions, and the IRS considers the activity to be a program of the fiscal sponsor, rather than a separate organization or entity.

## What steps do we need to take to form a nonprofit corporation in Texas?

### *Step 1: Check Availability of Name*

The Secretary of State will allow an entity seeking incorporation to use a name that is “distinguishable” from a name already in use. Tex. Bus. Org. Code [§5.053](#).<sup>5</sup>

**Name Restrictions:** Some names require prior approval from specific entities. For example, a nonprofit must obtain prior approval from the Texas Higher Education Coordinating Board to use the following terms: college, university, seminary, school of medicine, medical school, health science center, school of law, law school, law center, and words of similar meaning. A nonprofit that wants to use the terms veteran, legion, foreign, Spanish, disabled, war or world war must obtain written approval from a Congressionally recognized Veteran’s organization. Tex. Bus. Org. Code [§5.062](#). Use of the terms Olympic, Olympiad, Olympian, and Olympus is precluded under state and federal law unless authorized by the U.S. Olympic Committee.

**Corporate designation not required:** Unlike a for-profit corporation, a Texas nonprofit corporation does not need to add an organizational designation such as “Inc.,” “Ltd.,” “Incorporated,” or “Company” to its name.

<sup>3</sup> Texas law defines a nonprofit association as an “unincorporated organization...consisting of three or more members joined by mutual consent for a common, nonprofit purpose.” Tex. Bus. Org. Code [Ch. 252](#).

<sup>4</sup> For more on unincorporated associations, visit [www.sos.state.tx.us/corp/forms/208\\_boc.pdf](http://www.sos.state.tx.us/corp/forms/208_boc.pdf)

<sup>5</sup> Effective June 1, 2018, Sections 5.053, 5.012, and 5.153 of the Texas Business Organizations Code were amended to replace the term “deceptively similar” with “distinguishable name.”

**Use of Term “Foundation”:** A foundation is a non-governmental entity established as a nonprofit corporation or a charitable trust. Its purpose is to make grants to unrelated organizations, institutions, or individuals for scientific, educational, cultural, religious, or other charitable purposes. A Texas nonprofit can use the term “foundation” in its name, but runs the risk of misleading the public if grantmaking is not part of its organizational purpose. If your organization’s purpose does not include grantmaking or providing funds to other charities, consider omitting “foundation” from your organization’s name.

**Check Name Availability:** Check the name availability and legality of the organization’s proposed name by calling or emailing the Texas Secretary of State in Austin: (512) 463-5555, [corpinfo@sos.state.tx.us](mailto:corpinfo@sos.state.tx.us). For more information on entity names, visit the Secretary of State’s information page on [Names of Entities](#).<sup>6</sup>

**Name Reservation:** (Optional) If an organization wants to ensure that its proposed name is not “taken” before filing its Certificate of Formation, it can reserve the name with the Secretary of State for a period of 120 days. If the name is available, the organization can reserve it using the Secretary of State’s online tool, [SOSDirect](#), 24 hours a day, 7 days a week; or file [Form 501](#) (Name Reservation).<sup>7</sup> Filing instructions are included on the first page of the Form 501.

**Assumed Name:** (Optional) A nonprofit organization may operate under an assumed name or dba (“doing business as”) by filing [Form 503](#)<sup>8</sup> Assumed Name Certificate with the Texas Secretary of State. Tex. Bus. Org. Code [§5.051](#).

### Step 2: Prepare Certificate of Formation

The Certificate of Formation<sup>9</sup>, as the name implies, is the document filed with the Secretary of State to form the nonprofit corporation. The Certificate, which becomes a public document, defines what the corporation will do and who will be initially responsible for the management of the corporation. Secretary of State [Form 202](#)<sup>10</sup> meets the minimum statutory filing requirements for a Certificate of Formation, but requires additional language if it is to be used as part of an IRS application for tax exempt status under Section 501(c)(3). If a Certificate of Formation does not include the necessary language, it will need to be amended and restated.

