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Alternative Operating Structures, Governance Best Practices and Fraud Risk Management

Choosing the Structure

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I. INTRODUCTION

Nonprofit entities have many organizational options for their mission-driven activities. This paper will consider the reasons for undertaking such activities through a subsidiary or affiliate, the pros and cons of various structural options in the context of managing risk (both to the assets of the organization as well as to its tax-exempt status), and discuss the mechanics of managing the relationship between the two entities.

II. CONSIDERATIONS IN WHETHER TO USE AN ALTERNATIVE OPERATING STRUCTURE

There are many reasons that an existing tax-exempt organization might choose to create an alternative operating structure and/or operate one or more programs through a related or subsidiary organization. This section of the paper will focus on three of the most common reasons: tax concerns, liability concerns, and issues related to management of the program or activity.

A. PROTECTING EXEMPT STATUS WHEN ENGAGING IN BUSINESS ACTIVITIES

Organizations that are exempt from Federal Income Tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, (the "Code") may engage in business operations.[1] These operations may be related to the organization's exempt purpose or may be engaged in to earn revenue for the organization even though the business is not related to the organization's exempt purpose.[2] Where a Section 501(c)(3) organization engages in unrelated business activities, the organization must take care that it does not negatively impact its exempt status by allowing such unrelated business activities to become substantial.[3]

A charitable organization is subject to tax on its gross income from any active trade or business that is regularly carried on and not substantially related to the organization's exempt purpose.[4] This includes income when an exempt organization is a partner in a partnership that carries on a trade or business not substantially related to the charity's exempt purposes, regardless of whether or not the income from the trade or business is actually distributed.[5]

As exceptions to the general rule, unrelated business taxable income ("UBTI") does not include (1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation (the "volunteer exception"); (2) any trade or business carried on by a §501(c)(3) organization primarily for the convenience of its members, students, patients, etc. (the "convenience exception"); or (3) any trade or business that consists of selling merchandise, substantially all of which is received by

[1] *See generally* IRC §§ 571-575.
[2] *See id*.
[3] *See* Treas. Reg. § 1.501(c)(3)-1(e)(2).
[4] *See id*. at § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).
[5] *See* IRC §512(c)(1); Treas. Reg. § 1.681(a)-2(a); *see also Service Bolt & Nut Co. Profit Sharing Trust v. Comm'r*, 78 T.C. 812 (1982).

the organization as donations (the "thrift shop exception").[6] Income and deductions applicable to unrelated business income are subject to the modifications under §512(b).

In addition to the exceptions from unrelated business taxable income, certain items of income are excluded from UBTI treatment. Pursuant to §512(b), dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, and certain income from research is excluded from taxation.

The generation of unrelated business taxable income is a common and acceptable practice for tax-exempt organizations. There is no bright line "upper limit" on the amount of UBTI an organization may generate. However, as UBTI grows, it raises the question as to whether the unrelated business has become a substantial purpose of the organization.[7] Because a single non-exempt purpose, if substantial, is sufficient to destroy exemption regardless of the number of truly exempt purposes, an exempt organization must be mindful of its unrelated business, understanding the risks that the unrelated business may be indicative of a substantial non-exempt purpose. As UBTI grows, the IRS will examine whether an exempt organization's exempt activities are "commensurate in scope" with its financial resources resulting from its business activities. Where the business activities grow so large that they generate revenues that outpace the organization's exempt activities (i.e. the exempt activities and the financial resources are no longer commensurate in scope), the organization risks its exempt status.[8] As a result, an organization may choose to "spin off" one or more unrelated business activities either to a subsidiary organization or a stand-alone organization. Subject to certain exceptions that will be more fully discussed in Section V.B. below, this type of "spin-off" frees the organization from generating unrelated business income and the potential risks to its exempt status attendant thereto.

While unrelated business activities can generate UBTI and potentially risk exempt status as noted above, even arguably related business activities can at times prove problematic. Where the related business is undertaken in a way the IRS deems to have a commercial hue, the organization may risk its exempt status under the Commerciality Doctrine, a non-Code doctrine.[9] Spinning such activities off into a taxable subsidiary avoids this risk.

B. LIABILITY ISSUES

Concerns over liability and the potential impact on the organization's assets are a second motivation for creating a separate organization. By separating high-risk activities into another entity – a wholly owned subsidiary or otherwise – the tax-exempt organization insulates itself from potential tort and contract liabilities associated with those activities. This insulation is of course dependent on the separation being respected; that issue will be discussed below in Sections V.E. and VI.

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[6] *See* IRC §513(a).
[7] *See, e.g.*, Treas. Reg. 1.501(c)(3)-1(c)(1).
[8] *See* Rev. Rul. 64-182.
[9] *See, e.g., Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003); *see generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, § 4.10 (John Wiley & Sons, Inc., 10th ed. 2011).

C. MANAGEMENT ISSUES

Management considerations serve as an additional significant rationale for creating a separate entity to house mission-driven activities. Operating an active business requires focused dedication to the business activities and skill in managing the business operations. That level of focus and specialized skill may not exist on the tax-exempt organization's board or within its senior management. Even in instances where it does exist, the business activities create the risk of loss of focus and disciplined attention to the organization's exempt purpose and primary exempt activities. Spinning off the business activities allows each board and management team to focus on the activities of the organization he or she serves, maximizing that organization's purposes, and to do so consistent with the fiduciary duties owed by the individual to the organization and/or its shareholders. Additionally, depending on the type of subsidiary chosen, it may allow more flexibility in providing executive incentive compensation to attract the most suitable management for the business operations.

D. OTHER RATIONALES

While tax concerns, liability concerns, and management issues are three major reasons to create a separate organization to house mission-driven business activities, there are numerous other rationales. For example, a lender may prefer to work with a single purpose entity in making a loan. A new entity may be beneficial for purposes of obtaining tax credits such as new market tax credits or low income housing credits. The organization may be seeking to attract private capital to help fund its project, necessitating a structure that allows private investor ownership. The activities may involve conduct that would be prohibited in the Section 501(c)(3) structure, such as substantial lobbying or political intervention. This section is not intended to provide exhaustive list of reasons to form a separate organization. Rather, it is intended to demonstrate the variety of issues that may lead a charitable organization to create a new operating entity. Depending upon the reason, the choice of form chosen by the charity may be impacted.

III. A BRIEF OVERVIEW OF THE OPTIONS[10]

Once the charitable organization has determined the need to create a separate entity to house operating activities, the decision-makers must understand the options available. This section of the paper will introduce the primary options.

