COMMERCIAL ACTIVITIES AND SUBSIDIARIES: ISSUES AND CHOICES IN PLANNING

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State Bar of Texas
15TH ANNUAL
GOVERNANCE OF NONPROFIT ORGANIZATIONS
August 24-25, 2017
Austin

CHAPTER 11

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TABLE OF CONTENTS

COMMERCIAL ACTIVITIES AND SUBSIDIARIES: ISSUES AND CHOICES IN PLANNING[1]

I. INTRODUCTION

Entrepreneurship has found an expression in philanthropy. Social entrepreneurship, venture philanthropy, cause-related marketing, corporate sponsorships, social impact bonds, and impact investments are all tools being used to varying degrees within the sector as tax-exempt organizations look for ways to become more self-sustaining in an age of budget cuts. Regardless of the motivation for engaging in these activities, there is an overarching legal issue that must always be considered: "How will this impact our exempt status?"

The answer to that question then informs strategies regarding the structure of the activity-whether it should it be spun off into a subsidiary, the method of operations, what types of fees should be charged, what type of advertising should be pursued, and other similar questions. Along with these determinations, the entity will consider ways to make itself more attractive to lenders and/or investors interested in more than a financial return on their investment and where to find these investors. The discussion below highlights the major legal issues to be analyzed and the structural concerns to be addressed to put the organization in a position to pursue its income-generating strategies in a legally compliant manner.

II. QUALIFICATION FOR TAX-EXEMPT STATUS

Approaching strategies in a legally compliant manner begins with consideration of the core elements that must be satisfied for an organization to maintain its tax-exempt status.

A. Organizational test.

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure, must be organized and operated exclusively for appropriate exempt purposes (religious, charitable, scientific, educational, etc.), must not allow its assets to inure to the benefit of insiders, and must avoid substantial lobbying and political intervention.[1] Pursuant to Reg. 1.501(c)(3)-1(b)(1)(i), an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities that are not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose.[2] Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the federal government, or to a state or local government, for a public purpose.[3]

B. Operational test.

For purposes of the operational test, an organization must show that it is (or will be) operated exclusively for exempt purposes.[4] In this context, the word "exclusively" means "primarily."[5] Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in the relevant section of the Code (for purposes of this article, Section 501(c)(3)). [6] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[7] The purpose(s) of the organization must be closely evaluated to determine whether they are exempt and, if non-exempt, whether the non-exempt purpose is substantial. A single non-exempt purpose, if substantial, destroys eligibility for exemption.[8] In determining whether an organization is operated to further a substantial non-exempt purpose, the decision-maker looks to the purposes furthered by an organization's activities rather than the nature of those activities.[9] As one court noted: "[u]nder the operational test, the purposes towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a).... [I]t is possible for ... an activity to be carried on for more than one purpose.... [T]he critical inquiry is whether ... [an organization's] primary purpose for engaging in its ... activity is an exempt purpose...."[10]

The fact that an organization engages in a trade or business does not result in denial of tax-exempt status if the trade or business is in furtherance of such organization's exempt purposes.[11] The question is whether the trade or business is pursued in furtherance of the organization's purposes. If the trade or business is unrelated to the organization's purposes (i.e. not pursued in furtherance of those purposes) and is a substantial activity, the organization would not be entitled to exemption.[12] This primary purpose test, as it relates to the conduct of a trade or business, is further influenced by the commerciality doctrine discussed below.

[1] This paper originally appeared as an article in Taxation of Exempts, Volume 28, Number 4 and is reprinted here with permission.

The regulations further provide that in order to be organized and operated for one or more exempt purposes, the organization must serve a public rather than a private interest.[13] An organization will be found to serve primarily a private interest, as opposed to a public interest, unless the private interest served is merely incidental to the public interest.[14] Whether the private interest is incidental to the public interest is determined on a case-by-case basis depending upon the nature of the activities undertaken and the manner by which the public interest is derived.[15] Any private interest must be incidental to the public interest both quantitatively and qualitatively.[16] To be qualitatively incidental, "the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals."[17] To be quantitatively incidental, the activity must not provide a substantial benefit to a private person in the context of the overall benefit conferred by the activity to the public.[18] For example, with respect to educational organizations, the dissemination of information and/or training of individuals serve a public interest by increasing the capabilities of those receiving instruction which thereby serves to better the public welfare. Although all educational activities result in private benefit (i.e. students at any school at any level are necessarily benefited), such private benefit is incidental; the ultimate benefit is to the public, absent the educational focus being to train students for a single employer.

C. No private inurement.

Within this broad concept of a prohibition on private benefit is the doctrine of private inurement. The private inurement doctrine is meant to ensure that a tax-exempt organization's "insiders" (i.e. persons in a position to influence the organization's affairs) do not use such position to siphon off any of a charity's income or assets for personal use. Common cases of private inurement revolve around payment of excessive compensation, certain rental arrangements, certain lending arrangements, and the sale of assets for more than fair market value to the organization.

There is an absolute prohibition on allowing assets to inure to the benefit of the organization's insiders.[19] "Insiders" include the organization's founders, directors, officers, key employees, and members of the families of these individuals, as well as certain entities controlled by these individuals.[20] If such action occurs, the Service may revoke the organization's tax-exempt status. However, as an alternative measure in the context of public charities and social welfare organizations, the Service can impose intermediate sanctions, with excise taxes assessed directly against the insiders and other decision makers who approved the transaction in question.[21] For example, suppose an insider were paid an excessive salary. Rather than revoke the organization's tax-exempt status (which would be within its purview), the Service could assess an excise tax sanction against the insider. This would equal 25% of the excess benefit (which, if not corrected in a timely manner, will result in a second tier tax of 200% of the excess benefit), as well as excise tax in the amount of 10% of the excess benefit (not to exceed $20,000) imposed against decision makers of the charity who knowingly participated in the transaction.[22]

D. Not an action organization / not against public policy.

An action organization-that is, an organization that is attempting to influence legislation by propaganda or otherwise in a more than insubstantial manner, or an organization intervening for or against a candidate for elective public office-is ineligible for exemption as it is not operated exclusively for exempt purposes.[23]

Finally, case law has added to the foregoing elements the requirement that an organization must not be in violation of public policy in order to qualify for exempt status.[24]

E. Commerciality concerns.

While it is well recognized that unrelated business activities can generate unrelated business taxable income and potentially risk exempt status, even related business activities can at times prove problematic. If a related business is undertaken in a way that the Service deems to have a "distinctively commercial hue," the organization may risk its exempt status.[25] The terminology of an organization having a "distinctively commercial hue" is most often referenced in the context of the commerciality doctrine-a non-Code doctrine examining whether an organization operating a business is truly doing so in furtherance of an exempt purpose.[26]