The following provisions need to be included in the Certificate:

**Purposes Clause.** The purposes clause should define the charitable purpose of the corporation. The purposes clause should not be so narrow that it unduly limits the nonprofit’s activities, and not so broad that it prevents the nonprofit from obtaining 501(c)(3) exemption from the IRS. All that is required is: “The Corporation is a nonprofit corporation organized for exclusively charitable, scientific, religious, and educational purposes within the meaning of section 501(c)(3) of the IRC of 1986, as amended.”

**IRS Language.** To obtain tax-exempt status from the IRS under Section 501(c)(3) of the IRC, the Certificate of Formation also needs to include the following special clauses:

<sup>6</sup> [www.sos.state.tx.us/corp/boc\\_presentation/VI\\_names.shtml](http://www.sos.state.tx.us/corp/boc_presentation/VI_names.shtml)

<sup>7</sup> [www.sos.state.tx.us/corp/forms/501\\_boc.pdf](http://www.sos.state.tx.us/corp/forms/501_boc.pdf)

<sup>8</sup> [www.sos.state.tx.us/corp/forms/503\\_boc.pdf](http://www.sos.state.tx.us/corp/forms/503_boc.pdf)

<sup>9</sup> Known in some other jurisdictions as “Articles of Incorporation”.

<sup>10</sup> [www.sos.state.tx.us/corp/forms/202\\_boc.pdf](http://www.sos.state.tx.us/corp/forms/202_boc.pdf)

- ◆ *Dissolution Clause* – a statement that upon dissolution of the nonprofit, any remaining assets will be distributed to other organizations exempt under Section 501(c)(3).
- ◆ *Inurement Clause* – a statement that no part of the earnings of the nonprofit shall inure to the benefit of individual members, and
- ◆ *IRS Clause* - a general statement that the corporation may not take action that would be inconsistent with the requirements for tax-exemption under Section 501(c)(3).

Visit the Texas CBAR online library for a sample [Certificate of Formation](#) containing samples of these clauses.<sup>11</sup>

**Initial Directors:** The certificate must name the directors constituting the initial board. The initial board of directors will serve in this capacity until replaced as outlined in the bylaws and the Certificate of Formation. A Texas corporation must have a minimum of three directors. Of the three, there must be a President and a Secretary, who cannot be the same person. Tex.Bus.Org.Code [§22.204](#). They do not need to be Texas residents.

**Incorporator:** The incorporator is the person who signs the Certificate of Formation and must be 18 years of age or older. The incorporator does not need to be one of the initial directors. The incorporator does not need to acknowledge the certificate before a notary. Once the Secretary of State approves the Certificate of Formation, the incorporator's work is completed.

**Registered Agent and Address:** The Certificate of Formation must provide the name and address of the corporation's registered agent and office. The registered office generally cannot be a post office box. The business address of the corporation does not need to be the registered office of the corporation although this is frequently the case. The registered agent is the person designated to receive, accept, forward or otherwise notify the corporation of important legal notices. The agent is often the incorporator or another officer or director of the corporation, but does not have to be. The organization should appoint as registered agent a person who will remain affiliated with the corporation for at least a year. The person agreeing to serve as registered agent must sign a written consent to serve (Secretary of State [Form 401-A](#)), which must be kept with the corporate books and records. The signed consent form does not need to be filed with the Secretary of State. However, the corporation *must* notify the Secretary of State of any *change* in the registered agent or office by completing and filing [Form 401](#), Change of Registered Agent/Office.

**Members:** It is important to decide whether the corporation will be board driven or member driven. If the corporation is board driven, there are typically no members, or the members have very limited rights. Most nonprofit charities are board-driven.

