

## Forming a Nonprofit Tax-Exempt Child-Care Corporation in Texas

Some existing nonprofits may find that developing a child-care center within their existing structure may cut down on overhead expenses, streamline operations, maintain existing community relationships, and capitalize on the organization's strong reputation in the area. However the desire to separate the liability risk of a child-care business from other organizational programs, to operate the child-care program under a distinct mission, to recruit a separate board, and to seek funding sources dedicated to child-care funding may prompt a nonprofit to create a new entity to operate the child-care center.

### Steps to Creating a New Nonprofit

The necessary steps to forming a tax-exempt nonprofit corporation in Texas are:

- Choose a management structure and form an initial board of directors
- Check availability of name with the Secretary of State
- Prepare the Certificate of Formation
- Prepare bylaws
- File the Certificate of Formation
- Hold initial meeting of directors
- Apply for a Federal Employer Identification Number ("EIN")
- Apply for Recognition of Exemption from federal taxes
- Apply for Franchise (Margin) Tax exemption from the Texas Comptroller (by filing form AP 204)
- Apply for a Sales Tax exemption from the Texas Comptroller

For more detailed information on this process, see Texas C-BAR's publication, *How to Form a Nonprofit Tax-Exempt Corporation in Texas*. Key issues affecting child-care centers in the formation process are discussed below.

### Benefits and Limitations of a Nonprofit Corporation

One of the primary benefits of forming a nonprofit corporation is that the corporation's members and directors are generally shielded from personal liability (unless the member or director acts in bad faith, without utilizing ordinary care, and in a manner the director cannot reasonably believe is in the best interest of the corporation). It is also advantageous for a nonprofit to incorporate so that it can receive government community development loans and grants, which often require the organization to have a nonprofit objective.

## Definition of a Nonprofit Tax-Exempt Corporation

A Texas nonprofit tax-exempt public charity is a corporation that is organized under the laws of the state of Texas and has been recognized as tax-exempt by the Internal Revenue Service under Section 501(c)(3) of the Internal Revenue Code. To obtain nonprofit tax-exempt status, an organization must take action at both the state and federal level. Although the two processes are separate, federal tax-exempt law is key to many nonprofit corporation statutes and must be taken into account from the start of the formation process.

### Texas Law

The Texas Business Organization Code § 22.001(5) defines a nonprofit corporation as one in which “no part of the income or profit of which is distributable to its members, directors or officers.” A nonprofit corporation may be organized for any lawful purpose that is not expressly excluded by the Business Organization Code. Texas Business Organization Code § 22.051. A nonprofit corporation must have a formal, centralized management structure and can be managed by a board of directors, members, or a combination of the two.

### Federal Law

In order to qualify for tax-exempt status under Section 501(c)(3) of the tax code as a charitable organization, “a non-profit organization must be *organized* and *operated* exclusively for one or more *exempt purposes*:

**Organized:** A 501(c)(3) organization must be organized as a corporation, trust or unincorporated association. An organization’s organizing documents (certificate of formation, trust documents, articles of association) must: limit its purpose to those described in section 501(c)(3) of the Internal Revenue Code; not expressly permit activities that do not further its exempt purposes, i.e., unrelated activities; and permanently dedicate its assets to exempt purposes.

**Operated:** Because a substantial portion of an organization’s activities must further its exempt purpose(s), certain other activities are prohibited or restricted including, but not limited to, the following activities. A 501(c)(3) organization:

- must refrain from participating in the political campaigns of candidates for local, state or federal office;
- must restrict its lobbying activities to an insubstantial part of its total activities;
- must ensure that its earnings do not inure to the benefit of any private shareholder or individual;
- must not operate for the benefit of private interests such as those of its founder, the founder’s family, its shareholders or persons controlled by such interests;

- must not operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose; and
- may not have purposes or activities that are illegal or violate fundamental public policy.

**Exempt Purpose:** To be tax exempt, a child-care center must have one or more exempt purposes, stated in its organizing document. Section 501(c)(3) of the Internal Revenue Code includes the following exempt purposes: charitable, educational, religious, scientific, literary, fostering national or international sports competition, preventing cruelty to children or animals, and testing for public safety. Most child-care centers qualify with either a charitable or an educational purpose.

