

WORKING WITH GRASSROOTS GROUPS:

Legal Guide To Forming A Nonprofit Association In Texas

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Purpose and Acknowledgment

The purpose of this Guide is to introduce attorneys new to community development practice to formation issues they may encounter when working with grassroots groups. As an attorney starting a community development practice, much of your work will involve working with grassroots groups. The Guide focuses on the Texas Unincorporated Nonprofit Association. (Note: We will use the terms “nonprofit association” and “association” interchangeably with “unincorporated nonprofit association.”) Many grassroots groups are best served by choosing an unincorporated nonprofit association. This entity form is very flexible and, in Texas, provides nearly identical liability protection and entity powers as a nonprofit corporation.

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Every effort has been made to make these materials as accurate as possible, however, these materials are not to be used as a substitute for the advice of an attorney. Persons reviewing this Guide should not act upon the information without seeking the advice of an attorney.

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Introduction

We use the term “grassroots group” to mean a group of persons working collectively to improve conditions in their community. A community is typically place-based but may also be a community of common interests. Common examples of grassroots groups include:

- Neighborhood associations
- Tenants associations
- Groups of parents concerned about the closure of a local school
- Community members coalescing around a proposed redevelopment plan
- Groups of individuals concerned about environmental threats to their community

Importance of Working with Grassroots Groups

By its very nature, community development work involves working with community groups. The practice focuses on working with these groups to develop strategies and find solutions to problems. Many of the tools and strategies of community development are designed for implementation by groups.

Forming an Entity for a Grassroots Group

A common first step for attorneys when working with a grassroots group is to help the group with entity matters. An active group should consider forming an entity. A primary reason for forming an entity is to shield the members and leaders from legal liability that may result from the actions of each other or the group. While there are numerous entity forms, a nonprofit entity aligns most closely with the common goals of most grassroots groups. An entity may also be necessary to achieve the goals of the group, including facilitating group decision-making and the ability to receive tax-deductible donations and access grant funding.

A nonprofit entity is governed by both state and federal law. State law, as codified in the Texas Business Organizations Code (“TBOC”),ⁱ will determine the choice and formation of the entity, as well as state and local tax exemptions. Federal law, as codified in the Internal Revenue Code (“IRC”)ⁱⁱ and implementing regulations, will apply to the organization’s exemption from federal taxes and ability of donors to deduct donations. The statutes most relevant to the formation of a Texas nonprofit entity are listed in Appendix A.

Texas Entity Options For a Grassroots Group

Under Texas law, the most common nonprofit entities are the nonprofit association and the nonprofit corporation. A group engaged in community development typically qualifies for either entity type. It is important to note that both entities can qualify for recognition as an organization exempt from federal taxes.

Nonprofit Association

Under the TBOC, a nonprofit association is an “unincorporated organization ... consisting of three or more members joined by mutual consent for a common, nonprofit purpose.”ⁱⁱⁱ Chapter 252 of the TBOC sets out the requirements for an Unincorporated Nonprofit Association.

Nonprofit Corporation

Under the TBOC, a nonprofit corporation is a corporation that does not distribute income to members, directors, or officers.^{iv} Chapters 1-12 (all filing entities), Chapter 20 (all corporations), and Chapter 22 (nonprofit corporations) of the TBOC contain provisions that apply to nonprofit corporations.

The nonprofit association and the nonprofit corporation share many characteristics. The following chart outlines key similarities and differences between the two entity forms.

Comparison Between Nonprofit Associations and Nonprofit Corporations

	<i>Nonprofit Association</i>	<i>Nonprofit Corporation</i>
Liability	<ul style="list-style-type: none"> • Under Texas law, entity is recognized as a distinct legal entity • Leaders and members of the organization are protected from personal liability for the acts of the entity 	
Ability to Enter into Contracts and Hold Real Property	Entity is able to contract and hold real property in the entity's name	
Power to Sue and Be Sued	Can bring a lawsuit and can be sued	
Governance	Governed by the Texas Uniform Unincorporated Nonprofit Association Act (Chapter 252 of the Texas Business Organizations Code)	Governed by the Texas Nonprofit Corporation Act (Chapters 1-12, 20, and 22 of the Texas Business Organizations Code)
Formation	<ul style="list-style-type: none"> • Not required to file formation documents • May file a form appointing a registered agent with the Secretary of State 	<ul style="list-style-type: none"> • Formed by filing a Certificate of Formation with the Secretary of State • Must pay \$25 filing fee • Must appoint a registered agent with the Secretary of State
Organizational Structure	<ul style="list-style-type: none"> • Must have at least 3 members • May have a board of directors 	<ul style="list-style-type: none"> • Must have at least 3 directors • May have members
Eligibility for Exemption from State and Federal Taxes	Eligible for exemptions from state and federal taxes	
Corporate Formalities	TBOC does not impose any legal requirements for holding meetings or keeping written minutes from meetings	TBOC imposes numerous requirements governing the structure and operations of a nonprofit corporation, including voting rights of directors and members, meeting procedures, and notice requirements for meetings
Indemnification	May indemnify managers but the TBOC does not include a provision regarding indemnification	May indemnify directors, but the TBOC places limits on indemnification
Filing and Recordkeeping	Required to keep correct and complete account records for at least three years after the end of each fiscal year	Must keep: (1) correct and complete books and records; (2) minutes of all board and member proceedings; (3) a record of the names and addresses of voting members
Funding	May receive grants and donations	