Member-driven organizations have higher administrative burdens than non-membership organizations, and additional laws apply regarding voting rights and notice of meetings. Voting memberships are useful when an organization wishes to be democratically controlled by its constituents, as they generally have the power to elect and remove members of the board of directors. Nonprofits may prefer this form when they seek increased

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<sup>11</sup> [www.trla.org/www\\_texasbar/wp-content/uploads/2016/08/Sample-Cert.-Formation-7.20.17.doc](http://www.trla.org/www_texasbar/wp-content/uploads/2016/08/Sample-Cert.-Formation-7.20.17.doc). To change or amend an existing Certificate of Formation, review the CBAR Sample Restatement Form at [www.trla.org/www\\_texasbar/wp-content/uploads/2018/05/Sample-Amended-Restated-COF-Form-414-5.1.18.doc](http://www.trla.org/www_texasbar/wp-content/uploads/2018/05/Sample-Amended-Restated-COF-Form-414-5.1.18.doc)

formal accountability to a particular community, or another strong reason, such as increased ability to attract funds from sources that require or encourage membership, or to demonstrate a base of support within a community or group of people. Voting memberships are commonly used by organizations such as social clubs, churches, chambers of commerce and trade associations.

If the corporation is not going to have members, the certificate of formation needs to state so; otherwise, it is assumed that the nonprofit has members.

### *Step 3: File the Certificate with Secretary of State*

Generally, the incorporator will need to submit the completed Certificate of Formation, with the appropriate clauses described in Step 2 above, in duplicate together with the appropriate filing fee. Online filing is available through the Secretary of state's online filing portal, [SOS Direct](#). Alternatively, it can be delivered to the Texas Secretary of State's office by mail to Box 13697, Austin, Texas 78711-3697, by fax to (512) 463-5709, or hand-delivery to the James Earl Rudder Office Building, 1019 Brazos, Austin, Texas 78701. If faxing, the certificate must be accompanied by credit card information on [Form 807](#)<sup>12</sup> (as described in the Form 202 instructions). For an expedited fee, an organization can get approval within approximately 72 hours. Even without the expedited fee, it generally takes no longer than a couple of weeks to receive a returned file stamped copy of the certificate. The incorporator will need to order a "certified copy" of the Certificate of Formation to submit with the federal tax-exemption paperwork. The certified copy may be ordered simultaneously with the filing of the Certificate of Formation for approximately \$1 per page.

The nonprofit corporation legally exists on the date stamped on the Certificate of Formation (or another future effective date, if one was specified on the Certificate of Formation).

### *Step 4: Prepare Bylaws*

The initial board of directors should prepare and adopt bylaws for the corporation simultaneously with the preparation of the Certificate of Formation or soon thereafter. If using IRS Form 1023 (not 1023-EZ), you must submit a copy of the bylaws signed by a corporate officer, along with your application for federal tax-exemption.

The bylaws are the rules governing the internal structure and internal management of the corporation. The bylaws, along with the Certificate of Formation, are the "governing documents" of the organization. State law requires certain provisions to be part of the bylaws, but most provisions are optional. The law often provides that "unless the certificate or bylaws state otherwise, then..." What that means is that, when the certificate and bylaws (the governing documents) are silent, Texas law governs by default. However, when the bylaws are not silent, the bylaw provisions apply, provided they do not conflict with the certificate or state law.

Some of the most important issues in drafting the bylaws include:

**Meetings:** the frequency and place of meetings, the type of notice required, and whether directors may vote by written proxy.

**Leadership:** the titles and specific responsibilities of the officers, qualifications for directors, the number of directors, the length of terms for the directors and officers, and the method for electing and removing directors and officers. The corporation must have a president and a secretary.

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<sup>12</sup> <https://webservices.sos.state.tx.us/forms/payment.pdf>

**Provisions for Membership (if the corporation has members):** the qualifications for membership, method of selection, dues and fees, voting rights, and the frequency and place of membership meetings.

**Quorum:** the number of members or directors required for a quorum to conduct business, and the proportion of votes required to take action on a matter (pursuant to Texas law, an act of the board is an act of the majority of the directors present unless a greater number is required by the certificate or bylaws).