The commerciality doctrine uses a counterpart analysis. Among the factors considered are whether the organization sells goods and services to the public for a fee, whether the organization is "in direct competition" with for-profit organizations, whether the organization set prices based on pricing formulas common in the industry, whether the organization utilizes promotional materials normally utilized by for-profit organizations, whether the organization advertises its services in a commercial manner, whether the organization has activities and hours that are basically the same as for-profit enterprises, how the organization calculates payment for its management, and whether the organization receives charitable contributions.[27]

For example, in *Easter House*, the Claims Court considered qualification for exemption of an adoption agency.[28] After reciting the operational test, the court

noted that "the key to determining whether an organization, which at first blush might appear to be engaged in commercial activities that would disqualify it from exemption under section 501(c)(3), is qualified for exemption is whether the business purpose of the activities is incidental to the charitable purpose or vice versa."[29] In agreeing with the Service and finding that the business purpose was primary, the court noted the agency's competition with commercial adoption agencies, the accumulation of substantial profits, a fee schedule intended to derive a profit, and a lack of any support from solicitations.[30]

Likewise, in a case frequently cited in the commerciality area, the Seventh Circuit affirmed the determination of the Service and the holding of the Tax Court in holding that an organization operating restaurants and health food stores ostensibly for the purpose of furthering the religious work of the Seventh-Day Adventist Church did not qualify for exemption.[31] There, the court explained that, in considering the effect of substantial commercial purposes on qualification for exemption, a court looks to "various objective indicia" including the "manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits...."[32] The Seventh Circuit noted that the entity was in direct competition with other restaurants, had a price structure set competitively with other businesses and a lack of any below-cost pricing, used promotional materials to enhance sales, and lacked any plans to solicit contributions.[33] Noting that the corporation did not accumulate net profits, the court considered that but one factor that was outweighed by the other "indicia" of commerciality.[34]

In *Airlie Foundation*,[35] the district court for the District of Columbia agreed with the Service that the subject organization failed to qualify for exemption as its activities evidenced a primary commercial purpose. The organization was organized for educational purposes and carried out its mission through organizing, hosting, conducting, and sponsoring educational conferences.[36] The organization additionally provided certain administrative support for environmental studies conducted at its facility. In clearly setting out the commerciality doctrine, the court stated that "[i]n cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose."[37] The court analogized the facts in *Airlie* to the organization in *BSW Group*, noting that the organization did not directly benefit the public (rather, it benefited other organizations that benefited the public) and did not limit its activities to tax-exempt organizations.[38] The court balanced the entity's fee structure and its willingness to subsidize certain attendees (both indicative of a non-commercial purpose) against the nature of the entity's clients (both taxable as well as tax-exempt), competition with commercial organizations, advertising expenditures, and significant revenues derived from weddings and special events, ultimately determining that the entity was organized for a substantial commercial purpose.

While the commerciality doctrine is not new, the continuing increase in charitable organizations seeking sustainability through commercial activities, or seeking to operate as social enterprises, has given the commerciality doctrine increased exposure. While greater license may be given to tax-exempt organizations operating social enterprise subsidiaries, it would be unwise to ignore the application of the commerciality doctrine altogether in this context.[39] There is a clear tension that exists between a doctrine that seeks to define charity as acting in a non-commercial manner and the idea of social enterprise, which involves charitable purposes achieved directly through commercial activities. Because the commerciality doctrine is court-created rather than legislatively crafted, no bright line or safe harbor exists to guide the charitable entrepreneur.

The Tax Court has made clear that in determining whether an organization is operated to further a substantial non-exempt purpose, the decision maker is to look to the purposes furthered by an organization's activities rather than the nature of those activities.[40] As a commentator has recently pointed out in this journal, the commerciality doctrine, in looking at the manner in which an organization carries out its activities in order to determine purpose, sets up a logical fallacy where purpose is the lens through which activities are viewed, yet those same activities somehow serve as an indication of purpose.[41] This circular argument is exemplified by the decision in *Living Faith*, in which the court initially noted that it must "focus on 'the purposes toward which an organization's activities are directed,' and not the nature of the activities" but subsequently stated that "[a]n organization's activities ... determine entitlement to tax exemption," and that "[w]hile 'the inquiry must remain that of determining the purpose to which the ... business activity is directed,' the activities provide a useful indicia of the organization's purpose or purposes."[42]

This type of ambiguity creates uncertainty and can lead to disparate results. No clear guidance exists to allow an organization comfort that its operations will show that its charitable or other exempt purpose trumps profit making. Indeed, in the hospital context (another situation in which taxable and tax-exempt organizations exist in the same sector), Congress enacted rules setting forth specific areas in which hospitals must provide demonstrable evidence that charitability trumps profit.[43] Outside of the hospital

context, however, exempt organizations are left with the commerciality doctrine, discussions of a "commercial hue," and trying to ascertain indicia of commerciality. Rather than exist in this state of unknown, organizations at risk of violating the commerciality doctrine may choose to spin such activities off into a taxable subsidiary or related organization to avoid such risk.

III. UNRELATED BUSINESS TAXABLE INCOME ISSUES

Assuming an organization is organized and operated for an exempt purpose but also has one or more activities that do not further the exempt purpose, the charity must analyze whether and to what extent it will be subject to the unrelated business income tax and, further, whether pursuit of the unrelated activities will endanger the charity's exempt status.

A. General rules.

As addressed above, organizations that are exempt from federal income tax under Section 501(c)(3) may engage in business operations. 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. If a Section 501(c)(3) organization engages in unrelated business activities, the organization must be cognizant of the generation of unrelated business taxable income (UBTI), including analyzing any exceptions or exclusions that may apply. The organization must take care that such activities do not negatively affect its exempt status by allowing the unrelated business activities to become so substantial they demonstrate the existence of a substantial non-exempt purpose or otherwise far outpace the charity's exempt activities (as discussed below).[44]

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.[45] Section 512(a)(1) defines the term "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions or modifications. Section 513(a) defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the function constituting the basis for its exemption. Reg. 1.513-1(d)(2) states that a trade or business is "related to exempt purposes of the organization" only where the conduct of the business activities has a causal relationship to the achievement of the exempt purposes. Further, the trade or business is "substantially related" only where the causal relationship is substantial.[46] For the causal relationship to be substantial, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes. Whether the income producing activities contribute importantly to the accomplishment of a purpose for which an organization has been granted exemption depends in each case upon the facts and circumstances involved.