Getting Started With a Grassroots Group

Step 1: Get to Know the Group

It is important to take the time to learn about the group and understand its goals. This step has three key purposes:

- Helping the organization develop a plan and specific outcomes
- Analyzing the possible risks in the planned activities
- Helping the group to determine best entity type
- Determining the scope of your legal representation

Key Areas to Explore

Getting to know the grassroots group is important to help establish trust and rapport with the members and leaders of the group. This trust and rapport will help you build the foundation for the effective representation of the group. There are five main areas to explore as you get to know the group and understand the best potential avenues for entity formation.

- What are the goals of the group?
- What activities are most important to the group?
- What are the funding prospects for the group?
- What is the capacity of the group?
- Who is involved in the group?

The Group's Goals and Purposes

It is important to probe deeply into the goals of the group. Grassroots groups serve as important vehicles for community connection and communication. This may be their sole purpose. Grassroots groups organize effective community advocacy on the issues important to the members of a community. Grassroots groups are also often key drivers of community economic development initiatives.

- Why did this group start?
- What holds the group together?
- What is driving the group?
- What does the group hope to accomplish by working together?

Activities

- What are the group's current and planned activities?
- Do those activities duplicate the activities of other organizations?

Likely Sources of Funding

- How much money does the group need to conduct its activities?
- Where is that funding likely to come from?
 - Many small nonprofits receive donations from small donors who do not itemize deductions and will not receive a tax deduction for their donation.
- What are the group's fundraising plans?
- Can the group partner with a fiscal sponsor?

3 Steps for Getting Started with a Grassroots Group

- 1 Get to Know the Group
- 2 Determine the Current Legal Status of the Group
- 3 Determine the Best Entity Form for the Group

- In a typical fiscal sponsor relationship, an organization that is eligible for 501(c)(3) tax exemption but has not applied for exemption establishes a relationship with an existing 501(c)(3) that agrees to accept donations on behalf of the organization and to help provide oversight over the organization's use of the funds.

The Group's Capacity

- Are there people within the group who can handle the paperwork and help ensure the necessary compliance for the group?
- Are the members able to make decisions and take action?
- Are the members able to work together to set priorities?

The Group's Participants

- Is there an active group of equally-engaged community members or is there just one community leader who brings in other people on an ad hoc basis?
- Who is a part of the organization?
- Is the group representative of the community?

Step 2: Determine the Current Legal Status of the Group: Is the Group Already an Unincorporated Nonprofit Association?

As you work through the pros and cons of each nonprofit entity choice for a group, you should also assess the current legal status of the organization. A grassroots group is likely to be in one of three stages:

- A loosely-formed group that meets on a periodic basis to discuss and act on projects and issues
- A group that may have some corporate elements such as bylaws, directors, officers, and periodic meetings
- A more tightly structured organization that meets on a regular basis, elects officers, has bylaws, and may have a board

As noted above, the TBOC defines an unincorporated nonprofit association as three or more people working on a common nonprofit purpose and doing so by mutual consent. The TBOC does not require written documentation of intent or actions for a nonprofit association to be formed. This low threshold means that many grassroots groups are already Texas nonprofit associations, although many may be unaware of their legal status. Consider this a good news/bad news situation.

Good News: If a group meets this definition, it is automatically recognized as a legal entity in Texas. As a separate legal entity, the nonprofit association will have the following protections and powers under Texas law:

- A person is not liable for an association's actions simply because the person is a member or participates in the management of the association's affairs.
- An association can enter into contracts and acquire, hold, and transfer an interest in real or personal property.
- An association may sue and be sued.
- An association is able to form an attorney-client relationship.

Bad News: If a group meets the definition of a nonprofit association, it may also be automatically recognized as a tax-exempt organization under federal law and may be subject to reporting and filing requirements. Federal tax law will be discussed later in this Guide.

Because the TBOC contains very few requirements for the formation and operation of a nonprofit association, the group may not need to do anything new to accomplish the goals of the organization.