**Controls:** the signatures required for execution of legal documents, signatures required for checks, and other controls over financial transactions and transfers of corporate assets.

**Committees:** the types of committees, responsibilities of committees, and qualifications for serving on a committee.

**Action without a meeting:** a board can take action without a meeting if authorized in the bylaws and written consent to the action is signed by the number of directors/committee members necessary to take it. The written consent must state the specific action taken, the signature of member and date of consent, and “prompt” notice to directors/ committee members who did not provide written consent. Tex. Bus. Org. Code [§22.220](#).

**Fiscal Year:** the accounting period of the corporations (which need not correspond with the calendar year).

**Bylaw Amendments:** the procedures for amending the bylaws.

#### *Step 5: Meeting of Initial Directors to Adopt Bylaws and Transact Business*

After the organization obtains its Certificate of Formation, it must hold an organizational meeting, called by the incorporator or a majority of the directors (or each of the actions that would have otherwise occurred at the organizational meeting may be agreed to by a unanimous written consent of the initial directors in lieu of a meeting). If a physical meeting will be held, the directors named in the Certificate of Formation must receive at least three days’ notice of the meeting, stating the time and place of the meeting. At the initial meeting, the following actions should be taken:

#### **Adopt bylaws.**

**Elect officers.** The corporation must elect a president and secretary. Any two offices may be held by the same person, except for the president and secretary. An officer may serve unlimited terms, unless the certificate or bylaws include term limits. The corporation can elect other officers’ positions as well, in accordance with the certificate or bylaws.

501(c)(3) application. If the nonprofit corporation will seek federal tax-exemption, the directors should vote to authorize the preparation and filing of the appropriate tax-exemption application.

At the initial meeting or subsequent board meetings, the following actions should also be taken:

- ◆ Appoint members of committees.
- ◆ Authorize purchase of corporate record books.
- ◆ Fix the location of the principal office.
- ◆ Select a bank or banks and authorize the opening of an account.

- ◆ Authorize check signers.
- ◆ Authorize payment or reimbursement of incorporation and filing expenses.
- ◆ Authorize the filing of state tax-exemption applications.
- ◆ Appoint a registered agent for service of process (if the agent named in the Certificate of Formation will not continue to serve in this capacity).<sup>13</sup>
- ◆ Select an insurance broker and authorize the purchase of general liability and property insurance, bonding, director's and officer's liability insurance, and employee fringe benefits such as medical insurance and retirement plans.
- ◆ Select an accountant or auditor.
- ◆ Authorize obtaining a nonprofit mailing permit to use special bulk nonprofit rates.

#### Step 6: Apply for a Federal Employer Identification Number

In order to be tax-exempt, an organization must obtain a Federal Employer Identification Number (EIN). To apply for an exemption, a nonprofit must obtain a Federal Employer Identification Number (EIN), regardless of whether it has employees. This is the identifying number used on all federal tax returns and receipts. The treasurer or authorized corporate officer will need the EIN, together with a file-stamped copy of the organization's Certificate of Formation, in order to open a bank account in the name of the nonprofit. Complete [IRS Form SS-4](#)<sup>14</sup> and place the original completed form in the organization's minute book. Then, using the information from the completed IRS Form SS-4, use the IRS' [online interactive application](#)<sup>15</sup>, which will assign the EIN instantly upon submission. Completing the IRS Form SS-4 before submitting the information through the interactive site ensures that you have a file copy of your Application for EIN.

#### Step 7: Prepare Federal Tax-Exemption Application

To obtain federal tax-exempt status as a Section 501(c)(3) charitable organization, a corporation generally needs to file an *Application for Recognition for Exemption Under Section 501(c)(3)* of the IRC. To become a tax-exempt 501(c)(3) nonprofit, a corporation must complete an IRS application for recognition of exemption. The application should be filed with the IRS within 27 months from the date of filing the Certificate of Formation with the Secretary of State. If it does so, it may be recognized as exempt back to the date of formation, and donors may treat donations as tax-deductible. If filed outside of this 27-month window, the recognition of exemption and attendant deductibility of contributions run from date the IRS recognizes the nonprofit as tax-exempt (the date of the IRS determination letter).