In *Industrial Aid for the Blind*,[47] the organization oversaw operations that included the manufacture of products by blind individuals and the selling of such products. The court determined that sale of products was an incidental activity to the sole purpose of providing employment opportunities to blind individuals. As a result, the activity was substantially related and the income derived therefrom did not constitute unrelated business taxable income.

In Rev. Rul. 76-37,[48] the Service dealt with an organization that operated a business of building and selling homes as part of its purpose of providing vocational training for students. Seventy percent of the building was performed by the students and, as a result, the homes were products of the exempt functions. The homes were built only on an as-needed basis for the training program. As a result, the Service held that the income was not UBTI because the activity contributed importantly to the organization's exempt purpose and was conducted on a scale no larger than reasonably necessary to perform the organization's exempt functions.

In Rev. Rul. 73-128,[49] the organization manufactured and sold toy products, hiring unemployed and underemployed individuals to create the products. The Service held that because there was a clear and distinct causal relationship between the activity and training of employees for the purpose of improving individual capabilities, and because there was no evidence that the activities were being conducted on a larger scale than necessary, the resulting gross income did not constitute unrelated business taxable income.

In Rev. Rul. 76-94,[50] the organization operated a grocery store as part of a therapeutic program for emotionally disturbed adolescents. The store was operated at a scale no larger than reasonably necessary for training and rehabilitation of the adolescents and was staffed in large part by the adolescents in the rehabilitation program. For these reasons, the Service held that the activity was substantially related to the organization's exempt purposes and, therefore, the gross income resulting from the activity was not unrelated business taxable income.

In comparison, in Rev. Rul. 73-127,[51] the organization operated a grocery store to sell food to residents living in an impoverished area at lower

prices, providing free grocery delivery service, and participating in the federal food stamp program while also providing limited job training for unemployed residents. The Service considered the grocery store operation to be conducted on a larger scale than reasonably necessary to perform the organization's training program and exempt functions, noting that only approximately 4% of the store's earnings were allocated to the training program. Moreover, the store was operated similarly to for-profit businesses in the area, and operation of the store and operation of the training program were distinct purposes of the organization. As a result, the income from the store was considered unrelated business taxable income.

A state university owned and operated a multipurpose auditorium on campus, where both school-related activities as well as outside activities (such as rock concerts, professional basketball games, and professional entertainment events) were held.[52] The Service considered whether income from such ticketed events (i.e. those that were not school-related activities) constituted unrelated business taxable income.[53] The Service noted that the fees charged to the general public were comparable to those charged by commercial facilities and that discounts or free admissions were generally not provided to students. Further, the university's fine arts department was not involved in the selection of or performance of the events, and the entertainers received essentially the same compensation as they would at a for-profit facility. The Service determined that the organization's reputation as an educational institution was of secondary importance, if a factor at all, in attracting attendees. Because the university negotiated with the performers for the amount of their compensation, and because the contract included a non-compete clause (i.e. no performance within a specifically defined and negotiated amount of time before or after in the immediate geographic vicinity), the Service noted that the predominant motivation underlying the organization's conduct of the activity appeared to be revenue maximization. Noting that the only criterion used by the university in its sponsorship of professional entertainment events was profitability, the Service determined that the emphasis on revenue maximization to the exclusion of other considerations indicated that trade/business was not operated as an integral part of the university's educational programs and therefore was not substantially related to such exempt purposes.

B. Exceptions/modifications.

Unrelated business taxable income does not include income from: (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 Section 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 the organization as donations (the "thrift shop exception").[54] Income and deductions applicable to unrelated business income are subject to additional modifications.[55]

In addition to the exceptions from unrelated business taxable income, certain items of income are excluded altogether. Pursuant to Section 512(b), certain passive income including dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, and certain income from research are excluded from taxation.[56]

C. Passive income from controlled entities.

In the category of there being an exception to every rule (or an exception to every exception in this instance), it must be noted that passive income received from a controlled corporation will be taxable to the extent the controlled organization reduces its taxable income by making deductible payments of such passive income to the parent charitable organization.[57] Even to the extent the controlled organization is a Subchapter C corporation that is taxed on its net income, Section 512(b)(13) will continue to apply with the rule being applied as if the entity were exempt for purposes of determining whether or not the payments to the parent charitable organization will be UBTI.[58] In other words, to the extent the controlled subsidiary reduces its taxable income as a result of taking a deduction for a "specified payment" (interest, annuity, royalty, or rent), the receipt of such passive income from the controlling parent will no longer be free of UBTI.[59] It should be noted that dividends are not specified payments under Section 512(b)(13), as dividends are not deductible to the controlled subsidiary. For purposes of Section 512(b)(13), control means that the parent controls 50% or more of the subsidiary by vote or value.[60] Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[61]

D. Commensurate-in-scope test.

The generation of UBTI is a common and acceptable practice for tax-exempt organizations. However, where a Section 501(c)(3) organization engages in unrelated business activities, the organization must take care that it does not negatively affect its exempt status by allowing such unrelated business activities to become substantial.[62] There is no bright line "upper limit" on the amount of UBTI an

organization may generate. As UBTI grows, however, it raises the question as to whether the unrelated business has become a substantial purpose of the organization.[63] 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 and the resulting income generated may be indicative of a substantial non-exempt purpose. As UBTI grows, the Service will examine whether an exempt organization's exempt activities and expenditures are "commensurate in scope" with its financial resources resulting from its business activities.[64]

The commensurate-in-scope test was first set forth by the Service in Rev. Rul. 64-182.[65] The short 1964 ruling involved a charitable grant-making organization whose income primarily came from rental proceeds. According to Rev. Rul. 64-182, a charitable organization that receives a significant amount of unrelated business income faces the question of whether the charitable activities carried out by the organization are "commensurate in scope" with its financial resources, including the unrelated business income. Said differently, according to Rev. Rul. 64-482, the question is not strictly speaking what percentage of revenue generated by the organization is unrelated business income. Rather it is whether, considering the financial resources of the organization, the extent of the charitable operations (judged by such factors as time, effort, impact, and use of after-tax unrelated business income) of the organization are appropriate.[66] 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.[67] Notwithstanding that the commensurate-in-scope test seems to allow a charitable organization to receive any amount of its revenue from unrelated business income, a charity should be concerned as its unrelated business income grows about whether the activity generating the unrelated business income will be characterized as a substantial non-exempt purpose, thereby threatening the exempt status of the organization. This concern is exacerbated by the lack of a bright line or any clear application of the commensurate-in-scope test. 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 the material on Choosing to Use a New Entity for Commercial Activities, below, this type of "spin-off" frees the organization from generating unrelated business income and insulates against the potential risks to its exempt status.