A. NONPROFIT CORPORATION

Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code ("BOC").[11] The BOC defines a nonprofit corporation as a corporation no

[10] Portions of the section have been excerpted from articles authored by Bourland, Wall & Wenzel, P.C. attorneys, including Darren B. Moore, *A Basic Framework of the Nonprofit Sector*, UTCLE 30th Annual Nonprofit Organizations Institute, January 2013, Austin, Texas, and Michael V. Bourland, David V. Dunning, *Setting the Stage for Planning with the Family Business Owner: Choosing a Business Entity in Today's Business World*, ALI CLE, Estate Planning for the Family Business Owner, August 2014, Boston, Massachusetts.

[11] *See* Tex. Bus. Orgs. Code § 22.001 et. seq.

part of the income of which is distributable to a member, director or officer of the corporation.[12] Income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered. Nonprofit corporations in Texas may be organized for any lawful purpose, though to qualify for recognition of exemption the corporation must be organized with an appropriate purpose identified (e.g. religious, charitable, educational, etc. for Section 501(c)(3) organizations) and otherwise satisfy the requirements for exemption. Pursuant to Chapters 2 and 22 of the BOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes.[13] While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. While nonprofit corporations in Texas do not have shareholders, they may have members which operate to control the organization in a way analogous to for-profit shareholders.[14]

B. FOR-PROFIT CORPORATION

For-profit corporations are domestic entities formed under Texas law for any lawful purpose or purposes (unless otherwise provided by the BOC).[15] Texas statutory law with respect to corporations was modified in 2013 to provide that a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation's certificate of formation.[16] The corporation may also include in the certificate of formation a provision that the board of directors and officers of the corporation shall consider any social purpose specified in the certificate of formation in discharging the duties of directors or officers under the BOC.[17] For-profit corporations are governed by Chapter 21 of the BOC.[18] Like nonprofit corporations, for-profit corporations have the ability to perpetually exist, sue and be sued in their corporate name, purchase, lease or own property in the corporate name, lend money, contract, and exercise other powers consistent with their purposes.[19] Once the corporation has been created through filing a certificate of formation with the Texas Secretary of State's office, a corporate liability shield protects the owners. Through the BOC and the development of Texas case law, the laws regarding the operation and management of corporations are well established and provide a relatively clear operational structure for the entity.

For-profit corporations are classified as C corporations or S corporations. Absent an affirmative S corporation election, a taxable corporation is taxed as a C corporation.[20] C corporations are taxed at the corporate level while S corporations operate as pass through entities

[12] *See id.* at § 22.001(5).
[13] *See id*. at §§ 2.001-002, 2.101-102, 3.003 and 22.054.
[14] *See id.* at § 22.101.
[15] *See id*. at §§ 2.001; 2.007.
[16] *See id*. at § 3.007(d).
[17] *See id.*
[18] *See id*. at § 21.001 *et seq.*
[19] *See id*. at § 2.101.
[20] *See* IRC § 1361(a)(2).

with shareholders receiving allocations of income and loss and paying tax at the shareholder level only. For purposes of an entity that will be owned solely or in part by a charitable organization, S corporations are not the best option because all income and gain are taxable as unrelated business income to the charitable shareholder.[21] As a result, this paper will focus only on C corporations.

C corporations are taxable on their net income at rates of up to 35%.[22] After-tax profits are taxable to the shareholders leading to what is described as double taxation.[23] A tax-exempt shareholder will not be taxed on income distributed to it unless such income is classified as UBTI to the tax-exempt shareholder.

C. PARTNERSHIP

Partnerships are business entities generally governed by a partnership agreement. Under Texas law, partnerships may be general partnerships, limited partnerships, or limited liability partnerships. Limited liability partnerships are not generally used within the charitable organization context and will not be discussed in this outline.

1. General Partnership

A general partnership is an association of two or more persons to carry on the business for profit as owners.[24] The general partnership is considered a separate business entity distinct from its owners.[25] General partnerships are the easiest entities to set up and dissolve among multiple owners. No state law filing is required to set up a general partnership. In fact, a general partnership could exist based on an oral partnership agreement between the parties, though this is not advised. In a general partnership, all partners are liable for partnership obligations unless otherwise agreed by the claimant or provided by law.[26] For federal tax purposes, a general partnership is a flow-through entity, meaning gains and losses flow through to the partners as opposed to being taxed at the partnership level.[27]

A general partnership is normally operated pursuant to a written partnership agreement executed by the partners outlining the terms of their agreement for sharing profits and losses, management, dissolution and transfers of partnership interest (although a written partnership agreement is not required to form a general partnership in Texas). To the extent these types of matters are not addressed in a partnership agreement, Texas statutory law provides an overall structure for the management and operation of the general partnership.

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[21] This is a quite different result than taxable owners who would prefer to avoid C corporation status generally to avoid double taxation.
[22] *See* IRC § 11(a)-(b).
[23] *See id.* at § 61(a)(7).
[24] *See* Tex. Bus. Orgs. Code § 152.051(b).
[25] *See id*. at § 152.056.
[26] *See id*. at § 152.304.
[27] *See* IRC § 701-702.

2. Limited Partnership

A limited partnership consists of one or more general partners who have joint and several liabilities for partnership obligations along with one or more limited partners who are liable only to the extent of their partnership account, absent the limited partner also serving as the general partner or the limited partner's participation in control of the business.[28] The general partner or general partners will have control of the day-to-day operational aspects of the partnership and any other matters allowed the general partner as set forth in the partnership agreement. In most cases, the general partner will be a corporation, limited liability company, or another limited partnership because the general partner is ultimately liable for all the debts and obligations of the limited partnership. The limited partners will be either individuals or entities. As addressed above, limited partners have no liability for the operations of the limited partnership unless they participate in the management of the business in their capacity as a limited partner (as opposed to in their capacity as a co-general partner or as an employee) or otherwise guarantee the debts of the partnership. Participation for purposes of imposing liability is addressed below at Section V.E.

A limited partnership is a state-created entity, and in order for the limited partnership to be created and the limited partners to receive liability protection, the limited partnership must file a certificate of formation with the Secretary of State.[29] The limited partnership should have a limited partnership agreement clearly setting out the rights and obligations of the partners, including the responsibilities of the general partner and the matters on which the limited partners will have control or a vote regarding the operations of the limited partnership. The structure of the limited partnership is flexible and can provide that the general partner will have control over almost all of the operational aspects of the limited partnership with the ability to only be removed "for cause" or by supermajority of the limited partners. In this fashion, a 1% owner, a 0.5% owner, or even a 0% owner may serve as the general partner and control the operations of the limited partnership. As with general partnerships, limited partnerships are flow-through entities for federal taxation purposes and are not taxed at the entity level. In addition to the flow-through status for tax purposes, a charitable organization will also receive its share of unrelated business taxable income generated by the partnership and, pursuant to the aggregate approach taken by the IRS, the partnership activities will be considered as if undertaken directly by the partner for purposes of determining the exempt status of the organization.[30] As a result, it is critical for an exempt organization to consider whether the activities being undertaken in the partnership further a charitable purpose.