There are two types of application for exemption for organizations that wish to become a 501(c)(3) nonprofit: Form 1023 EZ, for smaller organizations, and Form 1023 for all others.

**Form 1023EZ.** Organizations with assets of \$250,000 or less and annual gross receipts of less than \$50,000 may be eligible to file IRS Form 1023-EZ *Streamlined Application for Recognition of Exemption Under Section 501(c)(3)*, a shorter form for small charities. To qualify, applicants must complete the Form 1023EZ Eligibility Worksheet contained in the [Instructions](#). The organization must also choose a three character series of letters and numbers that best describes the organization and its purpose, called an NTEE (National Taxonomy of

<sup>13</sup> Make sure information concerning your registered agent is up-to-date. This is the person to whom important state notices will be sent. To change your registered agent, file [Form 408](#) with the Texas Secretary of State.

<sup>14</sup> [www.irs.gov/forms-pubs/about-form-ss-4-application-for-employer-identification-number-ein](http://www.irs.gov/forms-pubs/about-form-ss-4-application-for-employer-identification-number-ein)

<sup>15</sup> [www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online](http://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online)

Exempt Entities) Code. The 1023EZ application, along with \$275 “user fee”, can only be submitted online. The turnaround time for IRS approval of a small charity filing a 1023EZ is significantly shorter than a larger organization filing the long-form 1023. Although the 1023-EZ must be submitted online, you can view a preview of the form [here](#).<sup>16</sup>

Form 1023-EZ was updated in January 2018 to require the applicant to include more information than the previous version. Part III of the 1023-EZ calls for a brief (250 characters or less) description of the organization’s mission or most significant activities that further its exempt purpose. The organization must also certify answers to questions about annual gross receipts, total assets and public charity classification. A formerly exempt organization that was automatically revoked and applying for reinstatement must use the same NTEE Code in use at the time of revocation. If the organization seeking reinstatement uses another classification, it must file a full (regular) Form 1023.

**Form 1023.** Organizations with more than \$50,000 in gross receipts must file the regular or standard [IRS Form 1023](#).<sup>17</sup> Like the 1023EZ, Form 1023 should be filed within 27 months from the date the certificate of formation is filed with the Secretary of State. The Form includes detailed instructions for completion. The IRS also offers an [Interactive Form 1023 Application](#)<sup>18</sup> to guide an organization through the application process. It must be signed by a principal officer, an authorized employee, or an attorney for the corporation. The user fee for Form 1023 is \$600, by check or money order payable to United States Treasury. Send the completed Form and attachments by certified mail, return receipt requested to: Internal Revenue Service, P.O. Box 12192, Covington, KY, 41012-0192. As set forth in the Instructions, the completed Form 1023 must include the following as part of the application:

- ◆ Certified copy of the Certificate of Formation;
- ◆ Copy of bylaws;
- ◆ Detailed pro forma<sup>19</sup> financial statements, including revenue and expense statement for current and three preceding fiscal years; for new organizations, proposed budgets for the next two fiscal years including a list of anticipated financial support;
- ◆ Narrative description of past, present, and future planned activities with an emphasis on broad public benefit of the organization’s activities;
- ◆ Names and addresses of directors and officers and their annual compensation;
- ◆ Annual accounting period (fiscal year);
- ◆ Statement as to whether the organization is claiming status as a private foundation or public charity; and
- ◆ EIN.

