Alternative Operating Structures, Governance Best Practices and Fraud Risk Management

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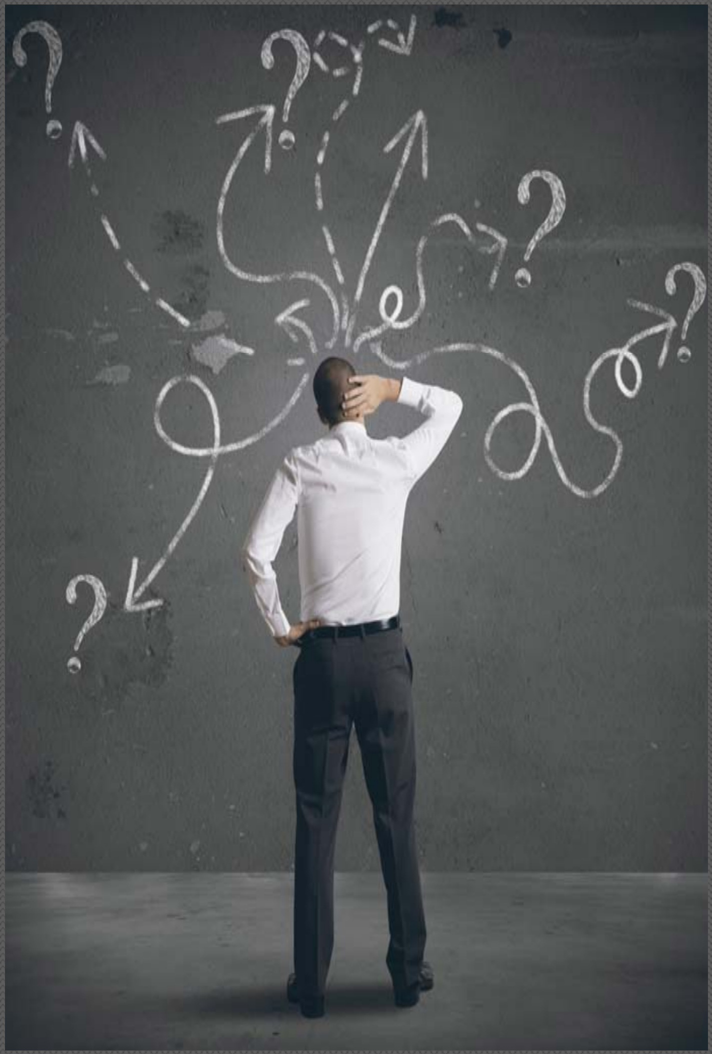
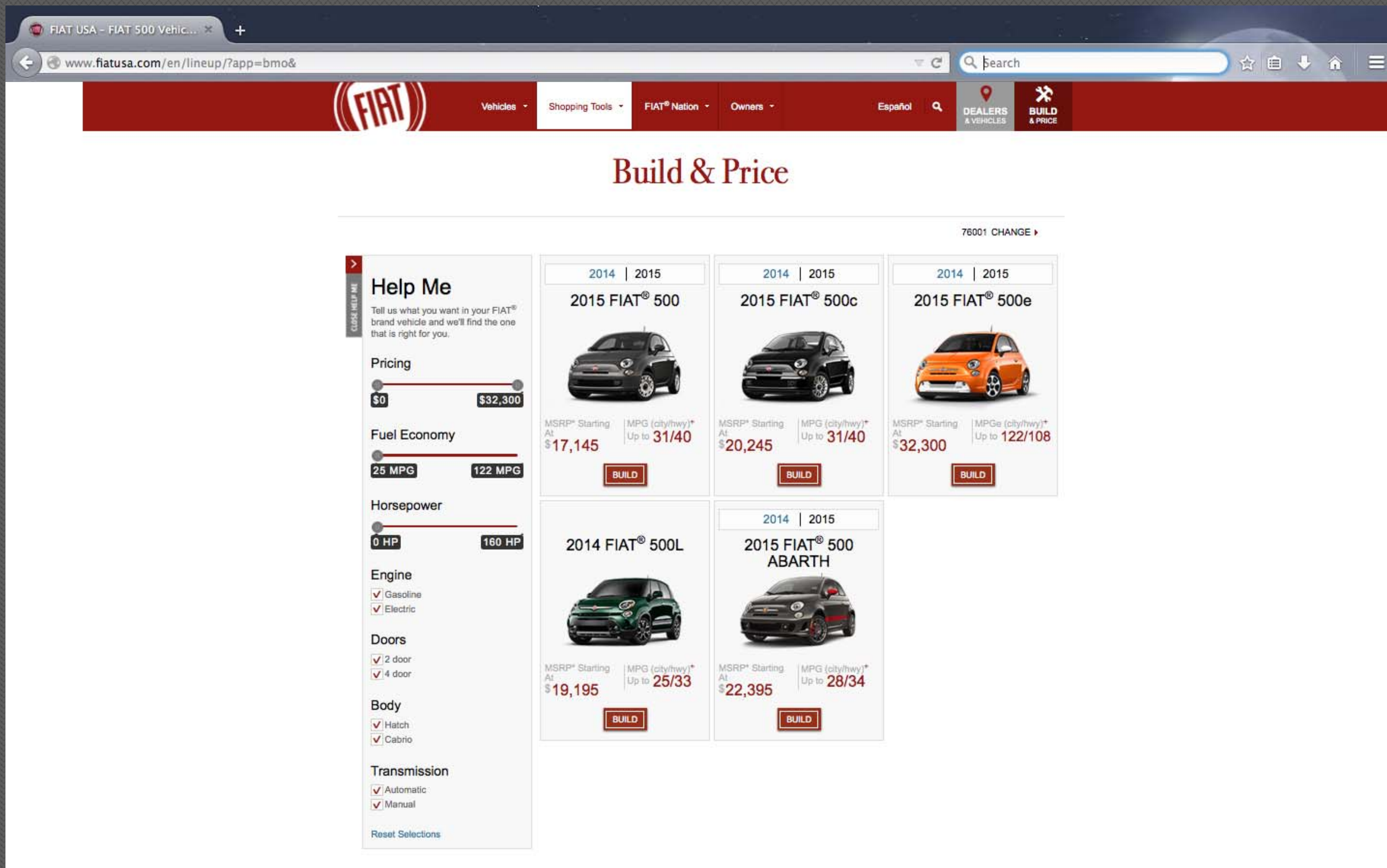
Enterprise Structure

