

# ESTABLISHING TAX-EXEMPT ARTS ORGANIZATIONS IN TEXAS



## ACKNOWLEDGEMENTS

This booklet was originally conceived by PAUL A. LECHE in 1981 when he served as chairperson of the Legal Aspects of the Arts Committee of the State Bar of Texas. The preparation of the first edition of this booklet was a joint project of the Legal Aspects of the Arts Committee and Texas Accountants and Lawyers for the Arts (TALA), then known as Volunteer Lawyers and Accountants for the Arts (VLAA).

The extensive 1993 revisions to the Texas Non-Profit Corporation Act necessitated an overhaul of this handbook for would-be nonprofit organizations. As a supplement to this booklet, TALA and the Legal Aspects of the Arts Committee now have available a videotape which outlines the procedures for forming tax-exempt arts organizations. Special thanks go to 1995 TALA intern PAUL FRIEDMAN for updating this handbook and to TALA Advisory Board member TINA LUNDY MELO of Fizer, Beck, Webster" Bentley, Houston, for her assistance in completing the videotape.

We wish to extend our deep appreciation to Professor K. BYRON McCOY of the University of Houston Law Center for preparing the incorporation section of this handbook; to TALA Advisory Board Member TERRI GRIGSBY ROGERS, CPA of KPMG Pelt Marwick, Houston, for preparing and editing the materials on tax exemption; and to TALA Board member JODY BLAZEK of Blazek & Vetterling, Houston and TINA LUNDY MELO for their assistance in editing this handbook.

This booklet was made possible in part by funding from the TEXAS COMMISSION ON THE ARTS and the CITY OF HOUSTON through the CULTURAL ARTS COUNCIL OF HOUSTON/HARRIS COUNTY, and by grants from the BROWN FOUNDATION, the HARRIS AND ELIZA KEMPNER FUND, and the STATE BAR OF TEXAS, CORPORATE COUNSEL SECTION.

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IN TEXAS**

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A publication of:

Texas Accountants and Lawyers for the Arts

Funded in part by:

Cultural Arts Council of Houston/Harris County  
Texas Commission on the Arts

Printed through the generosity of:

The Brown Foundation, The Harris and Eliza Kempner Fund, and  
The State Bar of Texas, Corporate Counsel Section

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## INTRODUCTION

Many artists, whether dancers, actors, directors, film producers, writers or sculptors, envision starting a visual or performing arts group as one vehicle to bring their work to the public. Most are capable of managing the creative side of the organization but many are ill prepared to deal with administrative matters involved in starting and maintaining a nonprofit, tax-exempt organization. This booklet will address the first hurdle: achieving nonprofit, tax-exempt status. It is not designed to replace qualified legal and accounting advice.

The process requires steps involving both the state and federal governments. Even though an organization need not be incorporated to obtain exempt status under § 501(c)(3) of the Internal Revenue Code (the “Code”), the advantages of the corporate form and the relative ease in becoming incorporated in Texas favor this route. The articles of incorporation must be carefully drafted to meet both state and federal requirements. It may take several weeks for the state to process the new organization’s articles of incorporation, although by fax a charter can be issued overnight.

While the articles of incorporation broadly define the existence of the nonprofit corporation, the internal rules of management of the corporation are provided for in the bylaws. Even though model articles of incorporation and bylaws are available, both documents should be carefully tailored to the needs of each organization.

Assuming the articles of incorporation contain the clauses required by both the state and the IRS, the next step is obtaining exemption from both state and federal taxation. Completing and filing IRS Form 1023, Application for Recognition of Exemption (under § 501(c)(3) of the Code), requires the nonprofit corporation to indicate its sources of funding, current and planned activities and other operational data. Organizations in existence fewer than eight months must also submit a proposed two-year budget detailing revenue and expenditures. IRS processing of this application may take several months.

Once federal tax exemption is achieved and a “letter of determination” issued to the organization by the IRS, application may be made to the Comptroller of Public Accounts for exemption from state franchise and sales tax will follow automatically once § 501(c)(3) status is received. Although exemption from franchise and sales tax may be obtained without receiving § 501(c)(3) federal exemption, some cultural organizations do not fall within the state’s definition of “charitable” and “educational.”

On paper the process seems simple. The effort in time and money, however, may include more than six months and thousands of dollars in professional services. Even though free legal and accounting services are generally available to new arts organizations through Texas Accountants and Lawyers for the Arts, the group must consider the value of these donated services plus the time required of members of the group to provide the information needed by the lawyer and accountant. If the group does not have broad based support from individuals in the community, the organization may never get off the ground or may soon flounder.

The advantages of exemption from federal income tax, state franchise and sales tax, as well as the privilege of soliciting tax-deductible contributions from public and private sources and the lower postage rates for bulk mailing may be very attractive to many groups. However, these advantages must be carefully weighed against the real costs in terms of time and energy required to maintain them. The alternatives of joining or working with an existing organization or operating under some other form of organization should be seriously considered.

This booklet is designed to answer many of the questions facing those interested in forming arts councils, visual arts group, dance companies, theatre groups, music ensembles, writers' organizations and other cultural groups. It is composed of commonly asked questions and answers regarding nonprofit and tax-exempt corporations. Each answer, when possible, references the appropriate section of either the Internal Revenue Code (the "Code") or the "Texas Nonprofit Corporation Act" (the "Act"), the state's detailed nonprofit corporation statute in existence since 1959. [See Vernon's Rev. Civ. Stat. Tex., Anno., Art. 1396 et seq. (Amend 1994)]. Unless a reference specifically cites the Code, it may be assumed that it refers to the Texas Act. Four other TALA publications, *Financial Management of Nonprofit Arts Organizations: A Guide to Fiscal Survival*, *Responsible Management: Duties and Liabilities of Directors and Officers of Nonprofit Arts Organizations*, *Insurance: A User-Friendly Guide for the Arts and Nonprofit World*, and *Pas de Deux: Labor and Employment Issues in the Arts and Nonprofit World*, address the management and financial issues of tax-exempt organizations once they are formed.