Step 3: Determine the Best Entity Form for the Group

After carefully gathering information about the group, you are ready to help the group determine whether a nonprofit association or a nonprofit corporation is the best entity for the group. Many grassroots groups believe that they must form a corporation in order to receive federal tax exemption or to be a “legitimate” organization. Many also see the association as a “starter” entity. While this may be true for some groups, the discussion below will show that an association is often the best long-term choice for a grassroots group. The chart below outlines the main differences between nonprofit associations and nonprofit corporations to help plan the right entity for a grassroots group.

Key Pros and Cons of Nonprofit Associations v. Corporations		
	<i>Nonprofit Association</i>	<i>Nonprofit Corporation</i>
Formalities	Few required formalities	<ul style="list-style-type: none">• Many corporate formalities required• For membership organizations, TBOC provides default requirements
Dealing with Outside Parties	Some parties may not feel comfortable dealing with an association ^v	Very familiar entity form to third parties
Funding	May be harder to attract donations and grants from institutional donors	Institutional donors are often more comfortable with a nonprofit corporation

The key factors to balance are ease of formation, operation, and dissolution and a legal form that may be more familiar to third parties. The reason for choosing a corporation over a nonprofit association is generally due not to legal differences but rather to third parties’ comfort and familiarity with the corporation. As a general rule, the following groups are the only ones that need to think about forming a nonprofit corporation rather than an association:

- Groups planning to apply for large grants, contracts, or certain government funding programs
- Groups that plan to work as community development corporations with more complex activities such as building affordable housing or operating a daycare center
- Groups that plan to hire employees
- Groups that plan to acquire real estate that is potentially eligible for an exemption from ad valorem taxes

If a grassroots group is unsure of which choice to make, it is usually best to start with a nonprofit association. Some groups may still want to form a nonprofit corporation—and for these groups it will be a good idea to review the charts above to determine the downsides of this step. Many grassroots groups might not have the capacity to undertake the formalities of a nonprofit corporation.

Forming a Nonprofit Association

A grassroots group will enjoy the protections and powers afforded to nonprofit associations even if it does not have any written documents. However, **some** groups will likely benefit by implementing some corporate formalities and documenting decisions.

Step 1: Review/Recruit the Group's Members

Members are the core of a nonprofit association. Under Chapter 252 of the TBOC, an association must have at least three members. A member is defined as "a person who under the rules or practices of a nonprofit association, may participate in the selection of persons authorized to manage the affairs of the nonprofit association or in the development of policy of the nonprofit association."^{vi} The TBOC does not specify requirements regarding members. The nature the group will help determine the eligibility for membership. For example, members may be:

- All residents or businesses in a geographically-defined community
- All tenants in a specific building
- All persons interested in homelessness

If the group is just forming, it can be helpful to have a committee form to help recruit members and possible leaders through widespread outreach. The committee can also serve to understand community concerns and begin to prioritize the activities an association could undertake.

Step 2: Review the Group's Leadership Structure

Effective leadership is important for the sustained success of any organization. If the group is already in existence, it will most likely have leaders. If the group chooses to formalize, it will be important for the leaders to confirm that they are able and willing to reach out to the community stakeholders and to adopt and maintain the corporate formalities required for the association. If the group does not yet have leaders, the group should undertake a broad outreach effort to attract committed community members. This work encompasses leadership development, organizing, and institution building. The group may want to bring in leadership development resources to help build a strong foundation for the organization.

The definition of member above indicates that the TBOC assumes nonprofit associations will have some version of a management structure although this is not required. The members decide who will manage the association. In deciding whether to create a leadership structure, members should consider the tradeoff between efficient decision-making and member and community accountability. Possible structures include:

- Members elect an executive committee (often with officers) and reserve most of the managerial decisions to the membership.
- Members elect a board and officers and vote on some of the managerial decisions.
 - Decisions are allocated among the board, officers, and members.
 - Members vote only on matters presented by the board.

While a nonprofit association is not required to have a board of directors, it may want to appoint a board or an executive committee to help centralize management. The association's bylaws will include eligibility, terms, and other requirements and duties for the board or the committee. Typical officer positions are president, secretary, and treasurer. The board or committee will likely be composed of the leaders of the association and, if possible, should include people with a wide variety of skills and the time to devote to the association.

5 Steps for Forming a Nonprofit Association

- 1 Review/Recruit the Group's Members
- 2 Review the Group's Leadership Structure
- 3 Draft or Revise Bylaws
- 4 Make Decisions According to Bylaws
- 5 Comply with Reporting Requirements

Practice Note

Even if you don't create a formal non-profit, the following are still best practices:

- Review the group's members
- Choose or ratify a leadership structure
- Adopt bylaws under Chapter 252 of the TBOC
- Make decisions according to bylaws
- Comply with reporting requirements

Under the TBOC and Texas common law, nonprofit corporation directors have three legal duties: the duty of care, the duty of loyalty, and the duty of obedience. The TBOC does not impose any legal duties on a nonprofit association; however, the common law duties, which result from trust law, may still apply.