D. LIMITED LIABILITY COMPANY

The limited liability company ("LLC") was originally enacted as a hybrid entity combining features of corporations and partnerships. It is a single entity in which all of the owners (called members) have liability protection from the operations of the LLC.[31] However, for federal tax purposes, it is treated as a partnership unless an affirmative election is made to be

[28] *See* Tex. Bus. Orgs. Code § 153.102.
[29] *See id*. at § 3.001.
[30] *See* Rev. Rul. 98-15; Rev. Rul. 2004-51.
[31] *See* Tex. Bus. Orgs. Code § 101.114.

taxed as a corporation or unless it has a single member, in which event it is disregarded absent an election to be treated as a corporation.[32] Therefore, it combines the benefits of limited liability of a corporation for all the owners of the LLC while retaining tax advantages of a partnership. This has caused it to be a popular entity choice. LLCs are governed by the Business Organizations Code and specifically Chapter 101.[33] LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.[34] Instead of bylaws, the LLC normally has an operational document called a company agreement (sometimes alternatively called an operating agreement or regulations) which is a hybrid of bylaws (for the corporation) and a partnership agreement (in a partnership).

The operational aspects of LLCs are flexible under Texas law. Unlike corporations which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual board of director meetings, election of officers, evidence of authorization of corporate acts, minute books, etc.), LLCs require much less with regard to "maintenance" of the entity. LLCs can be member-managed or manager-managed.[35] In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting though its own board of directors or can appoint others to manage the LLC with those "others" acting essentially as a board of directors of the subsidiary LLC. Whereas in a corporate situation the board of directors must elect officers in order to bind the corporation to any act or obligation, an LLC may act directly through its members or managers (depending on what type of governance structure it has) to bind the company. Furthermore, whereas a corporation must show appropriate resolution, meeting minutes or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence a particular person's authority to act on behalf of the LLC. Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple representations. Furthermore, LLC members and managers are not required to have annual meetings. These attributes cause the LLC to be an attractive form of business, especially for those that desire a lower-maintenance option to the rigidities of corporate law. Nevertheless, for protection of the separate status necessary to avoid having activities of the subsidiary attributed to the parent tax-exempt organization, some level of documented formality should be followed.

As noted above, Chapter 101 of the BOC provides that members and managers are shielded from debts, obligations, and liabilities of the LLC. This liability protection, with the simple control (such as management overlap), is a beneficial feature of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities.

The LLC is unique in that it can be classified as a disregarded entity, a partnership, or an association (taxed as a corporation) for federal income tax purposes. Where the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-exempt status (discussed below) but rather will effectively take on the tax attributes of its

[32] *See* Treas. Reg. § 301.7701-2(c)(2).
[33] *See* Tex. Bus. Orgs. Code § 101.001 *et seq*.
[34] *See id*. at § 3.001.
[35] *See id*. at § 101.251.

parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.[36] If there are two or more owners of the LLC, then the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (taxed as a corporation).[37] Being able to be treated as a partnership for federal income tax purposes can be advantageous to an LLC in that it allows it to take advantage of the flexibility in the partnership tax area discussed above while still retaining limited liability for all of its owners in a single entity. While this is a common benefit to LLCs, tax-exempt organizations participating in a multi-member LLC should be cautious about being taxed as a partnership for the reasons addressed under Section III.C. above (i.e. the income may flow through as unrelated business income and the activities of the partnership may affect the exempt status of the tax-exempt member).

Should a single member LLC wish to apply for exemption from federal income tax (as opposed to being a disregarded entity) or should the LLC have multiple members and wish to be recognized as exempt, separate conditions apply. The IRS has indicated that it will recognize the 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (which will be discussed below) and meets 12 additional conditions as follows[38]:

1. The original documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.

2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC's members be Section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a Section 501(c)(3) organization or governmental until or instrumentality.

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a Section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

[36] *See* Treas. Reg. § 301.7701-2(c)(2).
[37] *See id*. at §§ 301.7701-3(b)(1)(i); 301.7701-3(a).
[38] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with Section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in Section 501(c)(3) or governmental units or instrumentalities.

10. The organizational language must contain an acceptable contingency plan in the event one or more members cease at any time to be an organization described in Section 501(c)(3) or a governmental unit or instrumentality.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

12. The LLC must represent that all its organizations document provisions that are consistent with state LLC laws and are enforceable at law and in equity.

E. HYBRIDS: L3C'S AND BENEFIT CORPORATIONS

Low-Profit Limited Liability Corporations (L3C's) and Benefit Corporations are hybrid entities that are taxable in the same ways as LLCs and C corporations (respectively), yet are structured in a way so as to embed social purposes within the organizations. This structure is intended to help attract capital from private foundations looking to make program-related investments or from individuals desiring a social return on investment. Texas does not have statutory law recognizing L3C's or Benefit Corporations. However, there is nothing in the limited liability company law that would prohibit a limited liability company from structuring itself in a way that would be classified as an L3C in a state that recognized L3C's, and Texas statutory law with respect to corporations was modified in 2013 to provide that a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation's certificate of formation. The corporation may also include in the certificate of formation a provision that the board of directors and officers of the corporation shall consider any social purpose specified in the certificate of formation in discharging the duties of directors or officers under the BOC.[39] Accordingly, the benefits of the L3C and Benefit Corporation may be achieved in Texas, though those designations are not utilized. Because these entities are structurally similar to LLCs and C corporations, they will not be separately discussed unless there is a distinction worth noting.

[39] *See* Tex. Bus. Orgs. Code § 3.007(d).

IV. TAXABLE OR TAX-EXEMPT

An initial question that should be answered prior to creating any sort of subsidiary or affiliate structure is whether the new organization will be taxable or tax-exempt. Eligibility for exemption depends on the organization meeting specific requirements for exemption. Said differently, the determination of whether an organization should choose to be taxable or tax-exempt depends, in the first instance, on whether the organization will have purposes that qualify for exemption. For purposes of Section 501(c)(3) of the Code, purposes that qualify for exempt are qualified as follows:

> "Corporations, in any community chest, fund, or foundation, or organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

Assuming the organization will have such purposes and will avoid the prohibitions on private inurement, excessive lobbying, and political intervention, other factors that should be considered when making the determination whether to operate as a tax-exempt or taxable subsidiary include the necessity of tax exemption (for example, for capitalization or fundraising purposes or avoidance of federal income tax), the goal of creating equity that can be sold in the future, and whether there is consideration of bringing in outside investors.

V. SELECTING THE STRUCTURE

Considering the most utilized options set out above, this section of the paper will turn to factors that should be considered in selecting the structure.