Jane S. Lowery  
Executive Director  
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1991-present

## PART ONE

### INCORPORATING A NONPROFIT ORGANIZATION

#### INCORPORATION PROCESS

**What is a nonprofit organization?** According to the definition found in the Texas statute, a nonprofit organization receives "no part of the income or profit of which is distributable to its members, directors or officers." [§ 1.02]

**What are the benefits of nonprofit status?** The primary benefits flowing from nonprofit status are the ability to apply for tax exemption under § 501(c)(3) of the Code, state exemption from property, franchise and sales taxes; the privilege of lower postage rates; and perhaps most importantly, the privilege, if tax exempt under 501(c)(3), to solicit donations, gifts, bequests and contributions.

**What is the best form for a nonprofit organization?** The corporate form is most often used because it combines several advantages: freedom from personal liability under most circumstances, continuity of existence, flexibility and credibility.

**How does one select the name of the organization?** Unlike a business corporation in Texas, the name of a nonprofit organization need not contain the words "corporation," "company," or "incorporated" or their abbreviations. There are three (3) limitations on the selection of a corporate name. First, it may not contain any word or phrase which indicates that it is organized for any purpose other than the purpose(s) stated in the articles of incorporation. Second, it may not be the same as or deceptively similar to the name of another domestic corporation (or foreign corporation authorized to do business in the state) or to a name that has been reserved. Finally, the corporate name may not contain the word "lottery." [§ 2.04]

To determine whether a desired name is available, call the Secretary of State's office at (512) 463-5555. To use a name which is similar to one already in use, written permission from the current user must be obtained. If the desired name is available and there will be a delay in filing the articles of incorporation, one can "reserve" a name. This is accomplished by executing a form promulgated by the Secretary of State requesting reservation of the desired name and enclosing a \$25 fee. Upon receipt, the Secretary will reserve the name for 120 days. This may be renewed for an additional 120-day periods by paying the fee for each successive period. An application for name reservation or transfer of the exclusive use of a specified corporate name is subject to the procedures and period prescribed by Article 2.06 of the Texas Business Corporation Act. [§ 2.04(B)]

**How does one incorporate a nonprofit organization in Texas?** A corporation may be formed under the Texas Nonprofit Corporation Act for any lawful purpose. [A more detailed discussion of legally recognizable purposes may be found in the section below.] Anyone interested in incorporating should consider seeking qualified legal assistance. To incorporate, articles of incorporation are drafted and executed copies are submitted in duplicate to the Secretary of State with a \$25 filing fee. Expedited service may be obtained with an additional fee of \$10.

The articles must contain the name of the corporation and an incorporator who is a natural person of the age of eighteen years or more. [§ 3.01] There also must be a statement that the corporation is a nonprofit corporation, and a statement indicating the purpose or purposes for which the corporation is organized. The corporation may be organized for a term of years or perpetually. It must designate an initial registered office by street or building address and also designate an initial registered agent at such address. The initial board of directors, of not less than three members, must be named and their addresses given. If the corporation is to have no members, there must be a statement to that effect. If the management of the affairs of the corporation is to be vested in its members, a statement must be made to that effect. [§ 3.02(A)]

An existing unincorporated association may incorporate under the Act by majority consent of its members who shall authorize the incorporators to execute the articles. [§ 3.02]

**Are there limitations on the purposes of a nonprofit corporation?** The Act states that a nonprofit corporation may be organized for any lawful purpose, except those expressly excluded by the Act. It is necessary to include language in the articles of incorporation indicating the nonprofit intentions of the organization. [§ 2.01] Often this is done in a negative manner, by stating that the purpose of the organization is not for the pecuniary benefit of the officers, directors or members. For example: "No part of the net earnings of the corporation shall inure to the benefit of the its members, directors, or officers."

Once an organization's purposes have qualified it for nonprofit status under the Act, it must meet IRS requirements in order for the organization to be considered tax-exempt. To satisfy IRS requirements, the organization must meet three (3) tests: the operational test, the commensurate test, and the organizational test. (The organizational test is explained in detail in the next section.) When the IRS has recognized the tax-exempt status of a nonprofit corporation, the only way for the corporation to lose its status is to violate one or more aspects of these tests. The operational test is concerned with an organization's programs. To meet the operational test, the organization must be operated exclusively for one of the following eight purposes specified in § 501(c)(3) of the Code:

1. Religious,
2. Charitable.
3. Scientific,
4. Testing for public safety,
5. Literacy,
6. Educational purposes,
7. Amateur sports competition, or
8. Prevention of cruelty to children or animals.

The words "benevolent" and "philanthropic" should not be used since they may permit broader activities than those intended by § 501(c)(3). To identify the intentions of the organization, one may specify more detailed purposes, but care should be taken to have them fall within the chosen general category. However, if narrower purposes are stated, the activities of the organization may be limited. All that is required is: "The purposes for which the corporation is

organized are charitable and educational." The purpose clause should also state that the organization will not carry on any activities not permitted to be carried on by an organization exempt from federal taxation under § 501(c)(3) including an absolute prohibition against electioneering and a limitation of lobbying.

Related to the operational test is the commensurate test. To satisfy the test, an organization must maintain program activities that are commensurate in scope with its financial resources. While there is no specified payout percentage required by the IRS, the commensurate test requires that organizations have a charitable program(s) that is both real and takes into account the organization's circumstances and financial resources.

**Is there any other language required to be in the articles of incorporation for nonprofits seeking federal tax-exempt status under § 581(c)(3) of the Code?** The third requirement for tax-exempt status, the organizational test, focuses on an organization's formation documents and whether they contain the required provisions and language. To meet the organizational test of § 501(c)(3) of the Code, an organization must place both a dissolution and an inurement clause in the articles of incorporation.

The Code requires a nonprofit corporation to set forth in its articles of incorporation provisions regarding the distribution of assets. The "dissolution" clause states that assets of the organization are permanently dedicated to exempt purposes and that upon dissolution of the organization, any remaining assets must be distributed to one or more organizations exempt under § 501(c)(3) of the Code. Although § 602(3) of the Texas Act does not require an organization to distribute the assets remaining after dissolution to tax-exempt organizations, the IRS and courts have required them to do so in order to qualify as tax-exempt.