- **Duty of Care:** Managers must exercise ordinary care in the management of the organization. This includes providing oversight to the organization, reviewing and guiding the financial management of the organization, attending meetings, and reviewing minutes.
- **Duty of Loyalty:** Managers must not take advantage of their position within the organization for financial gain. This is often managed through a conflict of interest policy as discussed below.
- **Duty of Obedience:** Managers must follow the mission of the organization and any laws that apply to the organization.

Step 3: Draft or Revise Bylaws

An association should adopt bylaws under the TBOC Chapter 252, although bylaws are not required. Adopting bylaws under the TBOC is key to securing the maximum protections available to nonprofit associations under Texas law. Bylaws serve as the internal rules and member contract for the organization. Carefully drafting bylaws can help to prevent problems.

Step 4: Make Decisions According to Bylaws

In order for the group to maintain its limited liability, it must follow its bylaws when making decisions. An important element of effective decision-making is establishing the right quorum requirement. The organization needs to decide how many members should be present before decisions can be made at a meeting. The goal should be to require a quorum large enough to ensure group input for decisions but not so large as to impede the group from convening meetings and taking action. Be especially mindful of what will happen if participation begins to fade. Quorum for membership meetings is often 10 percent unless the membership group is very large. On the other hand, if the group is very small, a 10 percent quorum provision may result in an insufficient number of members required to make decisions. In smaller organizations, setting a minimum number as the quorum requirement can help ensure that the organization is accountable to its members while also being able to make quorum.

Important Items to Include in Bylaws:

- Purpose and mission of the organization (should be consistent with IRS requirements)
- Eligibility for becoming a member in the organization
- How meetings are held
- How decisions are made and type of quorum required to hold meetings and take action
- How leadership is selected

Step 5: Comply with Reporting Requirements

A nonprofit association has few reporting requirements under Texas law. However, the association may want to adopt the following two recommended best practices:

- Creating an annual financial report and maintain the report in the association's permanent records; and
- Create meeting minutes and maintain the minutes in the association's permanent records.

Additionally, as discussed below, the organization's status as an exempt organization under federal law will create additional reporting obligations.

Exemption From Federal Income Tax

As noted above, nonprofit associations and nonprofit corporations are both eligible for exemption from federal income taxes if they meet certain requirements and follow certain compliance responsibilities.

How to Qualify For a 501(c)(3) Exemption

Section 501(c) of the Internal Revenue Code (IRC) provides federal income tax exemption for a wide variety of organizations. Organizations that qualify for an exemption under Section 501(c)(3) also can receive donations that are deductible by the donor. Grassroots groups working on community development issues or working in low-income or distressed communities will typically qualify under this section of the Code.

To qualify as a 501(c)(3) exempt organization, an organization must meet the following requirements:

1. Be Organized and Operated for Exempt Purposes

The IRC lists the purposes eligible for exemption. The two categories that best fit the work for community grassroots groups are charitable and educational.

Organized: To qualify for a 501(c)(3) exemption, the association's bylaws must list the group's purposes as charitable or educational (or both) and must limit its purposes to those allowed by the IRC.

Charitable Purposes include:^{vii}

- Relief of the poor, distressed, or underprivileged
- Lessening neighborhood tensions
- Elimination of prejudice and discrimination
- Lessening the burdens of government
- Defending human and civil rights
- Combating community deterioration and juvenile delinquency

Educational Purposes include:^{viii}

- Instruction or training of individuals for the purpose of improving or developing their capabilities
- Instruction of the public on subjects useful to the individual and beneficial to the community

Operated: To qualify for the exemption, the association must engage primarily in activities in furtherance of its charitable or educational purposes. Common community development activities that are eligible for exemption include:

- Operating a food pantry
- Operating a community center
- Operating a leadership program for at-risk youth
- Offering ESL classes for the community

6 Steps to Qualify for a 501(c)(3) Exemption

- 1 Be Organized and Operated for Exempt Purposes
- 2 Follow Restrictions on Lobbying and Political Campaign Activities
- 3 Meet the Definition of a Statutory-Created Organization or a Sources of Income Test
- 4 Permanently Dedicate Assets upon Dissolution
- 5 Follow Restrictions on Commercial Activities
- 6 Follow Restrictions on Transactions that Benefit Private Individuals