**Charitable Purposes:** To meet the IRS requirements, the center's purpose must state that the nonprofit will be beneficial to society, and the center must serve an open class of people, not a limited number of group members or a group of specific individuals. The beneficiary class needs to be open and unspecified, but does not have to be large. A center established to serve the families in a specific neighborhood would qualify as a charitable organization, as long as it serves all the families in the neighborhood.

For example, the El Almanecer Day Care in Starr County, Texas adopted the following exempt purpose to demonstrate that it is organized to provide a community benefit. (Note: the nonprofit also included an educational purpose.)

To improve the human and social conditions of colonia residents in Starr County. Specifically, the organization will focus on the development and implementation of educational programs that enhance human capital for youth and their families, cultural activities that promote community participation, environmental awareness programs, and other activities that promote familial and communal cohesiveness and awareness.

**Educational Purposes:** To qualify with an educational purpose, a child-care center must demonstrate the "instruction or training of individuals for the purpose of improving or developing their capabilities, or the instruction of the public on subjects useful to individuals and beneficial to the community." The IRS allows a curriculum to present particular viewpoints if there ". . . is 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.

Under Section 501(k), the IRS recognizes the operation of a nonprofit child-care business as a nonprofit with an exempt purpose. To qualify, the center must demonstrate that it will provide care for children away from their homes so that substantially all the care provided by the organization is for the purposes of enabling individuals to be gainfully employed and the services being provided are available to the general public.

**Public Charity:** The IRS divides all 501(c)(3) charitable tax-exempt organizations into one of two groups: public charities and private foundations. The difference between the two categories is the source of their funding. Private foundations generally receive their funding from one or a few individuals. Public charities generally receive their funding from a broader base of public support, including individuals, the government, or other publicly supported organizations. Different rules apply to each category, the principal purpose of which is to ensure that private foundations are not using their funds primarily to benefit their few donors because in that case, the organization would not be considered a charity. Operational, distribution, and reporting requirements for private foundations differ from those of public charities and are more tedious. The key to being classified as a private charity is in the classification of the support that a nonprofit receives.

Child-care centers trying to qualify as public charities may structure their support under either Section 170(b)(1)(A) or Section 509(a)(2). The types of income that qualify as public support vary in ways that are significant for a child-care center.

**Section 170(b)(1)(A):** A center that qualifies under Section 170(b)(1)(A) is an organization that receives one third of its support, directly or indirectly, from the general public or government grants. The organization may count the following types of income as public support:

- donations from individuals, corporations, foundations, (the funding provided by each individual and each entity is capped at 2% of the center's total income when determining public support);
- government grants that are used to provide a benefit to a community. The grant may not be payment for services under a contract outsourcing work that the government entity is obligated to provide.

Note: Income from fees, even though it may be classified as related income, is not classified as public support.

Section 170(b)(1)(A) public charities may qualify as such using one of two tests: the one-third test or the facts and circumstances test. The one-third public support test is a strict mechanical formula. The annual 990 will automatically apply this test. An organization that does not meet this test may still qualify under the facts and circumstances test. To qualify, a center's income must show at least 10% public support. The center must then demonstrate that its operations meet the definition of a public charity through submission of minutes, descriptions of activities, and other documentation that the IRS may require.

**Section 509(a)(2):** A center that qualifies under Section 509(a)(2) may count as a public charity if, in addition to the sources listed above, it receives income from membership fees or from services related to the center's exempt purpose, in this case fees charged for center services. Income from individual services is capped at the greater amount of \$5,000 or 1% of the organization's budget. As many nonprofit child-care centers are finding it increasingly difficult to rely solely on subsidies to provide care, choosing to qualify under this section, which would allow the operation of a sliding fee scale program, may prove more sustainable in the long-term.

Section 509(a)(2) public charities may qualify as such using one of two tests: the one-third test or the “not more than one-third” test. Again, the one-third test is a mechanical formula. The “not more than one third” test limits gross investment income or the income from unrelated business activity to no more than one third” of the organization’s support.