The IRS has 270 days to rule on the application. Usually within 2-3 months, the IRS either requests additional information or approves the organization’s tax-exempt status by issuing a “determination letter” to the corporation formally approving the exemption. The approval process for smaller charities filing a 1023-EZ

<sup>16</sup> [www.pay.gov/public/form/preview/pdf/62759871](http://www.pay.gov/public/form/preview/pdf/62759871)

<sup>17</sup> [www.irs.gov/forms-pubs/about-form-1023](http://www.irs.gov/forms-pubs/about-form-1023)

<sup>18</sup> [www.stayexempt.irs.gov/home/starting-out/interactive-form-1023-rerequisite-questions](http://www.stayexempt.irs.gov/home/starting-out/interactive-form-1023-rerequisite-questions)

<sup>19</sup>“Pro forma” financial statements are meant to provide a general understanding of finances, unlike a financial statement that complies with [Generally Accepted Accounting Principles](#) (GAAP), which is the accounting standard for an up-and-running nonprofit corporation.

generally takes less time than the long-form 1023 Application. Regardless of which form the organization files, Federal law requires that the Determination Letter, 1023 Application and attachments, and correspondence to and from the IRS relating to the application must be made available for public inspection.

The IRS will presume that a corporation qualifying for a tax-exemption is a private foundation unless the corporation proves that it falls under the definition of a public charity. Generally, a nonprofit corporation will want to qualify as a public charity and not a private foundation. Operational, distribution, and reporting requirements for private foundations differ from those of public charities and are more restrictive and burdensome. To qualify as a public charity, a nonprofit corporation must generally receive funding from a broad base of private supporters. The IRS has very specific tests to determine public charity status. The [instructions to the IRS Form 1023](#) discuss this in more detail.

The instructions to the Form 1023 also point to the additional IRS Forms that must be filed annually by the tax-exempt, nonprofit corporation, including any income the nonprofit generates that is unrelated to its exempt purposes (described as “unrelated business taxable income”).

#### *Step 8: Apply for Sales, Franchise and Hotel Tax-Exemption from Texas Comptroller*

Nonprofit corporations are subject to all state taxes that for-profit corporations are subject to, including sales/use, franchise and hotel occupancy tax, unless the nonprofit corporation obtains an exemption from the Texas Comptroller of Public Accounts. The easiest method for obtaining state tax-exemption is by first obtaining federal tax-exemption. To apply for state exemption based on the federal exempt status, complete [Form AP-204](#).<sup>20</sup> Include a copy of the exemption determination letter issued by the IRS, including any addenda. The organization name on the IRS letter must match the organization’s legal name as listed in the Certificate of Formation.

#### *Step 9: Apply for Property Tax-Exemptions from the Local Tax Appraisal District*

Organizations engaged primarily in charitable activities may be eligible for a local option property tax-exemption. The availability of the exemption is at the option of local taxing authorities. Before an organization can apply for the exemption, the Texas Comptroller’s office must verify that the nonprofit organization is a statewide charitable organization engaged primarily in charitable activities. Complete and submit along with a copy of the Comptroller determination to their local appraisal district.

## **What are the legal obligations of a tax-exempt nonprofit?**

There are strict statutory obligations that nonprofits must follow under Texas law:

- ◆ The corporation may not make a loan to a director and any director who votes for the loan (and any officer who participates in making the loan) is jointly and severally liable to the corporation for the loan until repaid. Tex.Bus.Org.Code [§22.225](#).
- ◆ The corporation must maintain current and accurate financial records with complete entries of each financial transaction of the corporation. Tex.Bus.Org.Code [§22.352\(a\)](#).

<sup>20</sup> [www.window.state.tx.us/taxinfo/exempt/index.html](http://www.window.state.tx.us/taxinfo/exempt/index.html).