2. Follow Restrictions on Lobbying and Political Campaign Activities

The association must limit its lobbying activities per IRS guidance and must limit its political campaign activities to nonpartisan activities authorized by the IRS, such as open candidate forums. Endorsing candidates for political office on behalf of the organization is strictly prohibited. Advocating for or against city council ordinances or state legislation is allowable as long as it does not exceed 20 percent of the organization's expenditures if the annual budget is \$500,000 or less. An organization that plans to regularly lobby should consider filing Form 5768, *Election/Revocation of Election by an Eligible IRC Section 501(c)(3) Organization to Make Expenditures to Influence Legislation*, which provides an objective expenditures assessment of the association's lobbying. The organization may file the form at any time during a year the organization engages in lobbying activities. Form 5768 will only need to be filed once and will remain in place until the organization revokes the filing. Note that the organization will be unable to file the simple 990-N e-postcard once it files Form 5768.

3. Meet the Definition of a Statutory-Created Organization or a Sources of Income Test

Most associations will qualify for exemption under a sources of income test, which means that at least 33 1/3 percent of the revenues come from income classified as public support—generally small individual or corporate donations or from grants, including government grants. An organization that provides services as part of its programs may count some of those fees as public support. For small and emerging organizations, one problem in meeting the sources of income test is that the organization may not have enough small donors. The amount of each donor's contribution that can be counted as public support is limited to 2 percent of the organization's total support. This limit applies to donations from individuals, corporations, and foundations, but not to government grants. To avoid this problem, organizations should engage in broad fundraising.^{ix}

4. Permanently Dedicate Assets upon Dissolution

All money or property donated to a 501(c)(3) must be transferred to another 501(c)(3) organization if the association dissolves or ceases operations. Permanent dedication of assets also means that if an organization sells assets the sale must be an arms-length transaction and assets must be sold at fair market value.

5. Follow Restrictions on Commercial Activities

A nonprofit association must limit the funds that it receives from commercial activities. For many grassroots organizations this can become a problem if the association generates a large amount of income from advertising or from sales of items, such as t-shirts.

6. Follow Restrictions on Transactions that Benefit Private Individuals (No Private Inurement, Private Benefit, or Excess Benefit)

A nonprofit association must comply with IRS private inurement and private benefit rules to prevent both insiders and third parties from taking advantage of the association. For example, an organization should get the best deal and check market pricing for its transactions. This restriction does not prohibit an organization from providing goods and services to individuals as part of its exempt activities that further charitable or educational purposes.

How to Receive a 501(c)(3) Exemption

A nonprofit association that meets the requirements outlined above may already have exempt status under Section 501(c)(3), even if it has never applied for the exemption. An association that meets the requirements for recognition as an exempt organization under the IRC and has \$5,000 or less in gross receipts is automatically exempt under the IRC. However, an organization will not be able to provide definitive proof of its exempt status if it does not have a determination letter from the IRS, which can be a problem for securing donations.

For additional information, see IRS Publication 557 Tax-Exempt Status for Your Organization.^x

Obtaining Recognition of Federal Tax Exempt Status

Association's Gross Receipts	Which Form to File	Notes
\$5,000 and under	Association is automatically exempt	Association can obtain proof of exemption by filing Form 1023-EZ
Between \$5,000 and \$50,000, with total assets valued at less than \$250,000	Form 1023-EZ, unless the organization is ineligible to use this form (see Form 1023-EZ instructions)	<ul style="list-style-type: none"> • Online Form: Association first submits an eligibility worksheet and then application • No supporting documentation required • \$275 filing fee
Over \$50,000	Form 1023	<ul style="list-style-type: none"> • Complex multi-part form and extensive supporting documentation • \$600 filing fee

501(c)(3) vs 501(c)(4) Exemptions

While most community development groups will be able to qualify as a 501(c)(3) exempt organization due to their purposes and activities, groups who do not meet those requirements may still be able to qualify for tax exemption as a social welfare organization under Section 501(c)(4) of the IRC.^{xi} Some groups may want to form a 501(c)(4) because of the fewer limitations on political activity. The key differences between the two forms of exemption is that the 501(c)(4) does not allow a donor to claim a deduction for donations to the organization and the group will be ineligible for foundation grants and many other types of contributions. The chart below illustrates the differences between 501(c)(3) and 501(c)(4) organizations.