The "inurement" clause forbids distribution of any part of the net earnings of the corporation to its directors, officers, trustees or any private individual; provided, however, that reasonable compensation may be paid for services rendered to the corporation. Included in this clause are the limitation on lobbying and the prohibition against engaging in political activity. Section 501(c)(3) organizations are permitted to engage in lobbying only to an insubstantial extent. There is an absolute prohibition against participating in campaigns or endorsing candidates.

**How are the articles of incorporation filed?** The articles must be signed in duplicate by the incorporator. The duplicate, executed copies are then forwarded to:

Secretary of State  
Corporations Division  
P.O. Box 13697  
Austin, TX 78711-3697

with a filing fee of \$25. It usually takes the Secretary several weeks to process the articles and grant the corporate charter.

**What is "expedited service"?** To obtain faster notification of granting of the charter, an organization may submit an additional \$10 fee with the articles requesting expedited service. A representative of the Secretary of State will call to notify the group as soon as the articles are approved. A contact person and telephone number (including area code) should be furnished with the request for expedited service. Although notification is faster, it will still take several weeks to receive the certificate of incorporation by mail.

Same day service is available if a representative of the organization brings the completed articles to the Secretary's office in Austin. The filing fee is \$25 plus \$10 for the expedited service. The articles of incorporation will be filed while the representative waits and the certificate and copy are returned at that time. There are also several companies that will hand deliver the articles for a fee.

**Who may qualify as the registered agent of an organization?** The Act requires each corporation to have and continuously maintain a registered office in the state. A registered agent may be an individual resident of the state whose business office is the same as the organization's registered office, or a domestic or foreign corporation authorized to transact business in the state with a business office identical to the organization's registered office. [§ 2.05]

**What must an organization do if it changes its registered agent or office?** If an organization changes its registered agent, office, or both, it must file a document with the Secretary of State setting forth: the name of the Corporation, the former address of the registered office or agent, the new registered office or agent, a statement that the change was authorized by the Board of Directors or by an officer of the corporation authorized by the Board of Directors, and a statement that notice of the change has been given to the corporation at least ten (10) days before the date of filing. An original and a copy of the statement should be delivered to the office of the Secretary of State. Failure to maintain a registered agent and office, or to notify the Secretary of State of any changes in these, may result in revocation of the corporate charter by the state.

## **MEMBERS**

**Should a nonprofit corporation have voting members?** A nonprofit corporation may be established as a membership or nonmembership organization. In a nonmembership organization, the board of directors or others elect directors as described later. The Act provides that any nonprofit corporation may, in its articles or by-laws, vest the management of its affairs in its members. [§§ 2.09(8)(2), 2.14(C), "3.02(A)(9)] The term "member" in the Act denotes an individual possessing voting rights, including the right to elect directors. [§ 1.02(A)(6)] If there are many members who are not deeply committed and involved, then notices, meetings and voting may be an empty formality and an unnecessary expense. This is particularly true of publicly supported organizations where each contributor is also a "member." In such instances, it is much simpler to eliminate members as a legal class. However, this does not mean that contributors may not be called "members," merely that they do not possess voting rights. To avoid confusion it is preferable to avoid calling contributors members.

In some cases, voting members of a nonprofit corporation may benefit the corporation by broadening the circle of informed individuals capable of interpreting the corporation's programs for the public. Voting members also ensure broad based discussion with regard to the goals and activities of the organization and increase interest and participation within a community. For example, many arts councils have voting members comprised of individuals and representatives of other cultural organizations. Members may also broaden the base of financial support.

The benefits of voting membership must be balanced against its administrative necessities. It should be noted that a nonprofit organization can also broaden participation and financial support by establishing an Advisory Board or Committee. Advisory Boards are a good means of involving interested and influential persons who do not have the time to serve as Directors. If the organization wishes to have members, then the mechanics of membership should be included in the bylaws to simplify the process of amendment. If there will be no voting members, a statement so stating must be included in the articles of incorporation. *Silence is interpreted as authorizing voting members.* [§2.13(A)]

**What rights do voting members of a nonprofit corporation possess?** Members of the corporation have the right to elect the board of directors, to amend the articles of incorporation, and to amend the bylaws unless the authority to do so has been specifically delegated to the board of directors. Each member is entitled to one vote on each matter submitted to a vote at a meeting of members unless otherwise provided in the bylaws. A member may vote by proxy unless such right is specifically denied in the bylaws or articles of incorporation. A proxy will not be valid after eleven (11) months from the date of its execution, unless otherwise provided in the proxy. Proxy votes will be revocable unless the proxy states that the vote is irrevocable. If the vote is irrevocable, it may not remain irrevocable for more than eleven (11) months. The bylaws may provide that election of directors may be conducted by mail, by facsimile, or by any combination of the two. [§ 2.13]

If authorized in its articles of incorporation, a nonprofit corporation's directors, members, or committee members may use written consents for any action required or permitted to be taken at a meeting of members or directors. Any action by written consent requires the execution of consents by a number of persons equal to the number required to take action at the meeting. If there is less than unanimous consent, the action will not be effective unless the number of consents necessary for approval is delivered to the corporation in the manner required by § 9.10 of the Act, and is delivered within 60 days of the date of the earliest consent. [§ 9.10]

**What are the members' rights regarding the inspection of books and records?** The Act provides that members can, on written demand stating the purpose of the demand and at their own expense, examine and copy books and records relevant to the stated purpose of the request [§ 2.23]

**What is the significance of "record dates" and how and when are they set?** The Act requires corporations to send written or printed notice to each member entitled to vote at the meeting. (More specific information on the notice requirement is provided in the next section.) [§ 2.11] In conjunction, the Act establishes deficit roles that, in the absence of a provision in the corporation's bylaws, set record dates for determining which members (i) are entitled to notice of

a meeting, (it) have a right to vote at a meeting, and (iii) are entitled to exercise any rights regarding any other action. The record date may not be more than sixty (60) days before the date of the meeting or action that requires the determination of the members. [§ 2.11(A)]

After the corporation sets the record date for members entitled to notice, the corporation must complete an alphabetical list of such members, including their addresses and number of votes. The list must be ready two (2) days after the date of notice of the meeting, and any member or his agent is entitled, on written demand, to inspect and copy the list (subject to relevance and reasonableness limits with regard to inspection prior to the meeting). [§ 2.11(8)]

**How many meetings of the membership must be held annually?** There must be at least one annual meeting of the members. If there is more than one regular meeting of the members annually, the annual meeting is not required and the directors may be elected at any meeting as provided in the bylaws.