## **Organizational Issues**

### ***Choosing a Management Structure***

A nonprofit corporation may be managed by a board of directors, members, or a combination of the two.

**Board of Directors:** Nonprofits managed by a board of directors establish an initial board of directors at formation. The board of directors manages the organization, establishes policies, and makes decisions such as amendments of bylaws, mergers, or dissolutions. The initial board replaces itself in the future through the policies outlined in the organization’s bylaws. This type of board is called a self-perpetuating board.

**Member Management:** Under this structure, the members of an organization manage the organization through decisions such as amendments of bylaws, mergers, and dissolutions. Nonprofits managed by members have a board of directors that is periodically elected by the nonprofit’s members. Criteria for membership are outlined in bylaws. Member-managed nonprofits must still have a board of directors. Cooperative child-care centers organized by parents may incorporate a membership management structure to allow each family an equal voice in the center’s operation.

**Combination Management:** Under this structure, nonprofits distribute the management between the members and the board of directors in any way that makes sense for the organization. For example, a center might have a strong committee structure that incorporates parents and other members of the corporation.

Membership organizations allow greater accountability to a particular community of stakeholders. However, member organizations require extensive record-keeping and a management of a larger group of decision-makers that may make it more difficult for the nonprofit to function efficiently. Most nonprofit child-care centers are organized as non-membership organizations.

## **Bylaws**

The bylaws contain the rules governing the internal structure and internal management of the corporation. The initial board of directors of the nonprofit corporation should prepare and adopt bylaws for the corporation simultaneous with the preparation of the certificate of formation or soon thereafter. State law requires certain bylaw provisions, but most provisions are optional. The law often provides gap filler provisions that will apply by default when the bylaws are silent on particular issues. When the bylaws are not silent, the bylaw provisions apply, so long as they are not illegal and do not conflict with the certificate of formation or state law.

## **Initial Meeting**

After the organization receives the file-stamped copy of the Certificate of Formation, it must hold an initial meeting at which it will transact key business to complete the formation process. The organization meeting must be called by the incorporator or a majority of the directors. At least three days' notice must be provided to the directors named in the certificate, stating the time and place of the meeting.

## **Applying for Recognition of Exemption from Texas Franchise (Margin) Tax**

Obtaining tax-exempt status from the IRS is an important step, but not the only step that you will need in order to secure tax-exempt status for your organization. Nonprofit corporations are subject to the Texas franchise (margin) tax unless an exemption from the Texas Comptroller is obtained. Corporations which have already received their 501(c)(3) tax exempt status from the IRS should file Form AP-204 with the Comptroller at 111 E. 17<sup>th</sup> Street, Austin, Texas 78774, requesting a franchise (margin) tax exemption and enclosing a copy of their 501(c)(3) determination letter from the IRS. For a copy of Form AP-204, go to <http://www.window.state.tx.us/taxinfo/taxforms/ap-204.pdf>.

If a corporation has not yet received their exemption from the IRS, a 90-day provisional state franchise (margin) tax exemption may be granted. A copy of the corporation's application for federal tax exemption and a copy of the notice of receipt of application from the IRS should be sent to the Texas Comptroller's office along with a letter requesting the temporary tax exemption. Once the Texas Comptroller has granted your organization tax-exempt status, your organization will be exempt from Texas sales and margin taxes. Your organization may also qualify for exemptions from property taxes, but you will need to contact your local property tax authority to determine available exemptions and the exemption procedures.

### ***Ongoing Requirements after Obtaining Tax Exemption***

Once the organization has received tax exempt status, it will be required to file certain annual forms with the IRS, the Texas Comptroller, the Secretary of State, and, potentially, local tax authorities. Discuss these requirements with legal and tax advisors. For more information, see Texas C-BAR's publication, *Nonprofit Legal Toolkit*.

There are strict record-keeping obligations that a nonprofit must comply with under Texas law. It must keep correct and complete books and records of the corporation's accounts and minutes of all proceedings of the board, committees with board authority, and members. The corporation must also keep a record of the names and addresses of the members entitled to vote at its registered office.