Key Differences Between 501 (c)(3) and 501 (c)(4) Exemptions

	501(c)(3)	501(c)(4)
Purpose and Activities	Organized and operated exclusively (i.e., "primarily") for charitable, religious, scientific, literary, or educational purposes	Formed and operated only to promote social welfare to the benefit of the community as a whole
Deductibility of Donations	Donations to the organization qualify for maximum deduction as charitable donations	<ul style="list-style-type: none"> • Donations to the organization do not qualify for deduction as charitable donations • Membership dues may be deductible as business expenses
Lobbying (Contacting legislators to express a position for or against pending legislation)	Limitations on amount of lobbying activity	No restrictions on amount of lobbying activity as long as it furthers social welfare purpose
Political Activity	Absolute prohibition on partisan political activity. Nonpartisan political activity is allowed	Nonpartisan political activity and some partisan political activity is allowed so long as it furthers social welfare purpose
Advocacy (Examples — Contacting legislators to raise awareness about an issue; providing testimony on pending legislation if invited to do so by legislators)	No limits on advocacy as long as it furthers charitable purpose ((c)(3)) or social welfare purpose ((c)(4))	

To determine whether a grassroots group qualifies as a 501(c)(3) or a 501(c)(4), questions for the group include:

- How can the organization achieve power—by conducting programs or by conducting political activity?
- How much money does the organization need?

For an association that meets the requirements of a 501(c)(3), choosing a 501(c)(4) would only make sense if the group was committed to extensive lobbying or supporting candidates for political office. Some groups choose to form both types of organizations. These interrelated organizations must be managed carefully. Bolder Advocacy provides excellent guidance on this topic.^{xii}

Exemption From State and Local Taxes in Texas

The following exemptions from state and local taxes are available to certain qualified nonprofit associations:

Exemption from Franchise Tax

Nonprofit associations are required to pay franchise taxes (a business income tax) but may qualify for an exemption. Nonprofit associations may apply for exemption from paying franchise taxes through the office of the Comptroller. Some organizations are eligible for exemption from paying sales taxes if they have received recognition of exemption from federal income tax under Section 501(c)(3) or 501(c)(4) of the IRC. These organizations are able to file either Form AP-205 (Charitable) or Form AP-207 (Educational) with the IRS Determination Letter as the only supporting document.

Organizations that have not filed for recognition may still be eligible for a franchise tax exemption if they meet the definition of an exempt charitable or educational organization under the Texas Tax Code.^{xiii} The application requires documentation regarding the organization's structure, activities, and finances. Charitable organizations should file Form AP-205 and educational organizations should file AP-207. Due to the amount of additional documentation required for Forms AP-205 and AP-207, a more efficient approach may be for the organization to file Form 1023-EZ and then file Form AP-205 or AP-207.^{xiv}

An organization that does not apply for exemption but does not meet the minimum income threshold to owe taxes may file a No Tax Due Form.^{xv}

Exemption from Property Taxes

Nonprofit associations that own real property may qualify for exemptions from ad valorem taxes if they meet the definition of a charitable organization under the Texas Tax Code.^{xvi} However, certain exemptions, such as that for a community land trust or for an organization developing affordable housing for sale to qualified families are available only to organizations formed as a nonprofit corporation.^{xvii}

Exemption from Sales Taxes

Nonprofit associations may apply for exemption from paying sales taxes. A nonprofit association should consider applying for exemption from sales taxes through the Texas Comptroller if it plans to purchase items for the organization's use. Organizations are eligible for exemption from paying sales taxes if they have received recognition of exemption from federal income tax under Section 501(c)(3) or 501(c)(4) of the IRC. Charitable organizations should file Form AP-205 and educational organizations should file Form AP-207.

Organizations that have not filed for recognition may still be eligible for a sales tax exemption if they meet the definition of an exempt charitable or educational organization under the Texas Tax Code.^{xviii} The application requires documentation regarding the organization's structure, activities, and finances. Charitable organizations should file Form AP-205 and educational organizations should file AP-207. Due to the amount of additional documentation required by the application, a more efficient approach may be for the organization to file Form 1023-EZ and then file either Form AP-205 or Form AP-207.^{xix}

Compliance and Operations

Formation is only the first step in establishing a successful 501(c)(3) organization. Ongoing compliance with federal, state, and local requirements is equally important for the organization.

EIN

In order to open a bank account, hire employees, and file for tax exemption or file the annual reporting forms discussed in the chart below, the group will need to obtain a Federal Employer Identification Number (EIN). This number will be used on all federal tax returns and for any bank accounts opened in the group's name. To obtain an EIN, the group must complete IRS Form SS-4, available from the IRS website.^{xx} Be sure to place a copy of the EIN in the organization's records.

Recommended Policies

A nonprofit association should consider adopting additional policies for the organization. While the following documents are not required, the following policies are a best practice for organizations engaging in financial transactions:

Conflict of Interest: Policy that provides guidelines for insider transactions.

Whistleblower: Policy that provides guidelines for accepting information about wrongdoing at the organization. Often considered an employment policy, it can also be used to protect volunteers.

Document Retention: Policy that provides guidelines for retaining and destroying organizational documents. An association that does not need to file documents with the IRS should still consider adopting these policies. Sample documents are available at www.texasbar.org.