Unless the bylaws provide that no notice of the annual or regular meetings of members is required, notice of the time, date, and place of the meeting, and in the case of a special meeting, the purpose or purposes for which the meeting is called must be delivered not less than ten nor more than sixty (60) days prior to the meeting either in person or by mail. Special meetings of the members may be called by the president, the board of directors or by members representing not less than 1/10th of the members entitled to vote. The purpose(s) of the special meeting must be specified in the notice.

The quorum for a meeting of members should be stated in the bylaws. In the absence of such provision, a quorum shall be 1/10th of the votes entitled to be cast. [§ 2.10]

## **DIRECTORS**

**What is the role of the board of directors of a nonprofit corporation?** “Board of Directors” means the group of individuals vested with the management of the affairs of the corporation, irrespective of the name by which such group is designated. [§ 1.02(A)(7)] The board is a separate body distinct from the employees of the corporation, though some directors may also be employees. Directors need not be residents of Texas unless the articles or bylaws so require. [§ 2.14(A)] The number of directors may never be less than three (3); however, subject to this limitation, the number of directors may be increased or decreased by amendment to the bylaws, unless the articles provide that a change in the number of directors may be made only by amendment of the articles. [§ 2.15(A)]

Directors constituting the initial board must be named in the articles and will hold office until the first annual election of directors or for such other period as established by the articles of bylaws. [§ 2.15(B)] Directors may be divided into classes with varying lengths of terms. Unless specified, the Act provides that the terms shall be one year. In nonmembership organizations, to avoid directors serving indefinitely, the number of terms may be limited. The mechanics of directorship (i.e., qualifications, election, removal, etc.) should be placed in the bylaws and not the articles of incorporation to facilitate revisions. [§ 2.15(C)]

**How are directors elected?** Directors are elected by the members, if any; otherwise, the current directors elect their successors. In some cases, directors may be elected by the board of directors of another nonprofit corporation if the former has no members with voting rights and if so provided by the bylaws or articles. [§ 2.15(B)]

**What is the standard of conduct a director must follow in carrying out his or her duties?** A director must discharge his or her duties in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation. [§ 2.28] Until 1993, there was some ambiguity as to whether directors of nonprofit corporations could be held to the more stringent standard of conduct applicable to trustees of charitable trusts. The 1993 amendments to the Act settled that question by stating that “[a] director is not deemed to have the duties of a trustee of a trust with respect to the corporation.” [§ 2.28(E)]

**Can directors be removed from office?** Directors may be removed with or without cause by persons entitled to elect, designate, or appoint directors by any method provided in the bylaws, subject to two (2) requirements. First, notice of charges must be given to the director and he or she must be provided the right to be heard. Second, the number of directors may not be decreased to fewer than three. If the director was elected to the board, then the director must be removed by an affirmative vote of the same number of people that was required to elect the director. Unless otherwise provided in the articles or bylaws, a vacancy on the board shall be filled by a vote of a majority of the remaining directors. The replacement director is appointed to serve only the remainder of the unexpired term. [§ 2.15(D)]

**May a director profit from a transaction entered into with the nonprofit corporation?** A transaction between a nonprofit corporation and an interested party (e.g., a director) or an entity in which an interested party has an interest is not void or voidable, whether or not the interested party participated in the authorization of the transaction, as long as one of the following three (3) conditions are met.

- (i) The material facts regarding the relationship and transaction are disclosed to or known by the corporation, and the transaction or contract must have been authorized in good faith and with ordinary care by a majority of disinterested directors or members (even if the directors or members do not make up a quorum).
- (ii) The material facts regarding the relationship and transaction are disclosed to or known to the members of the corporation who are authorized to vote on the transaction or contract, and disinterested members vote in good faith and with ordinary care to approve the transaction or contract, or
- (iii) The contract or transaction is fair to the corporation when authorized, approved or ratified. [§ 2.30]

For federal tax purposes, sanctions are imposed if such transactions result in excess benefits and may be prohibited if the nonprofit is a private foundation.

**What are the requirements for holding meetings of the board of directors?** The Act does not specify the number of meetings which must be held annually. However, to comply with other provisions of the Act, at least one meeting must be held each year.

Regular meetings of the board may be held with or without notice as prescribed in the bylaws or articles. If either the bylaws, articles or a board resolution state the date, time and place of meetings, no additional notice is required. Unless otherwise restricted, meetings may be held by conference telephone or similar communications equipment.

Special meetings may be called with such notice as prescribed in the bylaws. The purpose of the meeting need not be stated unless required by the bylaws. [§ 2.19]

In order to transact business, a quorum must be present. A quorum is the lesser of:

- (1) a majority of the number of directors in the bylaws, or in the absence of a bylaw provision setting the number, a majority of the number of directors stated in the articles, or
- (2) any number, not less than three, fixed as a quorum by the articles or bylaws. [§ 2.17(A)(1) & (2)]

An example of a common bylaw provision is: “A majority of the directors present at a duly called meeting, but not less than three, shall constitute a quorum for the purpose of transacting business of the corporation.”

The size of the quorum should depend upon the size of the board and location of board members; a statewide board with a majority required for a quorum may have a difficult time conducting meetings. Also, a greater number for a quorum may be authorized by the bylaws under certain circumstances, such as amending bylaws, dissolution of the corporation, etc. Directors present by proxy are not counted toward quorum.

**Can directors and officers be indemnified for court costs and attorneys’ fees?** With certain restrictions, the Act permits and sometimes requires a director to be indemnified by the corporation for court costs and attorneys’ fees if such a person was, is, or is threatened to be made a named defendant in a proceeding because the person is or was a director. In order to be indemnified, the person must have conducted him or herself in good faith. If the action against the person concerns his or her official capacity as director, the person must have reasonably believed that the conduct was in the corporation’s best interests. If the conduct was not in the person’s official duty as director, the person must have reasonably believed that the conduct was at least not opposed to the corporation’s best interests. In the case of a criminal proceeding, the director must have had no reasonable cause to believe his conduct was unlawful in order to be indemnified. [§ 2.22(B)] The articles and bylaws may, however, restrict the circumstances under which a corporation is required or permitted to indemnify a director or officer under the Act. [§ 2.22(A)] The Act’s provisions regarding indemnification are extremely complex and should be consulted to resolve specific inquiries.