E. Cause-related marketing and corporate sponsorships.[68]

Broadly speaking, cause-related marketing includes situations in which a charity licenses its name or other intellectual property to a for-profit entity to be used in marketing the for-profit entity's products or services.[69] Frequently, this is seen in the context of an entity marketing its products or services by informing consumers that a portion of the proceeds will be paid over to the charity.[70] Corporate sponsorships, on the other hand, involve a for-profit organization providing funding to the charitable organization with the charity providing acknowledgement or recognition ranging from a "mere acknowledgement" to a substantial return benefit in the form of advertising.[71] As a result of this continuum, sponsorship payments must be analyzed to determine what, if any, portion of the sponsorship payment is subject to the unrelated business income tax.

1. Percentage of sales marketing.

One of the more popular forms of cause-related marketing involves a for-profit organization pledging a percentage of sales, revenues, or profits to a charity. Many states regulate this type of commercial co-venture activity as a form of consumer protection and some states additionally require registration.[72] Generally, the relevant regulations apply to the commercial co-venturer and require that entity to register with the state. Not all states have a commercial co-venturer registration requirement; therefore, the practitioner should verify the states in which the products will be marketed. Where states do have such requirements, care should be taken to ensure that any contract between the charity and the for-profit organization satisfy any requirements under state law for the for-profit co-venturer. However, this type of activity also implicates unrelated business taxable income concerns for the charity.

When appropriately structured, licensing arrangements allowing a for-profit organization to sell products or services in connection with the charity's intellectual property will be considered a royalty, and therefore excludable from UBTI as passive income.[73] A royalty is defined as a payment for the use of a valuable intangible right, such as a trademark, trade name, service mark, logo, or copyright, regardless of whether the property represented by the right is used.[74] Whether the royalty is structured as a percentage of sales, a flat fee, a percentage of sales with a minimum contribution, or a percentage of sales with a cap (or something different altogether), the question is whether the payment is for the use of the valuable right of the charitable organization, typically the charitable

organization's intellectual property in the form of its name and/or logo.[75] Critical to note, however, is that a royalty is passive and cannot include payments for services rendered by the owner of the property.[76] Thus, if the charity performs more than insubstantial services in connection with the license, the income received is considered compensation for personal services and the royalty exception would not apply (thus, likely incurring UBTI).[77] If the organization merely retains the right to approve the quality or style of the licensed products, such quality control rights do not cause the license payments to lose their characterization as royalties.[78] Personal appearances, endorsements, interviews or active participation in publication of a periodical are not considered passive or de minimis. Taking an active role in connection with the license will disallow royalty income treatment.[79]

The charity should ensure that it has quality control rights with respect to the use of its intellectual property, the ability to ensure that fundraising activities are done in a legally compliant manner, the ability to withdraw from the relationship if the charitable organization determines it needs to do so (particularly for purposes of protecting its reputation or exempt status), and the ability to audit the fundraising account(s) held by the commercial co-venturer. However, because of the rules related to the provision of services in the context of unrelated business income, the charity should otherwise seek to be passive so as to ensure that the payments to the charity constitute royalties that are not subject to the tax on UBTI. This tension between "active" involvement and being passive should be considered and appropriately documented as part of negotiating the contract but must also be carefully considered during the term of the contract.

Finally, in addition to the UBTI concerns addressed above, the minimal quality control rights are important to the charity's protection of the use of its name and logo by the corporate partner. At the same time, however, this presents a double-edged sword. The charity could be held responsible for the impressions the marketing may leave in the minds of consumers, through its approval of the placement of its name and logo on the sponsor's product.[80] If the charity's name and logo are used in such a way as to give consumers the reasonable impression that the charity endorses the product, the charity may be deemed to be receiving taxable income from advertising merely due to that *apparent* endorsement.

2. Qualified sponsorship payments vs. advertising.

The receipt of qualified sponsorship payments by a charity is specifically excluded from constituting income from an unrelated trade or business, such that this activity does not incur unrelated business income tax, but is instead treated as a charitable contribution to the charity.[81] A "qualified sponsorship payment" is defined as any payment made by any person engaged in a trade or business with respect to which there is *no arrangement or expectation* that the maker of the payment will receive any substantial return benefit, other than the use or acknowledgement of the name, logo, or product lines of that donor's trade or business in connection with the charitable activities of the exempt organization.[82]

A "substantial return benefit" draws the line between an acceptable sponsorship payment and a potentially taxable payment of money or property. This term is defined as any benefit other than (1) the use or acknowledgement of the corporate sponsor or (2) certain disregarded benefits, the fair market value of which does not exceed 2% of the corporation's total payment to the charity.[83] "Benefits" may be in the form of advertising, exclusive provider arrangements, goods, facilities, services, other privileges, or the rights to use an organization's intangible asset, such as a trademark, logo or designation. Under the 2% rule, if the value of the benefit to the payor corporation is 2% or less of the total amount of the sponsorship payment, then the benefit is completely disregarded and the entire payment is considered a qualified sponsorship payment.[84] If the fair market value of the benefit exceeds 2% of the payment, however, then except to the extent that a portion of the benefits are considered a use or acknowledgement, the entire fair market value of the benefit is considered a substantial return benefit.

A use or acknowledgement of the corporate sponsor is not considered a substantial return benefit and thus will come within the exception for qualified sponsorship payments.[85] A mere "use or acknowledgement" may include: (1) exclusive sponsorship arrangements; (2) logos and slogans that do not contain qualitative or comparative descriptions of the corporation's products, services, facilities or company; (3) a list of the payor's locations, telephone numbers, or internet address; (4) value-neutral descriptions, including displays of the payor's product line or services; or (5) the payor's brand names and product or service listings. Logos or slogans that are an established part of the company's identity are not considered to contain qualitative or comparative descriptions.[86]

For example, an exempt organization that organized an amateur sports team entered into a sponsorship agreement with a pizza chain, under which the pizza chain gave the charity uniforms for the members of its team, including the pizza chain's name and logo, and paid for some of the team's operating expenses.[87] At the final tournament, the charity distributed complimentary souvenir flags bearing the pizza company's name and logo to the company's employees who attended the game. The use of the pizza company's name and logo was a mere

acknowledgement of its sponsorship; the flags given to the employees constituted a return benefit, but because the fair market value of those flags were less than 2% of the company's entire sponsorship payment, the entire amount of the funding was considered a qualified sponsorship payment. Similarly, the display of a sponsor corporation's latest model of cars at a charity's event, and the use of the sponsor's name in the title of the event, constitute an acknowledgement of the sponsorship.[88] However, if the charity provides complimentary admission passes and special VIP treatment to the employees of the sponsor, those passes and treatment will be considered a return benefit and will be considered substantial if their value exceeds 2% of the sponsor's total payment.