- ◆ The corporation must prepare the following annual reports in accordance with the accounting standards of the American Institute of Certified Public Accountants: a statement of support, revenue and expenses, a statement of changes in fund balances, a statement of functional expenses and a balance sheet for each fund. Tex.Bus.Org.Code [§22.352\(b\)](#).
- ◆ The corporation must keep its records, books and annual reports at its registered or principal office for three years and make the records available to the public for inspection and copying. Tex.Bus.Org.Code [§22.353](#).
- ◆ The corporation must keep a current registered agent and their consent to serve on record.
- ◆ The corporation must submit Secretary of State [Form 802](#)–General Information (Periodic Report–Nonprofit Corporation) once every four years.
- ◆ If the corporation has members, it must hold an annual meeting of its members. Tex.Bus.Org.Code [§22.153](#). Notice of the meetings must be delivered between 10 and 60 days before the meeting, in person, by fax or email, or by mail. Tex.Bus.Org.Code [§22.156](#). The bylaws may provide that no notice is required (in which case, the bylaws should describe the time and place of the annual meeting). Tex.Bus.Org.Code [§22.157\(a\)](#).<sup>21</sup>
- ◆ If it has members, it must prepare an alphabetical list of the names of all of its voting members. Tex.Bus.Org.Code [§22.158](#). Unless otherwise provided for in the Certificate of Formation or the bylaws, members holding 1/10th of the vote constitute a quorum and a majority of the quorum is an act of the members. Tex.Bus.Org.Code [§22.159](#).
- ◆ Except as provided to the contrary in the bylaws, the corporation must hold an annual meeting the members. TBOC [§22.153](#). Notice of the meetings must be delivered between 10 and 60 days before the meeting, in person, by fax or email, or by mail. TBOC [§22.156](#). The bylaws may provide that no notice is required (in which case, the bylaws should describe the time and place of the annual meeting). TBOC [§22.157\(a\)](#). If the corporation has more than 1,000 members, it may give notice by publication in a newspaper in the community, if the bylaws so provide. TBOC [§22.157\(b\)](#).
- ◆ The corporation must prepare an alphabetical list of the names of all of its voting members. TBOC [§22.158](#). Unless otherwise provided for in the certificate of formation or the bylaws, members holding 1/10<sup>th</sup> of the vote constitute a quorum and a majority of the quorum is an act of the members. TBOC [§22.159](#).
- ◆ The corporation may not make a loan to a director and any director who votes for the loan (and any officer who participates in making the loan) is jointly and severally liable to the corporation for the amount of the loan until it is repaid. TBOC [§22.225](#).
- ◆ The corporation must maintain current and accurate financial records with complete entries of each financial transaction of the corporation. TBOC [§22.352\(a\)](#).

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<sup>21</sup>If the corporation has more than 1,000 members, and if the bylaws so provide, the corporation may give notice by publication in a newspaper in the community. Tex.Bus.Org.Code [§22.157\(b\)](#).

- ◆ The corporation must prepare the following annual reports in accordance with the accounting standards of the American Institute of Certified Public Accountants: a statement of support, revenue and expenses, a statement of changes in fund balances, a statement of functional expenses and a balance sheet for each fund. TBOC §22.352(b).
- ◆ The corporation must keep its records, books and annual reports at its registered or principal office for 3 years and make the records available to the public for inspection and copying. TBOC §22.353.

There are similarly strict requirements under federal law:

- ◆ A complete and accurate IRS information return (IRS Form 990, 990 EZ or 990-N e-postcard) must be filed annually and on time or the organization can face monetary penalties. Failure to file for three consecutive years will result in automatic revocation of the organization's tax-exempt status.
- ◆ A tax-exempt nonprofit must maintain and make available for public inspection copies of its IRS Form 1023 application for exemption and all correspondence; IRS determination letter; and last three years of Form 990 and attachments.
- ◆ An organization that is exempt from federal income tax, as described in Internal Revenue Code 501(c)(3), is required to report changes to its bylaws and other governing documents annually to the IRS on the organization's IRS Form 990
- ◆ An organization must notify the IRS of a change of address.

## Who monitors nonprofit organizations?

The board of directors is legally responsible for the activities of the organization, including guarding it against fraud and corruption. Private watchdog groups and the media monitor the behavior of nonprofits to investigate whether funds are spent appropriately. Information about the nonprofit, including the last 3 years of its IRS Form 990 tax returns, if its status has ever been revoked, IRS determination letter, certificate of formation,, and other information are publicly available through online search tools for the [Texas Secretary of State](#) (SOS direct) and the [IRS](#) (Tax Exempt Organization Search) and through nonprofit information clearing houses like [Guidestar](#).