**Can a nonprofit corporation limit the liability of directors to the corporation?**

Directors’ liability can be limited in the articles of incorporation. However, such limitations of liability should not apply to conduct that violates key directorial duties, such as the duty of loyalty to the corporation, or for which liability is expressly provided by statute.

## OFFICERS

**Who are the officers of the corporation?** The officers must consist of a president, a secretary, and such other officers as deemed necessary. Any two or more offices may be held by the same person except the office of president and secretary. The term of office may not exceed three years, and in the absence of any provision in the bylaws or articles, shall be one year. [§ 2.20(A)]

**NOTE:** Officers are usually elected by the board of directors. However, if the corporation has voting members, the bylaws may provide that the members shall elect the officers and whether the officers shall be members of the board of directors.

## BYLAWS

**What are bylaws?** The bylaws provide for the regulation and internal management of the affairs of the corporation and may contain any provision not inconsistent with law or with the articles of incorporation. [§ 2.09] They should be carefully drafted to ensure ease of administration and to avoid conflicts. (See checklist on page 22 for outline of provisions for bylaws.)

**Should the bylaws contain a provision for committees?** Provision for committees may be included in the bylaws but are not required unless such committee(s) shall have the authority of the board of directors in the management of the corporation (i.e., Executive Committee). The Executive Committee is formed by resolution, adopted by a majority of the directors in office and must be comprised of two or more persons, a majority of whom shall be directors. The establishment of such committee does not relieve the board of directors of any responsibility imposed upon it by law.

Other committees may be established by resolution of the board of directors. Appointment of members to these committees may be made by the board or by the president if so authorized. Such committee(s) may be comprised of directors or any other individuals.

The bylaws may provide for an Advisory Board to increase community input and to involve interested and influential persons who do not have the time to serve as directors. The appointment, composition and duties of the Advisory Board should be determined by the board of directors. [§ 2.18]

**What general provisions should be included in the bylaws?** In addition to provisions on directors, officers, members, and meetings, the bylaws should include the following:

- Fiscal Year - This accounting period need not be the calendar year. The corporation should consider having its fiscal year ending a slow period such as after the end of its season.
- Authority to sign checks - State specifically or in general which officers or agents may sign checks and the number of authorized signatures required (this may also be provided for by resolution).
- Authority to enter into contracts - A specific or general grant of authority may be given to certain officers.
- Authority to accept gifts and donations - Authority is generally given to the board to accept both restricted and unrestricted gifts.

**What matters should not be included in the bylaws?** Some provisions which may be included in the bylaws may instead be adopted by resolution. This would avoid the need to amend the bylaws frequently and allow more flexibility in the operations of the corporation. They are:

- Date, time and location of board meetings.
- Date, time and location of meetings of members.
- Amount of membership dues.

The bylaws should state: "The shall be \_\_\_\_\_ determined by resolution of the board of directors annually."

**How are bylaws amended?** Even though the initial bylaws are adopted by the board of directors, the power to alter or amend the bylaws is vested in the members, if any, unless such power is specifically delegated to the board of directors. If there are no members, then the power to amend the bylaws is vested in the board of directors.

**What is the organizational meeting of the board of directors?** Once the corporation receives its charter, a meeting of the initial directors is called by the incorporator. The purpose of this meeting is to adopt bylaws, elect officers, and for such other purposes as may come before the meeting; for example, opening a bank account, appointment of committees, etc. Three days notice in writing must be given to each director named in the articles stating the date, time, and place of the meeting.

## PART TWO

### OBTAINING TAX-EXEMPT STATUS

#### FEDERAL

**What are the advantages of obtaining tax-exempt status?** The principal advantage of tax-exempt status is that an organization is not taxed on most types of incomes. Additionally, exemptions may be granted from certain federal excise taxes and employment taxes, as well as state and local taxes. Many types of tax-exempt organizations are eligible for preferential second (2nd) and third (3rd) class postal rates. [39 U.S.C. §§ 4355(a) & 4452(d)] Mailings that are unrelated to an organization's non-exempt purposes are excluded from the qualification for reduced mailing rates. The organizations entitled to preferential postage rates are defined in the Domestic Mail Manual. [39 U.S.C. §§ 423.13 & 623.2]

Moreover, donations to organizations exempt under Code § 501(c)(3) are eligible for the charitable deduction. Thus, an organization which attains this exempt status enhances its ability to attract financial support. Finally, § 501(c)(3) organizations are exempt from federal unemployment taxation and those with three or fewer employees are exempt from state unemployment taxation. [I.R.C. § 3306(c)]

**Are there any disadvantages to tax-exempt status?** Although not disadvantages per se, there are factors which should be considered before tax exemption is pursued.

- (1) The applicant must submit Form 1023, Application for Recognition of Exemption to the IRS. Few exceptions to filing this form are available. They are limited to churches, including their associations and auxiliaries; subordinate organizations covered by a group exemption (such as the local chapter of a national organization); and an organization whose annual gross receipts normally do not exceed \$5,000.
- (2) The organization must have governing documents: articles of incorporation and bylaws (nonprofit corporation), trust instrument, or articles of association.
- (3) The organization must be organized and operated for tax-exempt purposes. These organizational and operational parameters of § 501(c)(3) may be too restrictive to allow the conduct of planned activities. Additionally, the organization must be organized exclusively for one or more exempt purposes. Thereafter, no more than an insubstantial part of the activities may be in furtherance of a nonexempt purpose.
- (4) If the primary purpose of the organization is carrying on a trade or business for profit, exemption may be denied even though net profits are expended for an exempt purpose.
- (5) Although the primary purpose of the organization is carrying out its stated exempt function, the conduct of a trade or business which is not substantially related to the furtherance of the organization's exempt purpose may be subject to taxation on the net profit derived therefrom.