- New/Expanding Business Activity
- Liability Concerns
- Management
- Other Reasons



See Paper, Section II, Page 1

Choices, choices . . .



- See Paper, Section III, Page 3

Options We'll Explore

1. Nonprofit Corporations
2. For Profit Corporations
3. Partnerships (General and Limited)
4. Limited Liability Companies

Hybrids: L3C's and Benefit Corporations???

See Paper, Section III, Page 3

An Initial Inquiry: Tax-Exempt?

1. Is there a tax-exempt purpose?
2. Will the organization be involved in substantial lobbying/political intervention?
3. Where will capitalization come from?
4. Is there an expectation of building an asset that can be sold?

- See Paper, Section IV, Page 10

Considerations in Selecting the Vehicle

- Impact on Exempt Status of the Owner/Parent
- Unrelated Business Taxable Income Issues
- Control and Management
- Owner/Parent Liability
- Managing the Relationship

See Paper, Section V, Page 10

Impact on Exempt Status of Owner/Parent

- Flow through entities create most concern
  - Aggregate approach:
    - Rev. Rul. 98-15
- Corporate entities generally not a concern
  - Exercise caution if parent is a private foundation

See Paper, Section V.A., Page 10

EO as GP/Managing Member

- Key Consideration: Must *not* lose control of charitable assets
  1. Is the EO's participation substantially related to its exempt purposes?
  2. Does the structure of the venture avoid conflicts between the EO's purpose and the EO's duty to further the private interests of non-exempt partners?

- See Paper, Section V.A., Page 10

EO Control of Charitable Assets: Favorable Factors

1. Limited contractual liability of exempt partner;
2. Additional GP's/managers obligated to protect interests of non-exempt partners;
3. Lack of control by non-exempt partners except during start-up (EO has control over major decisions);
4. Absence of obligation to return non-exempt's capital from EO funds;
5. Arm's length transactions with partners;
6. Management contract, if any, terminable for cause; has a limited term; renewal only on agreement; management by a party with independent activities

- See Paper, Section V.A., Page 10

EO Control of Charitable Assets: Unfavorable Factors

1. Disproportionate allocation of profits and/or losses in favor of non-exempt organizations;
2. Commercially unreasonable loans by EO to partnership;
3. Inadequate compensation received by EO for services it provides; excessive compensation paid by EO for services it receives;
4. Control of EO by non-exempt partners/lack of sufficient control by EO to ensure exempt purposes pursued;
5. Insufficient capital contribution by non-exempt partners;
6. Guarantee of non-exempt partners tax credits or ROI to detriment of exempt organization.

See Paper, Section V.A., Page 10

UBTI Considerations

- Flow through entities: Unrelated income flows through to exempt partner
- Corporate entities: Taxed at C corp level; passive payments to EO deductible by C corp and not taxable to EO

unless

- C corp is controlled by EO:
  - 512(b)(13) alters general UBTI rule re passive income (other than dividends)

See Paper, Section V.B., Page 14

Controlling the Vehicle

- Control the vehicle through control of management
  1. Nonprofit corporation: board of directors or members
  2. For profit corporations: board of directors or shareholders
  3. General partnership: general partners (equal rights of management unless partnership agreement says otherwise)
  4. Limited Partnership: General partner
  5. Limited liability company: Managers or members

See Paper, Section V.D., Page 15

Owner Liability for Vehicle

Texas law is very protective of the <u>corporate</u> veil

- Contractual obligations: alter ego/sham to perpetrate a fraud require *actual fraud* for direct personal benefit of shareholder
- Torts: injustice or inequity will result if separate corporate existence is recognized
  - Avoid complete overlap of governing persons
  - Ensure arms-length dealings
  - Appropriately capitalize the subsidiary
  - Don’t commingle funds

See Paper, Section V.E., Page 17

Maintaining the Vehicle: Controlled but Separate

- Subsidiary reasonably capitalized (parent may capitalize through equity contributions);
- Arm's-length transactions (leases, services agreements);
- Separate bank accounts and books;
- Avoid 100% overlap of the boards and officers;
- Officers of the sub report to sub's board who control sub;
- Make clear to third parties that the organizations are separate:
  - Clarity when signing agreements; separate letterhead; business cards that show separate identities

See Paper, Section VI, Page 22

Vehicle Safety vs. Driver Safety