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TEXAS NONPROFITS 101 – THE BASICS

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I. Introduction.

This article is intended to provide an overview of the basic rules and issues related to the formation and operation of a nonprofit organization in Texas, as well as the general process of applying for tax exemption with the Internal Revenue Service (“**IRS**”) and a general overview regarding rules applicable to certain exempt organizations.

II. Nonprofit Status vs. Tax Exempt Status.

A common area of confusion is the distinction between “nonprofit” status and federal “tax exempt” status. Nonprofit status is generally a state classification and relates to the type of entity—in Texas, a nonprofit corporation, for example. In some states, nonprofit status is instead referred to as “not-for-profit.”

Federal tax exempt status is a separate and distinct classification, governed by federal rules and regulations, and overseen by the IRS. An organization can be a nonprofit under state rules and not seek federal tax exempt status, or an organization can be designated as something other than a nonprofit at a state level (i.e., a limited liability company or “LLC”) and still be recognized by the IRS as tax exempt.

It is also worth note here that tax exempt status does not mean that

III. Tax Exempt vs. Charitable.

Another common area of confusion is the distinction between Federal tax exempt status and charitable status—or, more specifically, 501(c)(3) status. Organizations recognized under Section 501(c) of the Code are generally exempt from Federal income tax. However, only contributions to organizations recognized as exempt under Section 501(c)(3) (further described below) are potentially eligible for a charitable deduction.

IV. Types of Entities.

A. Nonprofit Corporation.

Nonprofit corporations are the focus of this article and are likely the most common choice of entity for organizations seeking recognition under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “**Code**”). Generally speaking, a Texas nonprofit corporation is viewed as a simple and flexible vehicle, with extensive statutory and common law guidance and without the burden of overwhelming regulatory compliance. We are fortunate in Texas—not every state can claim these same advantages. The Texas Business Organizations Code (the “**TBOC**”) provides nonprofit corporations with extensive powers, including the ability to perpetually exist; to sue and be sued in their corporate name; purchase, lease, or own property in their corporate name; lend money (so long as no loan is made to a director); enter into contracts; make donations for the public welfare; and exercise other powers consistent with their purposes. Nonprofit corporations are also flexible with respect to internal governance, generally permitting the amendment of internal procedures and operations (i.e., the amendment of governing documents) without overly burdensome procedures.

It is worth note that this article focuses on nonprofit corporations that are managed by a Board of Directors, since that is generally the simplest and most common governance structure for a nonprofit corporation. However, nonprofit corporations may have one or more classes of voting members, with myriad rights. The role of the members may be as limited as electing the Board of Directors and approving certain fundamental actions, or the members' role may much broader—effectively managing the organization. The majority of the provisions related to membership are set forth in Subchapter D, E and F of Chapter 22 of the TBOC.

Nonprofit corporations in Texas are governed by Chapter 22 of the TBOC, as well as certain other of the “hub” provisions of the TBOC. Generally speaking, the purposes for which a nonprofit corporation may be formed are quite broad—potentially encompassing organizations that would not qualify for federal tax exemption. Although there are significant restrictions placed on nonprofit corporations, the list is short and compliance is generally straight-forward.

TBOC Section 2.002 provides that the purposes of a domestic nonprofit entity may include serving charitable, benevolent, religious, eleemosynary, patriotic, civic, missionary, educational, scientific, social, fraternal, athletic, aesthetic, agricultural, and horticultural purposes. Section 2.002 also permits a professional, commercial, or trade association or labor union to qualify, and goes on to define other more specific purposes (i.e., animal husbandry) that are less relevant to the focus of this article. TBOC Section 2.010 lists certain activities that a Texas nonprofit corporation may not engage in; although worth review, the prohibited activities do not fall in the range of those typically carried out by charities. Section 22.051 further specifies that a nonprofit corporation may be formed for any lawful purpose or purposes not expressly prohibited under Chapter 2 or 22, including any purpose described by Section 2.002. Specific types of nonprofit corporations are set forth throughout Chapter 22 (i.e., dental health service corporations), but again these are not relevant to the typical charity.

Perhaps the most important and impactful TBOC restriction on nonprofit corporations is set forth in Section 22.053, which provides that a dividend may not be paid to, and no part of the income of a corporation may be distributed to, the corporation's members, directors, or officers. This restriction is similar to the prohibition on private inurement in the Code, but applies regardless of federal tax exempt status. Note that the TBOC dividend or inurement prohibition does not prohibit compensating members, directors, or officers for services provided to the corporation, but rather highlights the need to ensure that compensation is reasonable. Another significant restriction on nonprofit corporations is in Section 2.304, which provides that, upon winding up and termination, the assets must be distributed to another charity as described in Code Sections 501(c)(3), 170(c)(1) or 170(c)(2).

A nonprofit corporation is formed upon filing a Certificate of Formation (formerly known as Articles of Incorporation) with Secretary of State. Although the effective date is generally the date of filing, pursuant to Sections 4.052 and 4.053 of the TBOC, a Certificate of Formation can have the effective date delayed not more than ninety (90) days from the date the instrument is signed or based on the occurrence of a future event or fact (other than the passage of time). In order for an effective date based on the occurrence of a future event or fact to take effect, within ninety (90) days of filing the Certificate of Formation, a statement must be filed with the

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