In making this determination, the Service does not consider how related the sponsored activity is to the charity's exempt purpose nor whether the sponsorship activity is temporary or permanent.[89] A qualified sponsorship payment does not include any payment, the amount of which is contingent on the level of attendance at an event or other factors indicating the degree of public exposure to the sponsored activity.[90] A payment that is determined not to be a qualified sponsorship will be treated under the general principles of unrelated business income.[91] Benefits to the corporate sponsor will be evaluated separately. For instance, payments related to the provisions of facilities or privileges by a tax-exempt organization to a sponsor or designated person, advertising, a license to use the organization's intangible assets, or other substantial return benefits, are evaluated separately in determining whether the organization must realize unrelated business income from those payments.[92]

When there are numerous forms of recognition given to the sponsoring corporation, a portion may constitute an acceptable use or acknowledgment, and another portion may constitute a substantial return benefit. If the sponsor's payment to the organization exceeds the fair market value of the substantial return benefit, the organization may treat the excess as a qualified sponsorship payment.[93] The burden is on the exempt organization to show this excess, or no portion of the payment will be treated as a qualified sponsorship payment.[94] To make this allocation, the organization must determine at the time the benefit is provided to the sponsor the fair market value of any non-monetary portion of the substantial return benefit.[95] However, when there is a written, binding sponsorship contract, the fair market value of any substantial return benefit provided pursuant to the contract terms is determined as of the date of the contract, absent a material change in the contract terms.[96] If there is a material change in the contract, including an extension, renewal or significant change in the consideration furnished, the contract is considered a new sponsorship contract as of the effective date of such change. Again, any payment or portion of a payment that is determined not to be a qualified sponsorship is evaluated under the general rules of unrelated business income.

For example, a corporation sponsored an exempt organization's annual marathon and walkathon by providing drinks and refreshments for the organization to serve to its participants.[97] The corporation also gave the organization prizes to be awarded at the event. The organization recognized the corporation's sponsorship by listing its name in promotional fliers, newspaper advertisements of the event, and on t-shirts worn by the participants. The organization also re-named the event to include the sponsor's name. These activities constituted acknowledgement of the corporate sponsorship and thus were considered neither substantial return benefits nor taxable to the organization as UBTI.

Exclusive *sponsorship* arrangements are not considered substantial return benefits. These may include an exempt organization acknowledging the corporation as the exclusive sponsor of the organization's activity, or acknowledging the corporation as the exclusive sponsor representing a particular business or industry.[98] For example, a tax-exempt organization conducting an annual college football bowl game sold the right to broadcast the game to commercial broadcasters.[99] A major corporation agreed to be the exclusive sponsor of the game. Under the contract, in exchange for a $1 million payment, the name of the bowl game was to include the corporation's name. Also, the corporation's name and logo would appear on the players' helmets and uniforms, scoreboard and stadium signs, the playing field, on cups used to serve drinks at the game, and on all printed material distributed in connection with the game. The exempt organization also agreed to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes was $6,000 and the fair market value of the advertising was $10,000. The agreement was not contingent on the number of individuals attending the game or on the television ratings. The organization's use of the corporation's name and logo in connection with the game was considered an acknowledgment of the sponsorship, and the exclusive sponsorship arrangement was not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) did not exceed 2% of the total payment (2% of $1 million is $20,000), the benefits were disregarded, and therefore the entire payment was a qualified sponsorship payment.

An exclusive *provider* arrangement, however, such as one that limits the sale, distribution, availability or use of competing services, products or facilities in connection with the organization's activity,

is not considered a qualified sponsorship. For example, a corporate sponsor would be considered to have received a substantial benefit if the organization agrees that only the sponsor's products would be allowed to be sold at the organization's event in exchange for the sponsorship payment.

Advertising is a form of a substantial return benefit that could potentially incur UBTI. Income from the sale of advertising in publications of tax-exempt organizations generally constitutes UBTI, which would be taxable to the extent it exceeds the expenses directly related to the advertising.[100] Advertising is defined as "any message or other programming material that is broadcast or otherwise transmitted, published, displayed or distributed, and promotes or markets any trade or business."[101] This would include any message containing qualitative or comparative language, price information, or other indications of savings or value, endorsements, or inducements to sell or use any company service or product. If a single message contains both advertising and an acknowledgment, the entire message is treated as an advertisement. For example, a message stating the sponsor's name, phone number and location is considered an acknowledgement, but if that same message also, in any way, prompts the consumer to choose that company over others, it will be considered an advertisement.[102] Note that in certain circumstances, it is possible to have related advertising such as by "coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments."[103]

The posting of a link to the contributor's Web site constitutes an acknowledgement of its sponsorship;[104] however, there continues to be uncertainty as to the treatment of other Web-related items such as flashing banners and items that could be seen as an endorsement. A moving banner may be more likely to be considered taxable advertising, as it could be seen to be more promotional than a simple link.[105] Where the regulations leave open the distinction between advertisements and allowed uses and acknowledgements, the courts may be inclined to take a more strict (possibly more common sense) approach and consider a message to be an advertisement if it merely *looks* like an advertisement or if it is possible for a consumer to view it as an endorsement.[106] The sponsorship rules unfortunately were not designed with these Web activities in mind, so they do not provide a more nuanced approach, such as addressing whether the charity's motivation in providing a link should be considered in determining whether the charity is promoting the sponsor's products or services.[107]

IV. CHOOSING TO USE A NEW ENTITY FOR COMMERCIAL ACTIVITIES

There may come a time when circumstances suggest a substantial reorganization. This may result from the nature of the organization's activities (for example, excessive UBTI, commerciality concerns, or engaging in prohibited activities such as lobbying). Even if exempt status is not at risk, there may be compelling justifications for considering a new entity (cleansing UBTI, liability protection, attracting private capital). In such a case, the directors should consider whether the activities should be conducted in a subsidiary or related or affiliated entity, whether the separate entity should be taxable or tax-exempt, and what legal form the separate entity should take.