A. IMPACT ON EXEMPT STATUS

1. Corporations

A subsidiary organization that is organized as a corporation (whether it is exempt from federal income tax or not) will not negatively impact the tax-exempt status of the parent charitable organization as long as separateness is maintained between the entities. Maintaining separateness will be discussed at Section VI below. However, if the parent charitable organization is a private foundation, care must be taken with respect to transfers from the parent

to an exempt corporate subsidiary (capitalization of the subsidiary or otherwise) with regard to the subsidiary being itself treated as a private foundation, which would necessitate expenditure responsibility.

Further, a private foundation parent must be mindful of the private foundation prohibitions, specifically, the prohibition on excess business holdings and the prohibition on jeopardizing investments. Both the excess business holding prohibition and the prohibition on jeopardizing investments are inapplicable to the extent the foundation is able to treat its investment in the subsidiary as a program-related investment.

2. Partnerships

Partnerships risk negatively impacting the exempt status of a tax-exempt organization partner. Specifically, the unrelated business income is passed through to the partners and the tax-exempt organization would get its allocation. Further, the aggregate approach is used to consider the activities of the partnership along with the activities of the exempt organization in considering satisfaction of the operational test for ongoing exempt status.[40]

A tax-exempt organization engaged in a partnership (whether general or limited) must consider whether it has lost control of its charitable assets. This is particularly troublesome with respect to a tax-exempt partner serving as the general partner of a limited partnership where the general partner has fiduciary obligations to operate the partnership to the economic benefit of the limited partners. Because tax-exempt organizations must operate primarily for their exempt purpose, participation in a joint venture requires scrutiny in order to determine whether participation in such venture causes the tax-exempt organization to operate more than insubstantially in an other-than-exempt purpose. The IRS has developed a two-pronged test to make such determination. First, the exempt organization's participation must be substantially related to the exempt purpose of the exempt organization. Second, the structure of the partnership arrangement must avoid conflicts between the exempt organization's purpose and the exempt organization's duty (if any) to further the private interests of non-exempt partners in the venture. With respect to the first prong, the examination requires a review of the purpose of the joint venture, with an eye toward whether an exempt purpose is being served. If the exempt purpose bears only a tenuous relationship to the purpose of the joint venture, there is a risk of the organization losing its exemption. Assuming the purpose of the joint venture is substantially related to the exempt organization's exempt purpose, the second prong looks to whether the exempt organization retains sufficient control of the joint venture to ensure that such exempt purposes are actually met. As a part of this second prong, a determination that any benefits conferred upon private interests are incidental, both quantitatively and qualitatively, must be made. This requires looking to the benefit conferred on private partners and comparing that benefit to the benefit received by the exempt organization with respect to the furthering of the exempt organization's purposes.

The IRS has outlined certain factors it considers favorable with respect to the structure of a joint venture arrangement and certain factors it considers unfavorable. The favorable factors are as follows:

[40] *See, e.g.*, Rev. Rul. 98-15, 1998-1 C.B. 718.

1. Limited contractual liability of the exempt partner;

2. Limited rate of return on invested capital of the non-exempt parties;

3. Exempt organization's right of first refusal on sale of partnership assets;

4. Presence of additional general partners/managers obligated to protect the interests of the non-exempt organization partners;

5. Lack of control by the non-exempt organization partners except during the initial start-up;

6. Absence of any obligation to return the non-exempt organization's capital from exempt organization funds;

7. Absence of profit as a primary motivation;

8. Arm's length transactions with partners;

9. The management contract, if any, is terminable for cause by the joint venture (controlled by the exempt organization partner), has a limited term, any renewal is subject to approval of the joint venture, and provides for management by a party with independent activities;

10. The exempt organization has effective control over major decisions of the venture, as well day to day operations; and

11. There is a written commitment in the governing documentation of the joint venture to a fulfillment of the exempt purposes.

The unfavorable factors are as follows:

1. Disproportionate allocation of profits and/or losses in favor of non-exempt organizations;

2. Commercially unreasonable loans by the exempt organization to the partnership;

3. Inadequate compensation received by the exempt organization for services it provides or excessive compensation paid by the exempt organization for services it receives;

4. Control of the exempt organization by the non-exempt organizations or a lack of sufficient control by the exempt organization to ensure it is able to carry out its exempt purposes;

5. An abnormal or insufficient capital contribution by non-exempt organizations;

6. A profit motivation by the exempt organization; and

7. A guarantee of non-exempt organization protected tax credits or return on investment to the detriment of the exempt organization.

These factors are not exhaustive. Furthermore, not all of the favorable factors must be met and not all of the unfavorable factors must be avoided. Rather, the test is one of facts and circumstances based on a totality of the facts and circumstances.

3. Limited Liability Company

A limited liability company may have a single member (the tax-exempt parent) or multiple members. Where the limited liability company has a single member, the entity is disregarded for federal tax purposes unless an election is made for it to be regarded, in which event it will be treated for tax purposes as a corporation (see Section 1 above). In the event it is treated as a disregarded entity, it has no independent tax filing or information filing requirement, but rather its income and loss and activities are considered to be part of the exempt parent and are reported on the exempt parent's Form 990. As a result, if the activities undertaken in the disregarded single-member LLC are unrelated to the activities of the parent, not only do they create unrelated business taxable income, but they risk the parent's exempt status to the extent they become large enough to be considered a substantial purpose. Accordingly, a disregarded single-member LLC is not an appropriate choice for substantial unrelated business activities.

Where the LLC has multiple members, the LLC may choose to be taxed as a corporation or a partnership. Again, if it is taxed as a corporation, the rules set forth at Section 1 above apply. If, on the other hand, as is more common, it is taxed as a partnership, the partnership rules at Section 2 above apply with each member receiving its allocation of gain and loss while the activities of the LLC will be aggregated with the activities of the tax-exempt organization in determining eligibility for exempt status.[41]

In addition to the concern over the impact of unrelated business income being allocated to the tax-exempt organization that is a member of an LLC taxed as a partnership, and the activities of the partnership being aggregated with the activities of the tax-exempt organization, where the LLC has multiple members, some of which are exempt and some of which are taxable, and where the activities of the LLC are unrelated to the exempt purposes of the tax-exempt organization, the tax-exempt organization must be sensitive to concerns of private benefit and private inurement when it is serving as a managing partner in the same way as if it were serving as a general partner of a limited partnership. The assets of the exempt organization may not be used to provide substantial benefits to for-profit partners. Critical to this consideration is the ongoing control of the tax-exempt organization over its charitable assets. A loss of control of charitable assets risks the exempt status of the tax-exempt organization member of the LLC even if the activities are related to the tax-exempt organization's charitable purposes.

[41] *See* Rev. Rul. 98-15.