There are special record-keeping obligations for corporations that raise more than \$10,000 a year. The board must prepare or approve an annual report of the corporation's financial activity, which must be made available to the public for inspection and copying during normal business hours. The report must conform to the accounting standards of the American Institute of Certified Public Accountants. Corporations with members must hold an annual meeting for the members once a year. Notice of the meetings must be delivered between 10 and 60 days before the meeting, in person, by fax, or by mail. The bylaws may provide that no notice is required, but the bylaws must then provide the time and place of the meeting. 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.

The bylaws must specify whether notice is required for regular meetings, and if so, the type of notice. A quorum for business by the board is a majority of the number of directors set in the bylaws, but the bylaws can set a different number for a quorum, as long as the number is not less than three directors. Directors must always act in good faith and in a manner the director reasonably believes to be in the best interest of the corporation. A director must disclose any conflicts he or she has in transactions before the board, and he or she must abstain from voting on any transaction in which he or she has a conflict of interest. Certain government programs may still bar approval of the transaction when there is a conflict of interest.

Beginning in 2008, organizations with income under \$25,000 per year must file Form 990-N. An organization that obtains over \$25,000 a year must file IRS Form 990 within 4 ½ months following the close of the organization's fiscal year. Additionally, organizations having annual gross incomes of \$1,000 or more from unrelated business activities must file IRS Form 990-T and pay taxes on the unrelated business income.

Nonprofit directors are charged with managing the affairs of the corporation with good faith and in the best interest of the organization. Board members must attend meetings, understand the program and financial operations of the nonprofit, and act as good stewards of the nonprofit business. In return for good practices, the board member will be shielded from liability. As with other corporation

volunteers, a written description of time requirements, responsibilities, required skills or education, and the training the center will provide for each position will set a strong foundation for best practices.

### ***Monitoring of Tax-Exempt Organizations***

The Board of Directors is legally responsible for the activities of the organization, including guarding it against fraud and corruption. Private watchdog groups, such as the National Charities Information Bureau and the American Institute of Philanthropy, monitor the behavior of nonprofits in order to ensure that money is being spent appropriately and effectively. The state, through the Attorney General's Office, is responsible for investigating fraud and abuse claims. The IRS monitors nonprofits, ensuring that they are satisfying the requirements for being tax-exempt. The IRS can also individually sanction officials who abuse their positions within the nonprofit organization. Individual donors and members can regulate the organization by withholding financial support as well. Increased media coverage has also held nonprofits accountable to their true purposes. It is a good idea to contact a lawyer who can help you avoid unnecessary mistakes which might jeopardize the center's ability to incorporate or gain tax-exempt status. A lawyer can also offer advice on certain corporate responsibilities, such as withholding and paying Social Security tax as well as any other wage withholding taxes for employees. Such taxes generally apply regardless of your tax-exempt status.

### ***Qualifications for Board of Directors***

A committed board of directors with an appropriate mix of skills to oversee a child-care center is key to a successful and sustainable nonprofit child-care organization. Skills and expertise that a child-care center might consider when choosing board members include: knowledge of early childhood education, a good financial background, strong organizational and communication skills, fundraising experience, experience with child-care centers as a parent, or a strong commitment to the program. Texas law requires only three directors, but successful nonprofit organizations typically exceed the minimum requirements, often electing between five and nineteen directors. In addition, a child-care center must adhere to the state and federal governance requirements that apply to all nonprofit tax-exempt organizations. A center should make sure that board members understand their legal obligations, including reviewing and understanding an organization's financial status and financial statements.

Nonprofit child-care centers may invite parents to serve on the board of directors, and in fact may be required to do so by some funding sources. However, a parent should not receive any personal gain, such as free tuition, from their service on the board. A center seeking federal funds will have to conduct criminal background checks of potential directors. Convictions that will affect a candidacy are: a felony or misdemeanor classified as an offense against the person or family, or as public indecency; or a felony violation of any statute intended to control the possession or distribution of a substance included in the Texas Controlled Substances Act.