A. Taxable or tax-exempt.

An initial question, which 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, including having an exempt purpose. 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 Section 501(c)(3) status, the Code lists the purposes that qualify as "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...." Each of these purposes is a term of art with regulations and rulings setting forth and clarifying what it takes to qualify.

The term "charitable" provides a good example of the need to consult the regulations. As used in Section 501(c)(3), "charitable" is to be taken "in its generally accepted legal sense" and includes the following:

Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.[108]

As can be clearly seen from its definition, the concept of a "charitable organization" is expansive. Many specific types of purposes fall within this general rubric. Importantly, to be a charitable organization, the organization must serve a charitable class (that is, an

indefinite-typically large-group) in carrying out its activities. Each of the component parts of the definition of "charitable" (e.g. relief of the poor and distressed, lessening of the burdens of government, etc.) has its own definitions as well.

Assuming the organization will have an appropriate exempt purpose and will avoid the prohibitions on private inurement, excessive lobbying, and political intervention described above, additional factors should be considered when making the determination whether to operate a commercial enterprise as a tax-exempt or taxable subsidiary. Such considerations include the necessity of tax exemption (i.e., avoidance of federal income tax); whether the parent will capitalize the subsidiary on its own, through donations to the subsidiary, or through outside investors; the ability to pay compensation, including a share of the profits; the need for exemption for government or other contracts; and the branding and intellectual property issues at play.[109]

B. A brief overview of the options.[110]

Nonprofit entities have many organizational options for their mission-driven activities. Once the charitable organization has determined the need to create a separate entity to house operating activities, the decision makers must consider the legal form and understand the options available. This section of the article will introduce the primary options. As the author is a Texas practitioner, the article will use Texas as its basis; however, these entity choices are available and the decision points largely the same in other states.

1. Nonprofit corporation.

Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code (BOC).[111] The BOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation.[112] 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.[113] 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 one or more members that operate to control the organization in a way analogous to for-profit shareholders.[114]

2. For-profit corporation.

Standard business corporations in Texas may be formed under Texas law for any lawful purpose or purposes (unless otherwise provided by the BOC).[115] For-profit corporations are governed by Chapter 21 of the BOC.[116] 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.[117] 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.[118] 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. 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.[119] This includes the very small step Texas has taken toward hybrid entities such as the benefit corporation provided for in other states. The corporation may also include in its 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.

Taxable corporations are classified as regular C corporations or S corporations. Absent an affirmative S corporation election, a taxable corporation is taxed as a C corporation.[120] S corporations operate as flow-through entities with shareholders receiving allocations of income and loss and paying tax at the shareholder level only.[121] C corporations are taxable on their net income at rates of up to 35%.[122] After-tax profits are taxable to the shareholders leading to what is described as double taxation.[123] However, 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. For purposes of an entity that will be owned solely or in part by a charitable organization, S corporations are not the preferred option because all income and gain are taxable as unrelated business income to the charitable shareholder.[124] As a result, this article will focus only on C corporations.

3. Limited liability company.

The limited liability company (LLC) form 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.[125] For federal tax purposes, however, it is treated as a partnership unless an affirmative election is made to be taxed as a corporation or unless it has but a single member, in which event it is disregarded absent an election to be treated as a corporation.[126] 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.

In Texas, for example, LLCs are governed by the BOC and specifically Chapter 101.[127] LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.[128] 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.[129] 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 resolutions, 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. If 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. That means 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 parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.[130] If there are two or more owners of the LLC, 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).[131] The ability to be treated as a partnership for federal income tax purposes can be advantageous to an LLC in that it allows the LLC to take advantage of flexibility in partnership taxation (discussed below) 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 with respect to partnerships below (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 Service has indicated that it will recognize the Section 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (discussed below) and meets 12 additional conditions:[132]

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 unit 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.
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.

4. Partnership.

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

a. General partnership.

A general partnership is an association of two or more persons to carry on the business for profit as owners.[133] The general partnership is considered a separate business entity distinct from its owners.[134] General partnerships are the easiest entities to set up and dissolve among multiple owners. In Texas, 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.[135] 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.[136]

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.

b. Limited partnership.

A limited partnership consists of one or more general partners who have joint and several liability 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.[137] 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 seeking a return on their investment rather than control of the partnership business. 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.

A limited partnership is a state-created entity. In order for the limited partnership to be created and for the limited partners to receive liability protection, the limited partnership must file a certificate of formation with the Secretary of State.[138] 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, removable only "for cause" or by a 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.[139] As a result, it is critical for an exempt organization to consider whether the activities being undertaken in the partnership further a charitable purpose.

5. Hybrids-L3Cs and benefit corporations.

Low-profit limited liability corporations (L3Cs) 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 L3Cs or benefit corporations. However, there is nothing in its 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.

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.[140] Accordingly, the benefits of L3Cs and benefit corporations 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 below unless there is a distinction worth noting.

C. Selecting the structure.

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

1. Impact on exempt status.

An analysis of the choice of form should always begin with an examination of the impact the form of subsidiary or related organization will have on the exempt status of the parent.

a. Corporations.

Generally, a subsidiary organization that is organized as a corporation (whether it is exempt from federal income tax or not) will not negatively affect the tax-exempt status of the parent charitable organization as long as a separation is maintained between the entities. Maintaining such a separation will be discussed below. Note, however, that 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 (for capitalization of the subsidiary or otherwise) to understand whether the contribution will cause the subsidiary to fail the public support test and result in the subsidiary being treated as a private foundation, necessitating expenditure responsibility.

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

b. Partnerships.

Partnerships, as flow-through entities, risk negatively affecting the exempt status of a tax-exempt organization partner. Specifically, the Code requires an examination of how the revenue was generated at the partnership level and how any unrelated business income is passed through to the partners, with the tax-exempt organization getting its allocation. Further, an 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.[141] Because of this, it is common for the tax-exempt charitable organization to create a for-profit subsidiary to serve in the role of general partner.

A tax-exempt organization engaged in a partnership (whether general or limited) must consider whether it has ceded control of its charitable assets to a non-exempt partner. This is particularly troublesome with respect to a tax-exempt partner serving as the general partner of a limited partnership, since 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 for an other-than-exempt purpose. The Service has developed a two-pronged test to make such determinations.[142] First, the exempt organization's participation must be substantially related to an exempt purpose of the exempt organization. The examination requires a review of the purpose of the joint venture, with an eye toward whether an exempt purpose is being served. 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. 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. 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.[143] 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.