**NOTE:** Tax-exempt organizations with gross receipts over \$25,000 annually are required to file the annual information return, Form 990EZ, with the IRS to retain a listing in the IRS directory of § 501(c)(3) organizations. Tax-exempt organizations with receipts of \$100,000 or more file

Form 990. All § 501(c)(3) organizations must also file Schedule A. If the exempt organization earns more than \$1,000 of unrelated business income, Form 990 T is filed to calculate any income tax due thereon.

**What are the purposes for which an organization may qualify under § 501(e)(3)?** Section 501(c)(3) limits exempt purposes to the following; religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition (only if no part of its activities involve the provision of athletic facilities or equipment), or preventing cruelty to children or animals. Most cultural organizations fall into the categories of educational, charitable or literary.

**Why must a formal application for exemption to be filed with the IRS?** A nonprofit can only be classified as a § 501(c)(3) tax-exempt organization if it submits Form 1023, Application for Recognition of Exemption:

- (1) to establish to the satisfaction of the IRS that an exemption from federal income taxation is justified; and,
- (2) to notify the IRS whether exempt status is sought as a private foundation or public charity.

A successful applicant receives a letter from the IRS stating that it qualifies as a § 501(c)(3) organization. As a practical matter, prospective donors require this letter as evidence that their gifts or grants to an organization qualify for the charitable contributions deduction. Filing of Form 1023 may therefore be essential in order to attract financial support.

**What is the significance of classification as a private foundation versus a public charity?** Every organization that qualifies for tax exemption under § 501(c)(3) is presumed to be a private foundation unless it qualifies as a public charity under § 509. Avoidance of private foundation classification is generally desirable because restrictions apply to their operations which are not imposed on public charities. Private foundations are generally subject to a two percent (2%) excise tax on net investment income, may incur penalty taxes on certain transactions between the foundation and related persons, and must meet distribution requirements for charitable purposes. [§§ 4940-4945]

Nonprofit cultural organizations desiring to establish public charity status must meet the description of one of the following categories to be excluded from private foundation treatment under § 509:

- (1) A Type 1 publicly supported organization which normally receives at least one-third of its total support from governmental units or the general public in the form of contributions. This type of organization receives public charity status based on its broad base of supporters. Contributions from anyone individual, corporation or private foundation in excess of 2% of the organization's gross revenue are not counted as public support. For example, assume an organization receives total contributions of \$500,000 in a year and that individual X contributes \$50,000. Only \$10,000 of X's contribution

would be considered as public support. There are exceptions for unusual or unexpected gifts which are attracted merely by the organization's publicly supported nature. Organizations which generally qualify include museums, art centers and libraries.

- (2) A Type 2 publicly supported organization is called a "service provider." Such a nonprofit charges for participation in its exempt activities such as the sale of tickets for performances or tuition or fees for the performance of services. To qualify, an organization must receive at least one-third of its revenues from service income and donations. Additional restrictions are imposed on this type of publicly supported organization:
- a. No more than one-third of its revenues may come from gross investment income, such as interest, dividends, rents or royalties.
  - b. Exempt function revenues from any one person are counted as public support only to the extent they do not exceed the greater of \$5,000 or one percent (1%) of total support in any given year; and
  - c. Contributions from major donors, managers and members of the family of either of these persons are not counted as public support.

Organizations which generally qualify for exemption under this category include theaters, dance companies, orchestras and other performing arts groups.

- (3) Schools, churches, hospitals and medical research school in this context is an organization that (i) is engaged primarily conducting formal instruction, and (ii) has a regular faculty, curriculum and student body, and a place at where its activities are conducted. Therefore, a full-fledged music school such as Juilliard would qualify as a school, whereas a chamber group that holds some music classes would not. A church may be any religious organization that performs functions traditionally associated with churches, synagogues, etc., so long as (i) the religious beliefs of the organization are "truly and sincerely held," and (ii) the rituals and practices carried out in connection with those religious beliefs are not illegal or against clearly defined public policy. Few arts organizations will fall into any of these categories.
- (4) A supporting organization, i.e., one that is organized and operated for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified public charities in the categories listed above. The supporting organization must be operated, supervised or controlled by or in connection with the public charity it supports. One example of a supporting organization is one established to raise scholarship funds for students of a § 501(c)(3) school.

**What is meant by a ruling?** If the application claims exemption as a public charity, one of the three types of available rulings apply.

- (1) **Definitive Ruling.** If requested, the IRS issues its determination as to whether the organization qualifies as a public charity based on the information submitted in the application. The definitive ruling is used primarily by schools, hospitals and other organizations which are not required to meet a support test in order to receive exemption.

Although a definitive ruling is available to a publicly supported organization which has completed its first taxable year consisting of at least eight months, such a request is only made if there is sufficient financial information to clearly establish that the applicant meets the support test.

(2) **Advance Ruling.** If a publicly supported organization reasonably expects to meet support test requirements, it may request non-private foundation treatment for its first five years. During this advance ruling period, the organization is treated as a public charity by reason of its expected public support. However, at the conclusion of this period, the IRS requests a history of operations in order to determine whether the statutory support test has been met. If not met, the organization will be treated as a private foundation and be liable for an excise tax at the rate of two percent on net investment income.

**Is there a time limit for filing Form 1023, Application for Recognition of Exemption?** In order to be exempt from the date of formation, an organization must file the application within 27 months from the end of the month of creation. Although this is usually an adequate amount of time, extensions of time to file may be granted if the organization can show reasonable cause. Untimely filing results in recognition of exemption only for the period after the application is received by the IRS. **NOTE:** Failure to file an application results in the presumption that the organization is not exempt regardless of the fact that it exclusively carries on activities described in § 501(c)(3). As a practical matter, early filing is recommended because until a positive response is received, the nonprofit must file a normal income tax return, pay state franchise taxes and may not receive charitable donations.

**What information is required in the application?** The application form may be obtained from the local IRS office or by calling the toll free number: 1-800-829-3676.

The application is a pre-printed form, the first 8 pages of which must be completed by all applicants because it is designed so that all types of organizations claiming exemption under § 501(c)(3) may use the form. Not all of the questions set forth in the application form will relate to every organization.