A Note Regarding Potential Conflicts of Interest

Conflicts of interest sometimes arise within an association's work. When a group forms in order to advocate around particular community or neighborhood conditions, such as a group organized against a feedlot or a tenants association, the goal for the whole community may conflict with what is best for an individual member. The conflicts of interest policy discussed here does not address these issues. The best way to resolve these issues are through group discussion and decision-making. Carefully drafted bylaws that provide a clear procedure for discussion and for making decisions are key to addressing these types of conflicts.

Ongoing Compliance Requirements

For easy reference, the chart below provides the ongoing requirements for a nonprofit association that is also recognized as a 501 (c)(3) or (c)(4) exempt organization.

Compliance	Texas	IRS
Annual Financial Filing	None	Forms 990-N, 990-EZ, or 990 ^{xxi} due on or before May 15th Every organization claiming to be exempt from federal taxes must file one of these forms.
Books and Records	Must keep accurate books and records for three years	Recommended to maintain year-end financial statement in permanent records
Meetings	While Texas does not impose requirements, it is recommended that an association follow bylaws and document decisions	Follow conflict of interest policy when applicable
Oversight	Attorney general has right to inspect books and records	IRS can audit the organization

Alternatives to Being a Self-Standing 501(C)(3)

A grassroots group may decide that it is not ready to manage its own federal tax-exempt status but still wants to receive some tax-deductible donations. A common example of this situation is a group that would like to offer food at community events. Many local groceries require a copy of an organization's 501(c)(3) determination letter in order to donate food and supplies. For a grassroots group in this situation, a fiscal sponsorship or a group exemption may be a good alternative.

Fiscal Sponsorship

An association that is not ready to file for its own status may form a fiscal sponsor relationship with an established 501(c)(3). A fiscal sponsorship is a formal arrangement through which an established tax-exempt 501(c)(3) charitable organization acts as a fiscal sponsor and accepts tax-exempt donations for an organization that has not filed for tax-exempt recognition from the IRS. The sponsor maintains ultimate responsibility for ensuring that the funds are used for tax-exempt purposes.^{xxii}

A fiscal sponsorship is typically established through a written contract. The sponsor must maintain detailed records showing that any contributed funds were indeed used for 501(c)(3) exempt charitable purposes^{xxiii} There are many ways to set up a fiscal sponsorship. For a nonprofit association that has formed, the most practical model is a re-grant model in which the sponsor will accept donations in the name of the association and then fund the association.^{xxiv} It is important to note that, in this arrangement, donations do not simply pass through to the association.

Pros and Cons of a Fiscal Sponsorship Arrangement	
Pros	Cons
<ul style="list-style-type: none">• A contractual relationship that is easy to form and dissolve• Allows an association time to develop programs• Established organization serving as fiscal sponsor may also act as mentor to association	<ul style="list-style-type: none">• The fiscal sponsor maintains ultimate control over funds raised through sponsorship and may redirect funds if it determines that association is not using funds according to tax-exempt purposes and regulations.• Fiscal sponsor and association may need to compete for funding from the same donors and donors may not be willing to fund both.• Fiscal sponsors may require an administrative fee that is too expensive for the association.

Group Exemption

An association may choose to receive tax exemption as part of a group exemption. This is a common structure when the association is part of a network of similar associations, such as the local chapter of a national organization. In this arrangement, the central organization receives an exemption for itself and for affiliated groups that meet the criteria established by the central organization. The central organization maintains oversight and control over the purposes and activities of the affiliate groups. While each group may raise its own funds, the central organization must provide oversight over the expenditures of each group. An affiliate group does not need to make a separate application to the IRS. The group will work with the central organization to establish eligibility and the IRS Exemption Letter issued to the central organization will also serve as the determination letter for each group.^{xxv}

APPENDIX A

STATUTES APPLICABLE TO ENTITY FORMATION

State Entity Formation

Texas Business Organizations Code

- Chapters 1-12; 20, 22, and 252

<https://statutes.capitol.texas.gov/?link=BO>

Federal Income Tax

Internal Revenue Code

- 26 U.S.C. §§ 501(a) and (c)

<https://www.law.cornell.edu/uscode/text/26/501>

- 26 U.S.C. §511

<https://www.law.cornell.edu/uscode/text/26/511>

- 26 U.S.C. §513

<https://www.law.cornell.edu/uscode/text/26/513>

Code of Federal Regulations

- 26 C.F.R. §§ 501(c)(3)-1 et. seq.