Through a number of pronouncements, the Service has outlined certain factors it considers favorable with respect to the structure of a joint venture arrangement and certain factors it considers unfavorable.[144] The favorable factors are as follows:

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, is renewable only with the 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.
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.
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.

c. 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.[145] 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.[146] 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 UBTI, 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.

An LLC with multiple members may choose to be taxed as a corporation or a partnership.[147] Again, if it is taxed as a corporation, the rules set forth above apply. If, on the other hand, as is more common, it is taxed as a partnership, the partnership rules 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.[148]

If a tax-exempt organization is a member of a multi-member LLC that is taxed as a partnership, the organization will have to be concerned about the activities of the partnership being aggregated with its own, including activities of the LLC that are unrelated to the exempt purposes of the exempt organization. It will also, however, need to 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.[149] 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.

2. Unrelated business taxable income.

As with any tax-exempt entity, a tax-exempt corporate subsidiary is exempt from federal income tax with respect to its related revenue but is subject to taxation on its unrelated business income.[150] To the extent a controlled tax-exempt organization reduces its unrelated business taxable income by making a "specified payment" of passive income to the parent charitable organization, the parent charitable organization will be subject to unrelated business taxable income on such payments.[151] As addressed above, deductible passive payments include rents, royalties, and license fees; however, dividends are not deductible to the controlled entity and therefore not taxable to the parent.[152] To be clear, this rule related to passive income received from a subsidiary bringing UBTI to the parent applies only if the subsidiary is controlled by the parent (which, by virtue of being a subsidiary, is inevitably the case). In this context, "controlled" means that the parent controls 50% or more of the subsidiary by vote or value.[153] Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[154]

A subsidiary taxed as a Subchapter C corporation subsidiary is subject to taxation at corporate rates on its net income. As with a tax-exempt corporate subsidiary, Section 512(b)(13) 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.[155]

Section 512(b)(13) does not come into play with respect to a single-member LLC electing to be disregarded for federal income tax purposes because 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.[156] Likewise, 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, so Section 512(b)(13) is inapplicable. Rather, these entities pass through gain and loss to their partners/members regardless of whether or not the income from the trade or business is actually distributed.[157]

3. State taxes.

The charity forming a subsidiary or related organization should consider the impact of state taxes. State income taxes (where they exist), property taxes, and other state taxes of course vary from state to state. This article will not seek to analyze those variations. Because the author is a Texas practitioner, and because Texas is unique in its state taxes, its tax rules will be discussed.

All of the organizational options identified in the discussion of UBTI issues, above, are subject to the Texas Margin Tax, a tax on an entity's revenue less the

greatest of (1) total revenue times 70%; (2) total revenue minus cost of goods sold; (3) total revenue minus compensation; or (4) total revenue minus $1 million.[158] Corporations, if exempt under Section 501(c)(3) , are eligible for exemption from the Texas Margin Tax.[159] Likewise, passive entities (as defined under Texas Tax Code section 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. As a result, in Texas, state taxes should be taken into consideration in determining whether a subsidiary organization should be created as a nonprofit corporation or LLC (taxed as a corporation) that will obtain exemption under Section 501(c)(3) and therefore be eligible for exemption from Texas taxes as well. This is particularly true if the organization is anticipated to have total revenue significantly in excess of $1 million.

4. Control and management.

With respect to control, a tax-exempt organization will generally control its nonprofit subsidiaries through interlocking directorates or serving as the sole member.[160] 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,[161] a majority of the membership interests in a limited liability company, a majority of the partnership interests in a general partnership, or serving as 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 operational 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).[162] Furthermore, a private foundation together with its disqualified persons may not own more than 20% of the voting interest in 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.[163]

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 that manages the affairs of the corporation.[164] The board generally elects officers to handle the day-to-day operations of the corporation.[165] Within the nonprofit context, the organization may elect not to have a board and instead be member-managed.[166] Within the for-profit context, a similar result can be obtained through the use of a shareholders' agreement and direct management by the shareholders,[167] though both 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. (From a control standpoint, though, the governing documents may require that a majority of the 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.[168] 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 will be given 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 some separation will be discussed below.

Limited liability companies under Texas law may be member-managed or manager-managed.[169] 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.[170] 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. This will provide 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.[171]

Management of a limited partnership is accomplished by the general partner(s).[172] 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 BOC) or a similar type of activities.[173] 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 exercised 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.

Regardless of the organizational type, the governing persons owe fiduciary duties to the entity that they govern and, if for profit, to the owners. Within the limited liability company context, these fiduciaries may be limited or modified.[174] In the partnership context there may be an agreement to set parameters around the fiduciary duties of care and loyalty, but those duties may not be completely eliminated and the parameters may not be manifestly unreasonable.[175]

5. 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 the discussion of qualification for tax-exempt status, 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 a 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).[176] As a result of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.[177] 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.[178] The exception to this general rule applies 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.[179] 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 shareholder used the corporation to perpetrate an actual fraud for the direct personal benefit of the shareholder.[180] Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to section 21.223 of the BOC.[181] 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.[182]

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 an obligation of the corporation pursuant to section 21.223(a)(3) of the BOC. The majority of courts in Texas have chosen to exclude corporate formalities as a factor altogether 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.[183]

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 and the veil-piercing rules under that law.[184] 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 in tort cases provided by the Texas Pattern Jury Charges omit reference to showing actual fraud.[185] 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).[186]

Whether creating the subsidiary in a state with less-rigid veil-piercing laws, or because tort claims are often treated differently than contractual claims for veil-piercing purposes (including in Texas), the parent organization should be mindful of maintaining

sufficient separation to avoid a piercing result. 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 arm's-length transactions between the subsidiary and the parent; allowing the subsidiary to carry out its own decision making; maintaining separate meetings; keeping separate minutes; maintaining separate bank accounts; etc.[187] 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."[188]

A Texas limited liability company also provides a liability shield to its owners.[189] BOC sections 21.223-21.226 apply equally to limited liability companies.[190] (The sections addressed above providing the strict standard for piercing the corporate veil in the corporate context.) 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.[191] As in 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 as 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 cover veil piercings in the context of LLCs and may apply more lenient veil-piercing theories under common law.[192]

Neither general partnerships nor limited partnerships are subject to the veil-piercing standards because there is not a corporate liability shield to pierce.[193] In the context of the general partnership, absent agreement otherwise in the partnership agreement, partners are jointly and severally liable for partnership obligations.[194] This is one of the primary dangers of the general partnership and motivation for having a carefully drafted partnership agreement that specifies the party with 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 assumed joint and several liability for partnership debts and obligations.[195] 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 reasonably believes the limited partner is a general partner and relies on that belief.[196] In Texas, participation in control of the business must be something more than the non-exhaustive list of activities set out in section 153.103 of the BOC.[197] These non-control activities include acting in certain roles such as an employee, contractor, or agent of one of the partners; consulting with or advising the general partner on business issues; assuming specific obligations of the partnership; and exercising specifically enumerated voting rights with respect to the partnership that serve to protect the limited partner's interests in the partnership. None of these activities rise to day-to-day control.