The application asks questions to elicit factors indicating the organizations qualifications. The preparer should exempt to flush out, or paint a picture of the organization, in the eyes of the IRS reviewer. Many questions interrelate. For example, Item 4 and 5 should be evidenced in Item 10 and 15.

As part of the application, each applicant is requested to supply the following information:

- (1) A conformed copy of the organization's articles of incorporation and bylaws (including amendments and restatements) if incorporated; if not incorporated a conformed copy of its governing instrument.
- (2) The fiscal year which must be coordinated with S8-4 and bylaws.
- (3) Federal employer identification number which can be obtained by filing Form 88-4. This number is required whether or not the organization has employees.
- (4) The anticipated sources of financial support in order of magnitude.

- (5) A description of the organization's fund raising program, both actual and planned. The response must show how the organization is distinguishable from a business. Sample grant requests and donor letters are requested. This question searches for impermissible unrelated business activity and member benefits.
- (6) A narrative statement describing the activities to be carried on, including the nature of contemplated expenditures, the benefits provided to the general public and assessment of charges, if any, and the relationship of the activities to the exempt purpose of the organization. Be clear and concise in describing activities. Do not merely restate the language of the governing document. This is a very important section of the application in that the IRS, based on this information, will determine that the organization's activities will further its exempt purposes. For many organizations this item is the most significant as it describes the fashion in which the organization will actually operate. The first year's performance schedule for a theater company would be listed or the classes to be taught would be described. Actual brochures or flyers, if available, should be attached.
- (7) A listing of the organization's governing body and their annual compensation. The qualification of each individual is not required, but should be submitted for those that will be compensated.
- (8) The relationship of the applicant to other organizations, whether exempt or nonexempt. Connections to for profit businesses are closely scrutinized.
- (9) The benefits derived from membership, dues assessments and the solicitation program for members, if applicable. This information is used to evaluate non-qualifying benefits to a closed group, as opposed to a required charitable class.
- (10) A description of the fees, if any, that the organization charges for its services and how those charges are determined. If a sliding scale is used, explain who qualifies for reduced fees.
- (11) A statement as to whether the organization limits its services to particular individuals or classes thereof. The issue is again whether the organization proposes to serve a limited or closed class of individuals.
- (12) A description of any activities which may be considered as influencing legislation, along with a § 501(a) election if desirable. Form 5768 is submitted.
- (13) A statement as to whether the organization is claiming status as a private foundation or public charity, and if so, whether an advanced or definitive filing is required.
- (14) Financial statements and/or two-year projected budget. More details than requested should be furnished in most cases, particularly regarding revenue sources and compensation to be paid. The responses to question in Part II must be reflected in numbers.

Organizations which are claiming public charity status by reason of being publicly supported are required to provide a detailed statement of receipts and disbursements and balance sheet for the most recent and three preceding fiscal years or the years of existence, if less. Proposed budgets for two run fiscal years are required of new organizations which have not completed one taxable year of at least eight months.

The application must be signed by an officer. Additionally, a power of attorney, Form 2848 can be attached to appoint an authorized individual who should be the person to be contacted by the IRS to resolve any questions which might arise. The CPA or attorney who prepared the application is normally designated. Send the application certified mail receipt requested to:

Internal Revenue Service  
EPIBO Division  
Mail Code 4950 DAL  
1100 Commerce St.  
Dallas, TX 75242

## **FEE**

Form 8718 with a filing fee of \$465 or 5150 must be attached. A cashier's check, rather than a normal bank check, speeds the processing.

**What happens if the IRS raises questions about the application?** Submission of a well prepared and documented application aids but may not assure proper consideration by the IRS. It is not uncommon for the Service to request additional information such as a details of proposed salaries, a more current financial statement, or a detailed explanation of a proposed business activity. The information request indicates a response deadline, though an extension of the time can be requested if needed. IRS representatives usually try to assist the organization to make reformatations necessary to achieve tax-exemption.

If the organization receives notice that the Service has issued an adverse determination letter or proposes modification of exempt status, appeals procedures are available.

If it is discovered that significant omissions were made in the application or if exemption was claimed under the wrong statute, the application may be withdrawn at any time prior to the issuance of a ruling upon written request of an authorized representative.

**What happens if the application is approved?** If the application is approved, the IRS will send the organization a "letter of determination." This letter will usually state the employer identification number, the ending date of the advance ruling period, public charity status, the ending month of the organization's accounting period (fiscal year) and the IRS contact person.

Keep the original letter in a safe place. It is recommended that numerous copies be printed since proof of exempt status will have to be presented frequently.

## **STATE**

**What is franchise tax?** Franchise tax is imposed on each domestic or foreign corporation that is doing or authorized to do business in Texas. It is based on a percentage of either the corporation's taxable capital, or taxable earned surplus, whichever is greater. However, no franchise tax is payable if the result is less than \$100.00. Unless a corporation is exempt, the first franchise tax payment is due approximately 15 months after the date of incorporation.

Failure to pay franchise tax when due results in tax liens filed against the corporation's assets, revocation of corporate privileges, i.e., personal liability of directors, and finally of the corporate charter.

**How may an organization obtain exemption franchise tax?** Exemption from franchise tax is obtained through application to the Comptroller of Public Accounts. The state has many categories of exemption, including "charitable" and "educational"; however, the state defines these categories differently from the IRS. Although many organizations may not fall within these categories, the state also allows exemption for those groups which have obtained federal tax exemption. After receiving the "letter of determination" from the IRS, an organization seeking franchise tax exemption should send a copy of the IRS letter along with a request for exemption to:

Comptroller of Public Accounts  
111 E. 17th  
State of Texas  
Austin, TX 78774

**How may an organization obtain exemption from sales tax?** Exemption from sales we should be requested at the same time as exemption from franchise tax. If the exemption is granted, the Comptroller will return an exemption letter to the group. Texas has no "tax-exempt number." The Comptroller's office will furnish a form to be given to vendors when purchasing taxable supplies.

Exemption from **paying** sales tax does not mean the group is exempt from collecting sales tax on taxable items it sells such as tee shirts, posters, and booklets. Procedures on collecting and depositing sales tax are available from the local office of the Comptroller or call 1-800-252-5555.