<https://www.law.cornell.edu/cfr/text/26/1.501%28c%29%283%29-1>

APPENDIX B

ADDITIONAL RESOURCES

Publications

IRS Publication 557: Tax-Exempt Status for Your Organization

<https://www.irs.gov/pub/irs-pdf/p557.pdf>

Texas C-BAR Forming a Nonprofit Tax-Exempt Corporation in Texas

http://texasbar.org/wordpress/wp-content/uploads/2011/07/FormingNonProfitTX_REV15_Web.pdf

Texas C-BAR Nonprofit Legal Toolkit

http://www.trla.org/www_texasbar/legal-toolkit-for-texas-nonprofits-rev-2018/

Agency Websites

Internal Revenue Service

<https://www.irs.gov/>

Texas Secretary of State

<https://www.sos.state.tx.us/>

Texas Comptroller of Public Accounts

<https://comptroller.texas.gov/>

Resource Websites

Legal Bitstream

<http://www.legalbitstream.com/>

Texas Community Building with Attorney Resources (Texas C-BAR)

<http://www.texasbar.org>

Moore Thoughts on Nonprofits

<http://moorenonprofitlaw.com/wp-content/uploads/2013/06/Setting-Up-Your-501c3-Nonprofit-Organization.pdf>

Nonprofit Law Blog

<http://www.nonprofitlawblog.com/>

APPENDIX C

SAMPLE DOCUMENTS

Bylaws

- [Texas C-BAR Sample Bylaws](#)
- [Simple Bylaws for a Group with Limited Organizational Experience](#)

[Simple Agenda](#)

[Simple Minutes](#)

[Simple Resolution](#)

[Form 1023 EZ Instructions and Eligibility Worksheet](#)

[Form 1023 EZ](#)

[Fiscal Sponsorship Agreement](#)

Endnotes

- ⁱ Texas Business Organizations Code (TBOC), available at <https://statutes.capitol.texas.gov/?link=BO>.
- ⁱⁱ 26 U.S.C. Section 501.
- ⁱⁱⁱ TBOC Section 252.001(2).
- ^{iv} TBOC Section 22.001(5).
- ^v For example, the Texas Workforce Commission rejected the request of an unincorporated association to open an account because the agency representative was not familiar with the entity form. The agency instead opened an individual employer account in the name of the association's registered agent. While this type of situation can be solved with additional communication with the agency, it takes additional work on the part of the organization.
- ^{vi} TBOC Section 252.001(1)
- ^{vii} 26 CFR 1.501(c)(3)-1(d)(1).
- ^{viii} 26 CFR 1.501(c)(3)-1(d)(3).
- ^{ix} IRC Sections 509(a)(1) and 509(a)(2). For a helpful detailed breakdown of the public support test, see this entry at the Nonprofit Law Blog: <http://www.nonprofitlawblog.com/public-support-tests-part-i-509a1/>.
- ^x <https://www.irs.gov/pub/irs-pdf/p557.pdf>
- ^{xi} 26 U.S.C. Section 501(c)(4).
- ^{xii} <https://bolderadvocacy.org/>
- ^{xiii} Texas Tax Code Section 151.310.
- ^{xiv} For additional information, see Texas Comptroller of Public Accounts: <https://comptroller.texas.gov/taxes/publications/96-1045.php>.
- ^{xv} No Tax Due Form available at <https://comptroller.texas.gov/help/franchise/no-tax-due.php?category=taxes>.
- ^{xvi} Texas Tax Code Section 11.18.5.
- ^{xvii} For additional information, see Texas Comptroller of Public Accounts: <https://comptroller.texas.gov/taxes/property-tax/exemptions/>.
- ^{xviii} Texas Tax Code Section 151.310.
- ^{xix} For additional information, see Texas Comptroller of Public Accounts: <https://comptroller.texas.gov/taxes/publications/96-1045.php>.
- ^{xx} <https://www.irs.gov/pub/irs-pdf/iss4.pdf>
- ^{xxi} See <https://www.irs.gov/forms-pubs-search?search=990> for forms and instructions.
- ^{xxii} See Robert A. Wexler, Fiscal Sponsorship – Doing it Right!, (October 10, 2004), available at http://www.mtnonprofit.org/uploadedFiles/Files/Org-Dev/Principles_and_Practices/MNA_Sample_Docs/Fiscal-Sponsorships.pdf.
- ^{xxiii} See National Network of Fiscal Sponsors, Guidelines for Comprehensive Fiscal Sponsorship, available at <http://www.tides.org/fileadmin/user/NNFS/NNFS-Fiscal-Sponsorship-Guidelines-for-Comprehensive.pdf>.
- ^{xxiv} See Colvin, Fiscal Sponsorship: Six Ways to Do it Right, 2005: <https://www.adlercolvin.com/fiscal-sponsorship-six-ways-to-do-it-right-a-synopsis/>.
- ^{xxv} See IRS Publication 4573 Group Exemptions, available at <https://www.irs.gov/pub/irs-pdf/p4573.pdf>, for more information.