B. UNRELATED BUSINESS TAXABLE INCOME

A tax-exempt nonprofit corporate subsidiary is exempt from federal income tax with respect to its related revenue. However, like any other tax-exempt organization, it will be taxed on its unrelated business income. To the extent a controlled tax-exempt subsidiary reduces its unrelated business taxable income by making deductible payments of passive income to the parent charitable organization, the parent charitable organization will be subject to unrelated business taxable income on such payments.[42] Deductible passive payments include payments such as rents, royalties, and license fees. Dividends are not deductible to the controlled subsidiary and therefore not taxable to the parent. To be clear, this rule related to passive income received from a subsidiary being UBTI to the parent only applies where the subsidiary is controlled by the parent. In this context, controlled means that the parent controls 50% or more of the subsidiary by vote or value. Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[43]

A C corporation subsidiary will be taxed at corporate rates on its net income. As with a tax-exempt corporate subsidiary, Section 512(b)(13) of the Code continues to apply in the context of a controlled corporate subsidiary. Because the C corporation is not subject to the rules on unrelated business taxable income, the rule is applied as if the entity were exempt for purposes of determining whether or not the payments to the parent charitable organization will be unrelated business taxable income.[44]

A single member LLC is disregarded for federal income tax purposes, meaning all of its gain and loss are treated as gain and loss of the parent charitable organization directly. Accordingly, to the extent the single member LLC engages in activities that are unrelated to the purposes of the parent, the parent will have unrelated business taxable income.

Organizations that are flow-through organizations for federal income tax purposes, such as partnerships and multi-member LLCs that are taxed as partnerships, are not taxed at the entity level. Rather, these entities pass through gain and loss to their partners/members. To the extent the gain or loss is from activities that are unrelated to the exempt purposes of the charitable partner/member, the charitable partner/member will recognize unrelated business taxable income.

C. TEXAS MARGIN TAX

All of the organizational options identified in Section III above are subject to the Texas Margin Tax.[45] Corporations, if exempt under Section 501(c)(3), are eligible for exemption from the Texas Margin Tax.[46] Likewise, passive entities (as defined under Texas Tax Code §

[42] *See* IRC § 512(b)(13).
[43] *See id*. at § 318.
[44] *See id*. at § 512(b)(13)(A).
[45] *See* Tex. Tax Code § 171.001(a); certain exceptions apply to the imposition of the Texas Margin Tax that are not applicable to this discussion. For example, where all owners of a general partnership are natural persons, the general partnership will not be subject to the Texas Margin Tax. Where an entity is involved (such as is discussed in this paper), each of the entity types is subject to the Texas Margin Tax.
[46] *See* Tex. Tax Code § 171.063(a)(1).

171.0003) are not subject to the Texas Margin Tax. However, taxable corporations, limited liability companies that are operating businesses (regardless of whether they are disregarded for federal income tax purposes), general partnerships owned by other filing entities, and limited partnerships are subject to the Texas Margin Tax. Generally, Texas state tax issues will not be the determinative factor as between organizational types, though it may play a factor in determining whether the organization should be created as a nonprofit corporation or LLC (taxed as a corporation) that will obtain exemption from Section 501(c)(3) and therefore be eligible for exemption from Texas taxes as well.

D. CONTROL & MANAGEMENT

With respect to control, a tax-exempt organization controls its nonprofit subsidiaries through interlocking directorates or serving as the sole member. For-profit subsidiaries are controlled through owning a majority of the voting interests, which typically means owning a majority of the stock in a C corporation,[47] a majority of the membership interests in a limited liability company, a majority of the partnership interests in a general partnership, or the general partner in a limited partnership. Of course, shareholders agreements, operating agreements, and partnership agreements may be used to vary these rules as to operation control.

While control may be effectuated through these measures, control is not always desirable. As referenced above, where a tax-exempt organization controls (by vote or value) another tax regarded organization, passive income received from the controlled organization (other than dividends) will be taxable as unrelated taxable income of the tax-exempt parent organization to the extent they reduce the unrelated business taxable income (or its analog in the for-profit setting).[48] Furthermore, private foundations may not own more than 20% of a business entity that is controlled by the private foundation or one or more of its disqualified persons unless the subsidiary entity is a program-related investment or generates only passive income.[49]

Part of understanding the ability of the tax-exempt parent to control the organization is understanding the management structure of the subsidiary organization. Corporations (whether for-profit or nonprofit) are generally governed by a centralized board of directors who manage the affairs of the corporation.[50] The board generally elects officers to handle the day-to-day operations of the corporation.[51] Within the nonprofit context, the organization may elect not to have a board of directors and rather be member-managed.[52] Within the for-profit context, a similar result can be obtained through the use of a shareholders' agreement and direct management by the shareholders.[53] However, each of these latter two situations is less common.

If the corporation at issue is a nonprofit corporation, its board of directors will be elected by its member(s) (if the organization has one or more members) or will be self-perpetuating, though from a control standpoint the governing documents may require that a majority of the

[47] Unlike S corporations, a C corporation may have multiple classes of stock to effectuate control.
[48] *See* IRC § 512(b)(13)(B)(i)(I).
[49] *See id.* at § 4942.
[50] *See* Tex. Bus. Orgs. Code § 21401.
[51] *See id.* at § 21.417.
[52] *See id.* at § 22.202.
[53] *See id.* at § 21.101(a).

board always be appointed by the parent organization or consist of directors who are related to the parent organization. Within the for-profit context, the shareholders elect the directors.[54] As a result, the tax-exempt parent, unless the corporation is managed by its members or its shareholders, will not have direct involvement either in the governance decisions or in the day-to-day operations. Rather, the input into those matters is accomplished through the election of the board. Depending on the purpose of the subsidiary, it is not uncommon that the organizations have some overlap of officers as well as board members; the extent of that overlap and the need to maintain separateness will be discussed below.

Limited liability companies under Texas law may be member-managed or manager-managed.[55] This management structure is similar to (though often less formal than) being managed by the member/shareholder or the board of directors of the corporation. While a limited liability company may choose to have officers, it is often the case that the managers carry out the day-to-day operations for the LLC.[56] The details of these arrangements are contained in the LLC's company agreement.