## **LOCAL**

**Are charitable organizations exempt from real and personal property tax?** State law provides that charitable organizations may be exempt from taxation on the buildings and tangible personal property they own. In this section of the law (Subtitle C, Chapter 11, Texas Tax Code), a charitable organization includes one "promoting or operating a museum, zoo, horary, theatre of the dramatic arts, or symphony orchestra or choir or one promoting or operating an art gallery, museum, or collection, in a permanent location or on tour, that is open to the public." The organization must be operated in a way which does not result in accrual of distributable profits to private persons or realization of private gain. By charter or bylaws, the organization must pledge its assets for use in performance of the organization's charitable function and upon dissolution of "it" the organization, the assets must be transferred to the state or to another § 501(c)(3) organization. Performance of non-charitable functions does not result in loss of exemption, if incidental. Organizations should contact their local county tax office or appraisal district to obtain exemption applications. The applications should be filed by May 1 with qualification based on one's status as of January 1 of the year claiming exemption.

## CHECKLISTS

### ARTICLES OF INCORPORATION

The following is the information required by an attorney to draft the articles of incorporation. The number designates the page where more information on the subject may be found.

1. \_\_\_\_\_ Name of Corporation (1)
2. \_\_\_\_\_ Statement of Nonprofit Status (2)
3. \_\_\_\_\_ Duration (2)
4. \_\_\_\_\_ Purpose(s) (2)
5. \_\_\_\_\_ Members, if any (5)
6. \_\_\_\_\_ Registered Agent and Street Address (2)
7. \_\_\_\_\_ Initial Directors and Addresses (2)
8. \_\_\_\_\_ Incorporators and Street Addresses (2)
9. \_\_\_\_\_ Inurement and Dissolution Clauses (3)

### BYLAWS

The following information should be included in the bylaws. The number designates the page where more information on the subject may be found.

1. \_\_\_\_\_ Name of Corporation (1)
2. \_\_\_\_\_ Purpose(s) (2)
3. \_\_\_\_\_ Board of Directors (7)
  - a. Number, qualification and term of office (7)
  - b. Nominations, election (8)
  - c. Duties (8)
  - d. Removal procedures (8)
  - e. Vacancies (8)
  - f. Transactions with Corporation (8)
  - g. Place, time and number of meetings (9)
  - h. Quorum (9)
  - i. Indemnification/Limitation of liability (10)
  - j. Committees (10)
4. \_\_\_\_\_ Officers (10)
  - a. Number and election (10)
  - b. Powers and duties (10)
  - c. Removal procedures (10)
5. \_\_\_\_\_ Members (if any) (5)
  - a. Classification (5)
  - b. Voting (5)
  - c. Dues (6)
  - d. Meetings, notice (7)
  - e. Inspection rights (6)
  - f. Quorum (7)

6. \_\_\_\_\_ General Provisions (11)
  - a. Fiscal Year (11)
  - b. Authority to sign checks (12)
  - c. Authority to enter into contracts (12)
  - d. Authority to accept gifts and donations (12)
7. \_\_\_\_\_ Amendment Procedures (12)

**FORM 1023**

The following should be provided to the attorney or accountant preparing the Application for on of Exemption. The number designates the page where more information on the subject may be found.

1. \_\_\_\_\_ Articles of Incorporation and Bylaws (17)
2. \_\_\_\_\_ Name, Address, Fiscal Year and Federal Employer Identification Number (17)
3. \_\_\_\_\_ Sources of Financial Support (17)
4. \_\_\_\_\_ Description of Fund Raising Program (17)
5. \_\_\_\_\_ Statement of Activities (18)
6. \_\_\_\_\_ List of Director's (18)
7. \_\_\_\_\_ Membership Benefits and Dues (18)
8. \_\_\_\_\_ Fee Schedule (18)
9. \_\_\_\_\_ Financial Statements and/or Two-Year Budget (18)

## **TEXAS ACCOUNTANTS AND LAWYERS FOR THE ARTS**

Texas Accountants and Lawyers for the Arts (TALA) is a nonprofit, tax-exempt organization dedicated to assisting the art community in Texas. A pool of more than 600 volunteers enables TALA to provide services throughout the state. TALA has helped to establish programs in four cities, Austin, Dallas, El Paso, and San Antonio, which provide services locally.

TALA directly assists eligible artists and nonprofit arts organizations through referrals to appropriate volunteers for art-related problems. TALA does-not help artists with personal problems such as divorce or completing individual tax returns, although TALA does offer tax advice to individual artists and nonprofit cultural organizations among other services. In addition, TALA frequently sponsors educational programs in various Texas cities.

Currently, TALA publishes a *Nesletter*, the quarterly *Art Law and Accounting Reporter*, the practical guides *Taxation of the Visual and Performing Artist*, *Financial Management of Nonprofit Arts Organizations*, *Copyright for Performing and Literary Artists*, *Copyright and the Visual Artist*, *Pas de Deux: Labor and Employment Issues in the Arts and Nonprofit World*, *Responsible Management: Duties and Liabilities of Directors and Officers of Nonprofit Arts Organizations*, *Insurance: A User-Friendly Guide for the Arts and Nonprofit World* and this handbook.

TALA receives funding from the Cultural Arts Council of Houston, the Texas Commission on the Arts, corporations, law and accounting firms, private foundations and many concerned individuals.

For further information on TALA or any of its programs contact:

## **TEXAS ACCOUNTANTS AND LAWYERS FOR THE ARTS**

1540 Sul Ross  
Houston, Texas 77006  
(713) 526-4876  
Fax (713) 526-1299

### **In Austin**

ALAA  
P.O. Box 2577  
Austin, Texas 78761  
(512) 476-4451  
Fax (512) 322-6764

### **In Dallas**

2917 Swiss Avenue  
Dallas, Texas 75204  
(214) 821-1818  
Fax (214) 821-9103

### **In El Paso**

Business Committee for the Arts  
Chamber of Commerce, 10 Civic Plaza  
BJ Paso, Texas 79901  
(915) 534-0532  
Fax (915) 534-0510

### **In San Antonio**

San Antonio Department of Arts and Cultural Affairs  
222 East Houston, Suite 500  
San Antonio, Texas 78205  
(210) 222-2787  
Fax (210) 228-0263