## Do we need an attorney to get tax-exempt status?

In almost every case, the answer is yes. As compared to regular businesses, nonprofits function in a heightened regulatory environment. A lawyer can help you by avoiding unnecessary mistakes, corporate responsibilities, (such as paying Social Security tax and other taxes on employees and recommend an accountant to assist with ongoing federal and state tax bookkeeping and reporting obligations. Texas organizations that do not have a lawyer and cannot afford to pay for one might be eligible for services through Texas Community Building with Attorney Resources ([Texas CBAR](#)).

The following resources provide management support services to nonprofit organizations.

— Last reviewed May 2018 —

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## **AMARILLO**

### **Amarillo Area Foundation Nonprofit Services Center**

[www.amarilloareafoundation.org](http://www.amarilloareafoundation.org)

## **AUSTIN**

### **Texas CBAR**

4920 N. IH-35, Austin, TX 78751

(512) 374-2712

Email: [texasbar@trla.org](mailto:texasbar@trla.org)

[www.trla.org/nonprofits](http://www.trla.org/nonprofits)

### **Texas Association of Nonprofit Organizations**

[www.tano.org](http://www.tano.org)

## **BEAUMONT**

### **Southeast Texas Nonprofit Development Center**

700 North Street, Suite D, Beaumont, TX 77701

(409) 832-6565; [www.setxnonprofit.org](http://www.setxnonprofit.org)

## **DALLAS**

### **The Center for Nonprofit Management**

2902 Floyd Street, Dallas, TX 75204

[www.cnmconnect.org](http://www.cnmconnect.org)

## **HOUSTON**

### **Nonprofit Connection**

50 Waugh Drive, Houston, TX 77007

(713) 685-2300; [www.unitedwayhouston.org/nonprofit-connection](http://www.unitedwayhouston.org/nonprofit-connection)

## **JACKSONVILLE**

### **A Circle of Ten**

205 E. Commerce, #205, Jacksonville, TX 75766

(903) 541-0013; [www.circleof10.org](http://www.circleof10.org)

## **LUBBOCK**

### **Volunteer Center of Lubbock**

1706 23rd Street, #101, Lubbock, TX 79411-1213

(806) 747-0551

[www.volunteerlubbock.org](http://www.volunteerlubbock.org)

## **MIDLAND**

### **Nonprofit Management Center of the Permian Basin**

3500 North A Street, Suite 2300, Midland, TX 79701

Email: [info@nmc-pb.org](mailto:info@nmc-pb.org)

<http://nmc-pb.org>

## **SAN ANTONIO**

### **San Antonio Area Foundation Center for Nonprofit Support**

303 Pearl Parkway, Suite 114 San Antonio, Texas 78215

(210) 225-2243

Email: [info@saafdn.org](mailto:info@saafdn.org)

<http://www.saafdn.org>

## **TYLER**

### **East Texas Center for Nonprofits**

4000 Southpark Drive, Tyler, TX 75703

(903) 581-6376

<https://uwsmithcounty.org/east-texas-center-for-nonprofits-2/>

## **WICHITA FALLS**

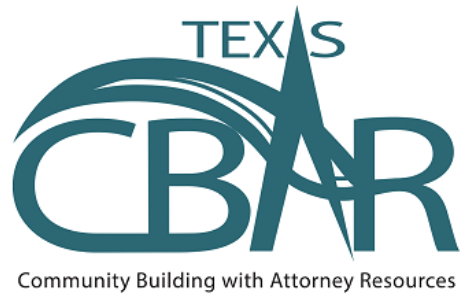
### **Nonprofit Center of Texoma**

2301 Kell Blvd., Ste. 218, Wichita Falls, TX 76308

(940) 322-4961

<http://nonprofitcenterwf.org>





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