With respect to a general partnership, the partnership agreement will specify decision making for the organization. While there is no requirement under Texas law that the partnership agreement be memorialized in writing, it is recommended that a written general partnership agreement be put in place to have a clear understanding among the partners of their ownership interest, their sharing of profit and losses, their obligation (if any) to contribute additional capital, the sharing of management among the partners, the ability of a partner to withdraw from the partnership or to cause the dissolution of the partnership, the restrictions on transfer of partnership interest, and the ability to incur debt or other liabilities for the partnership. Absent agreement otherwise, each partner will have equal rights in the management of the business of the general partnership with the ability to bind the partnership.[57]

Management of a limited partnership is accomplished by the general partner(s).[58] One of the features of a limited partnership, as discussed above, is the general rule that limited partners do not participate in the operation or activities of the limited partnership (absent falling within the laundry list provided by the Business Organizations Code) or similar type of activities.[59] However, limited partners may have the ability in the partnership agreement to remove and replace the general partner, similar to the ability to remove and replace members of a board of directors in the corporate setting or the manager(s) in the limited liability company setting. This ability may be without cause, for cause, by a super-majority vote, etc. There is also no prohibition on a limited partner creating a subsidiary entity to serve as the general partner, such as the tax-exempt parent serving as the limited partner in a partnership but creating a single-member LLC to serve as the general partner. This type of layered structure requires careful attention to ensure that corporate roles are respected.

[54] *See id*. at § 21.405.
[55] *See id*. at § 101.251.
[56] *See id.* at §§ 101.251-101.253.
[57] *See id.* at § 152.203(a).
[58] *See id*. at § 153.152.
[59] *See id.* at § 153.103.

Regardless of the organizational type, the governing persons owe fiduciary duties to the entity that they govern and, where for profit, to the owners. Within the limited liability company context, these fiduciaries may be limited or modified.[60] In the partnership context there may be an agreement to set parameters around the fiduciary duties of care and loyalty; however, those duties may not be completely eliminated and the parameters may not be manifestly unreasonable.[61]

E. OWNER LIABILITY

One of the primary issues that a tax-exempt organization must concern itself with when engaging in business activities or other high-risk activities is liability exposure. As addressed in Section II above, this is one of the primary rationales for forming a subsidiary. Therefore, the question becomes what type of liability protection is created by the use of the subsidiary?

A corporation, whether nonprofit or for-profit (and whether taxable or tax-exempt) provides a liability shield (sometimes called a corporate veil) to its owners (or members, as the case may be).[62] As a result of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.[63] However, the owners/members will continue to have liability for their own conduct, such as guaranteeing corporate obligations or their own negligent or otherwise tortious actions.[64] The exception to this general rule is when the court "pierces" the corporate veil, effectively finding that the corporate entity should be disregarded because the subsidiary corporation is the alter ego of the parent or because the corporation has been used as a sham to perpetrate a fraud.[65] Under either scenario, pursuant to Texas statutory law, a shareholder will not be held liable for contractual obligations of the subsidiary corporation unless there is a finding that the corporation was used by the shareholder to perpetrate an actual fraud for the direct personal benefit of the shareholder.[66] Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to Section 21.223 of the Business Organizations Code.[67] For purposes of Section 21.223 and piercing the corporate veil, actual fraud means dishonesty of purpose and intent to deceive as opposed to requiring that the party seeking to pierce the corporate veil prove all of the elements of common law fraud.[68]

Because of the standard set by Section 21.223, piercing the corporate veil in Texas poses a significant hurdle. While case law indicates that the relationship between the shareholder and the corporation must be reviewed in its totality to determine whether there is an alter ego relationship, failure to follow corporate formalities is not a basis to hold a shareholder liable for

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[60] *See, e.g.*, Tex. Bus. Orgs. Code § 101.401.
[61] *See id*. at § 152.002(b).
[62] *See* Tex. Bus. Orgs. Code § 22.151, § 21.223.
[63] *See, e.g., Willis V. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006).
[64] *See, e.g., Sanchez v. Mulvaney*, 274 S.W.3d 700, 712 (Tex. App.—San Antonio 2008, no pet.).
[65] *See Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986); Tex. Bus. Orgs. Code § 21.223.
[66] *See* Tex. Bus. Orgs. Code § 21.223(a)(2) and (b).
[67] *See SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory as running counter to the standards of Section 21.223); *see also Willis*, 199 S.W.3d at 271-273.
[68] *See, e.g., Latham v. Burgher*, 320 S.W.3d 602, 606-07 (Tex. App.—Dallas 2010, no pet.).

an obligation of the corporation pursuant to Section 21.223(a)(3) of the Business Organizations Code. The majority of courts have chosen to exclude corporate formalities as even a factor in determining veil piercing, though at least one court has interpreted the provision to mean it cannot be the only basis on which an alter ego is predicated.[69]

A final note: while piercing the corporate veil is a difficult task in Texas and corporate formalities are either not a factor (majority view) or not the only factor (minority view), that rule is based on a specific Texas statute and applies to contractual obligations or matters relating to or arising out of contractual obligations. Where tax-exempt organizations are utilizing subsidiaries formed as corporations in other states, care should be taken to determine what law will apply.[70] Likewise, Section 21.223 and the high standards contained therein do not technically apply to non-contractual obligations that do not arise out of contractual obligations. Said differently, the statutory standard is not directly applicable to tort causes of action. The proposed instructions for piercing the corporate veil and tort cases provided by the *Texas Pattern Jury Charges* omit reference to showing actual fraud.[71] Nevertheless, it is still required that the plaintiff seeking to pierce the corporate veil show that the corporate veil has been used to promote injustice or inequity (i.e. injustice or inequity will result if the separate corporate existence is recognized).[72]

Because a tax-exempt organization may find itself creating a subsidiary in another state (or having another state's laws apply to the conduct of a subsidiary) and because tort claims are treated slightly differently than contractual claims under Texas law, the parent organization should be mindful of maintaining sufficient separateness to avoid a piercing result. Separateness is discussed in Section VI below; however, some of the factors that should be observed are avoiding complete overlap of directors, officers, and employees ensuring that the subsidiary is appropriately capitalized to meet its needs; dealing in arms-length transactions between the subsidiary and the parent, allowing the subsidiary to carry out its own decision making, maintaining separate meetings, separate minutes, separate bank accounts, etc.[73] Even with such showings, however, the plaintiff in Texas seeking to impose liability through a corporate veil for a tort claim must nevertheless demonstrate that the "corporate entity was used to achieve an inequitable result."[74]

A limited liability company also provides a liability shield to its owners.[75] Pursuant to Section 101.002 of the Business Organizations Code, Sections 21.223-21.226 of the Business Organizations Code (those sections addressed above providing the strict standard for piercing the

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[69] *See* Elizabeth S. Miller, *Governing Persons and Owners in Action: Liability Protection and Piercing the Veil of Texas Business Entities*, State Bar of Texas, Essentials of Business Law Course: The Lifecycle of a Business, March 2014, at page 4 (citing *Burchinal v. P.J. Trailers-Seminole Mgmt. Co., LLC*, 372 S.W.3d 200, 217 (Tex. App.—Texarkana 2012, no pet.) and a string of cases for the majority rule and comparing *Schlueter v. Carey*, 112 S.W.3d 164, 170 (Tex. App.—Fort Worth 2003, pet. denied) as the minority view).

[70] *See e.g.* Michael W. Peregrine, *The Return of Alter Ego*, Health Lawyers Weekly, American Health Lawyers Association 2007 (discussing *Network for Good v. United Way of the Bay Area*).

[71] *See, e.g.*, PJC 108.2.

[72] *See id.; see also SSP Partners*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory and requiring the showing of inequity or injustice).

[73] *See, e.g.*, Steven V. Presser, *Piercing the Corporate Veil*, (Thompson-West 92004) at § 1.6; *see also* Peregrine, *infra*.

[74] *Lucas v. Texas Indus. Inc.*, 696 S.W.2d 372 (Tex. 1984).

[75] *See* Tex. Bus. Orgs. Code § 101.114.

corporate veil in the corporate context) apply equally to limited liability companies. Thus, members may participate in management and retain the liability shield, unlike the limited partnership context. As with corporations, members and managers of LLCs will continue to be liable if they guarantee obligations of the LLC as well as for their own tortious conduct. As within the corporate context, owning all of the interests of a limited liability company or failing to follow corporate formalities are not justifications for finding alter ego. Accordingly, in Texas the corporate shield for the LLC is equally strong as the corporate shield for a corporation. In line with the cautionary note above, tax-exempt organizations creating LLC subsidiaries in states other than Texas should understand what law applies, as many states do not have statutes that do not cover veil piercings in the context of LLCs and may apply more lenient veil-piercing theories under common law.[76]

Neither general partnerships nor limited partnerships are subject to the veil-piercing standards because there is not a corporate liability shield to pierce.[77] In the context of the general partnership, absent agreement otherwise in the partnership agreement, partners are jointly and severally liable for partnership obligations.[78] This is one of the primary dangers of the general partnership and motivation for having a carefully drafted partnership agreement that specifies who has authority to bind the partnership and under what circumstances. Within the limited partnership context, there is likewise no need to pierce the corporate veil to reach limited partners because the limited partnership has one or more general partners who have joint and several liability for partnership debts and obligations.[79] Limited partners will be liable only if they also serve as a general partner or participate in control of the business in such a way that a third party believes the limited partner is a general partner and relies on that.[80] Participation in control of the business must be something more than the following non-exhaustive list of activities set out in Section 153.103 of the Business Organizations Code[81]:

> (1) acting as:
>
> > (A) a contractor for or an officer or other agent or employee of the limited partnership;
> > (B) a contractor for or an agent or employee of a general partner;
> > (C) an officer, director, or stockholder of a corporate general partner;
> > (D) a partner of a partnership that is a general partner of the limited partnership; or
> > (E) a member or manager of a limited liability company that is a general partner of the limited partnership;
>
> (2) acting in a capacity similar to that described in Subdivision (1) with any other person that is a general partner of the limited partnership;

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[76] *See generally*, Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 Tex. J. Bus. L. 405, 420-24 (2009).
[77] *See, e.g., Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 Tex. App.—Dallas 2008, pet. denied).
[78] *See* Tex. Bus. Orgs. Code § 152.303(a).
[79] *See id*. at § 153.152.
[80] *See id.* at § 153.102.
[81] *See id*. at § 153.103.

(3) consulting with or advising a general partner on any matter, including the business of the limited partnership;
(4) acting as surety, guarantor, or endorser for the limited partnership, guaranteeing or assuming one or more specific obligations of the limited partnership, or providing collateral for borrowings of the limited partnership;
(5) calling, requesting, attending, or participating in a meeting of the partners or the limited partners;
(6) winding up the business of a limited partnership under Chapter 11 and Subchapter K[1] of this chapter;
(7) taking an action required or permitted by law to bring, pursue, settle, or otherwise terminate a derivative action in the right of the limited partnership;
(8) serving on a committee of the limited partnership or the limited partners; or
(9) proposing, approving, or disapproving, by vote or otherwise, one or more of the following matters:

(A) the winding up or termination of the limited partnership;
(B) an election to reconstitute the limited partnership or continue the business of the limited partnership;
(C) the sale, exchange, lease, mortgage, assignment, pledge, or other transfer of, or granting of a security interest in, an asset of the limited partnership;
(D) the incurring, renewal, refinancing, or payment or other discharge of indebtedness by the limited partnership;
(E) a change in the nature of the business of the limited partnership;
(F) the admission, removal, or retention of a general partner;
(G) the admission, removal, or retention of a limited partner;
(H) a transaction or other matter involving an actual or potential conflict of interest;
(I) an amendment to the partnership agreement or certificate of formation;
(J) if the limited partnership is qualified as an investment company under the federal Investment Company Act of 1940 (15 U.S.C. Section 80a-1 et seq.), as amended, any matter required by that Act or the rules and regulations of the Securities and Exchange Commission under that Act, to be approved by the holders of beneficial interests in an investment company, including:

(i) electing directors or trustees of the investment company;
(ii) approving or terminating an investment advisory or underwriting contract;
(iii) approving an auditor; and
(iv) acting on another matter that that Act requires to be approved by the holders of beneficial interests in the investment company;

(K) indemnification of a general partner under Chapter 8 or otherwise;
(L) any other matter stated in the partnership agreement;
(M) the exercising of a right or power granted or permitted to limited partners under this code and not specifically enumerated in this section; or

(N) the merger, conversion, or interest exchange with respect to a limited partnership.

Because partners in a general partnership and general partners in a limited partnership have joint and several liability for partnership debts and obligations, a tax-exempt organization participating in a partnership should consider the use of a corporate or LLC subsidiary to serve as the general partner in its place to avoid exposing the parent to unnecessary liability. In such instance, the tax-exempt organization would have the strong Texas corporate shield as a protection for its assets.[82]

F. CAPITALIZATION (FUNDRAISING)

A factor in determining the choice of form for the subsidiary is how the subsidiary will be capitalized. Appropriate capitalization is critical for showing that the organization is an authentic business entity separate from its parent for tax purposes as well as to avoid veil-piercing arguments in the tort (non-contractual) context. If it is to be capitalized by invested capital from private investors, it will need to be structured as a for-profit entity (C corporation, LLC, partnership) whereas if it is to be capitalized by donated capital, it will need to be structured as an exempt organization (typically a nonprofit corporation). To the extent the organization will seek private investors, it should be mindful of securities laws, which are beyond the scope of this paper. Likewise, if the organization is seeking loans or guarantees from the Small Business Administration, it will need to be structured as a for-profit entity.

If the tax-exempt parent is going to provide funding for the organization, it may do so as a donation or a loan to the extent the subsidiary is an exempt organization. If the subsidiary is a taxable organization, the tax-exempt parent will capitalize the subsidiary by providing cash and assets in exchange for ownership interests (stock, LLC membership units, or partnership unity) or through loans. To the extent the exempt organization parent chooses to capitalize the subsidiary through one or more loans, if the subsidiary is taxable, the parent must ensure that it receives fair value, meaning market interest and/or other market terms. Whether the subsidiary is taxable or tax-exempt, if the parent tax-exempt organization is using loans to capitalize the subsidiary, it should be mindful that, to the extent it controls the subsidiary (by owning more than 50% of the vote or value), loan repayments will not fall within the general exception to unrelated business taxable income because they will constitute "specified payments" under IRC § 512(b)(13).

As a final note of caution, to the extent the tax-exempt parent is investing in a taxable for-profit subsidiary, the parent should be mindful of the rules for prudent investments (Uniform Prudent Management of Institutional Funds Act, and, if a private foundation, Section 4944 of the Code) and may wish to consider whether the investment would constitute a program-related investment (again, under UPMIFA or Section 4944).

[82] Additionally, use of a subsidiary in this fashion avoids exposing the parent to loss of exempt status for flow through of any unrelated business activities from the partnership so long as the subsidiary has an authentic business purpose and separateness is maintained. *See, e.g.*, TAM 8939002.

G. DISTRIBUTION/LIQUIDATION ISSUES

At the opposite end of the spectrum of capitalizing the entity is winding down the subsidiary. To the extent the subsidiary is a tax-exempt organization, winding down is relatively straightforward. The subsidiary follows the rules set out in the Business Organizations Code (assuming it is a nonprofit corporation) by adopting a plan of dissolution that is followed by returning contributions held on condition of return and then transferring assets to one or more tax-exempt organizations. Typically, this will mean transferring the assets from the subsidiary to the parent tax-exempt organization. To the extent the subsidiary holds restricted funds and the parent will not be in a position to satisfy the restrictions, the subsidiary will need to seek release of the restrictions under Section 163.0007 of the Texas Property Code (the UPMIFA provisions for release or restrictions) or seek modification of the restriction from a court under Section 112.054 of the Texas Property Code pursuant to the doctrines of *cy pres* and/or equitable deviation.

In the event the subsidiary is a taxable corporation, Sections 336 and 337 of the Internal Revenue Code will require the subsidiary to recognize gain or loss when the appreciated or depreciated property is distributed in complete liquidation or sold in connection with complete liquidation. This results in tax being paid at the subsidiary level. To the extent the subsidiary is a pass-through organization (partnership or LLC taxed as a partnership), liquidation is generally a non-taxable event.[83]

In addition to the issues addressed above, the tax-exempt parent should ensure that the subsidiary's debts have been paid or provision has been made for those debts so that the distribution may not be tracked back to the parent entity under the Texas Uniform Fraudulent Transfer Act.[84]

VI. MANAGING THE RELATIONSHIP

Regardless of the choice of form used for the subsidiary, it is imperative that the relationship be maintained between the parent and the subsidiary in such a way as to demonstrate the separateness of the two organizations. This factor is critical both for tax purposes (ensuring that the activities of the subsidiary are not attributed to the parent) as well as for liability purposes (avoiding having the corporate veil pierced). While Texas law has a high standard for piercing the corporate veil for contractual obligations or liability resulting from contractual obligations, there are a number of factors that come to play for purposes of demonstrating a bona fide business purpose for tax purposes as well as for piercing the corporate veil in the tort context. Accordingly, tax-exempt organizations looking to establish separate subsidiaries are well-advised to consider the following factors:

1. Transactions between the parent and the subsidiary should be at arm's-length;

[83] *See* IRC § 731(b).

[84] *See, e.g.,* Tex. Bus. &. Com. Code § 24.006(a) (allowing a creditor to pursue recovery against a shareholder receiving a distribution from an insolvent corporation).

2. The exempt organization parent may provide space to the subsidiary; if the subsidiary is tax-exempt, the space may be provided at cost or as a donation, whereas if the subsidiary is a taxable corporation the parent should receive fair market value for the space;

3. The exempt organization parent may furnish intellectual property (including use of the parent's name or mailing lists) either as a capital contribution or through a licensing arrangement (keeping in mind the rules regarding the exception to the general unrelated business capital income rules);

4. The exempt parent may furnish all of the subsidiary's capital as equity contributions (keeping in mind the rules regarding prudent investing for taxable corporations);

5. The parent exempt organization and the subsidiary organization should have separate bank accounts and separate books, avoiding the comingling of funds;

6. 100% overlap of the two boards should be avoided to allow each board to focus on the specific delineated purposes of the organization satisfying his or her fiduciary duties to such organization and to allow independent directors to be in a position to avoid conflict of interest transactions with the other organization;

7. Ideally, officers should not be the same; particularly, one person is not the CEO of both organizations;

8. Officers of the subsidiary should report to the subsidiary's board of directors/board of managers;

9. The subsidiary's board of directors and officers should control the operations of the subsidiary (if the subsidiary is an LLC, this falls to the managers or the member acting in a member-managed organization);

10. With respect to employees, the employees of the parent may provide services to the subsidiary, though such services should be provided pursuant to an arms-length written administrative services agreement that requires reimbursement to the parent of the cost of such services (note: if the parent makes a profit on this, there could be UBI implications);

11. To the extent employees are working for both organizations, detailed time records must be kept to ensure that each organization is paying its proportionate share of the costs of the employee;

12. The subsidiary should have reasonable capitalization to be able to meet its day-to-day needs and expenses and any liabilities for the actions it is undertaking (including both cash assets as well as other assets of the subsidiary, along with insurance to cover the subsidiary's operations);

13. The organizations should have separate board meetings and keep separate minute books; and

14. The two organizations should seek to make it clear to third parties that the two organizations are separate, which is best accomplished through clarity when signing agreements, letterheads, and business cards that show the separate identities of the two parties.

To accomplish the arm's-length transactions and to document satisfaction of the above factors, the tax-exempt parent and its subsidiary (whether taxable or tax-exempt) should document their relationship through written services agreements, licensing agreements, employee sharing agreements, facility usage agreements, etc. (as may be applicable).

VII. CONCLUSION

While there are good reasons to consider creating separate or subsidiary organizations to carry out activities for a tax-exempt organization, undertaking this type of venture should not be done without careful planning. A tax-exempt organization must understand the options available and the implications of choosing an option on its federal tax exempt status, the generation of unrelated business income, and its potential liability for the activities of the separate entity. The planning process should include the creation of a business plan that shows the need for the organization, demonstrates how the organization will be capitalized to meet those needs, and plans for maintaining the separateness of the organization. Once the organization is created, that separateness should be maintained to avoid risks to the tax-exempt parent and its assets.

VIII. FURTHER READING

BRUCE R. HOPKINS, PLANNING GUIDE FOR THE LAW OF TAX-EXEMPT ORGANIZATIONS: STRATEGIES AND COMMENTARIES, John Wiley & Sons, Inc. (2004).

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