Partners in a general partnership and general partners in a limited partnership have joint and several liability for partnership debts and obligations. Therefore, should a tax-exempt organization find itself participating in a partnership, it 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 corporate shield as a protection for its assets.[198]

6. Capitalization (fundraising).

A factor in determining the choice of form for the subsidiary is how it 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 should 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 article. 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.[199]

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 equity) 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 UBTI because they will constitute "specified payments" under Section 512(b)(13)(c) .

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) and may wish to consider whether the investment would be program related.

7. Dissolution/liquidation issues.

At the opposite end of the spectrum from capitalization is distribution of assets upon the winding down of 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 state law. In Texas, the BOC requires adopting a plan of dissolution followed by returning contributions held on condition of return and then transferring assets to one or more tax-exempt organizations.[200] 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 or modification of the restriction(s).[201]

If the subsidiary is a taxable corporation, Sections 336 and 337 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 (a partnership or an LLC taxed as a partnership), liquidation is generally a non-taxable event.[202]

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.[203]

D. Managing the relationship.

Regardless of the choice of form used for the subsidiary, it is imperative that the relationship between the parent and the subsidiary be maintained 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 into 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.
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 UBTI 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. One hundred percent overlap of the two boards should be avoided to allow each board to focus on the specific delineated purposes of the organization. This allows individual directors to satisfy their 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. In particular, one person should not be 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 arm's-length written administrative services agreement that requires reimbursement to the parent of the cost of such services. (If the parent makes a

profit on this, there could be UBTI 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 for meeting its day-to-day needs and expenses, plus 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.
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, and by using 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, and such other agreements as may be applicable. The goal in both documentation and implementation is to avoid the parent controlling the day-to-day activities of the subsidiary.

V. CONCLUSION

Tax-exempt organizations utilize subsidiaries and related organizations for a number of different reasons ranging from management concerns to liability protection to tax necessity. While the nonprofit corporate form is generally used for charitable organizations conducting commercial activities, a number of different forms should be considered for a subsidiary or affiliate organization. The practitioner should first consider whether the subsidiary will be taxable or tax-exempt. If taxable, issues to be considered include control mechanisms, operational considerations, and tax impact on the parent. Finally, once created, the parent exempt organization must ensure that it maintains separation to protect the viability of the parent-subsidiary relationship. Understanding and managing the risks, and understanding the structural issues involved, will allow an exempt organization to carry out its mission effectively through the use of a subsidiary or affiliated organization without stepping into unforeseen traps.

[1] See Reg. 1.501(c)(3)-1(a).

[2] See Reg. 1.501(c)(3)-1(b)(4).

[3] See Reg. 1.501(c)(3)-1(b)(4).

[4] See Section 501(c)(3).

[5] See Reg. 1.501(c)(3)-1(c)(1).

[6] See *id.*

[7] See *id.*

[8] See *id*.; *Better Business Bureau*, 326 U.S. 279 283 34 AFTR 5 (1945).

[9] *B.S.W. Group, Inc.*, 70 TC 352 356-357 (1978).

[10] *Id*.

[11] See Reg. 1.501(c)(3)-1(e)(1).

[12] See Reg. 1.501(c)(3)-1(c)(1).

[13] See Reg. 1.501(c)(3)-1(d)1(ii).

[14] See GCM 37789 , 12/18/78.

[15] See GCM 38459, 7/31/80.

[16] See GCM 37789, 12/18/78.

[17] See *id.* (referencing Rev. Rul. 70-186, 1970-1 CB 128); see also Ltr. Rul. 9615030 .

[18] See Rev. Rul. 72-559, 1972-2 CB 247; Rev. Rul. 73-313, 1973-2 CB 174.

[19] See Reg. 1.501(c)(3)-1(c)(2).

[20] The concept of "insider" for inurement purposes includes disqualified persons identified under Section 4958(f)(1) for purposes of the intermediate sanction rules, but an "insider" for inurement purposes more broadly includes others who because of a unique position have the ability to influence or control the organization. See *American Campaign Academy*, 92 TC 1053 (1989).

[21] See Section 4958.

[22] See Sections 4958(a)(1); (d)(2).

[23] See Reg. 1.501(c)(3)-1(c)(3).

[24] See *Bob Jones Univ.*, 461 U.S. 574 33 AFTR2d 74-1279 (1983).

[25] See, e.g., *Airlie Foundation*, 283 F. Supp.2d 58 72 AFTR2d 93-5026 (D. DC, 2003).

[26] For an in-depth look at the commerciality doctrine, see generally Hopkins, *The Law of Tax-Exempt Organizations*, §4.11 (John Wiley & Sons, Inc., 2011).

[27] See, e.g., *Living Faith, Inc.*, 950 F.2d 365 69 AFTR2d 92-301 (CA-7, 1991).

[28] *Easter House*, 60 AFTR2d 87-5119, *aff'd* 846 F.2d 78 (Fed. Cir., 1988).

[29] See *id.* at 60 AFTR2d 87-5124.

[30] See *id.* at 60 AFTR2d 87-5125-26.

[31] See *Living Faith, supra* note 27 at 950 F.2d 376-77.

[32] See *id.* at 950 F.2d 372.

[33] See *id.* at 950 F.2d 373-374.

[34] See *id.* at 950 F.2d 374.

[35] Note 25, *supra.*

[36] See *id.* at 283 F. Supp.2d 60.

[37] See *id.* at 283 F. Supp.2d 63 (emphasis in original).

[38] See *id.* at 283 F. Supp.2d 65.

[39] See, e.g.,*Council for Bibliographic and Information Technologies*, TC Memo 1992-364 (ignoring the Service's arguments concerning the commercial hue of certain activities noting that the organization at issue was formed by and controlled by a tax-exempt organization). In addition to the fact that the organization was formed by a tax-exempt organization, it should not be overlooked that the organization was providing services that the court viewed as necessary and indispensable exclusively to tax-exempt organizations.

[40] See *B.S.W. Group, Inc*, 70 TC 352 (1978).

[41] See Chaney, "Commerciality, Charter School Management Organizations, and Social Enterprise," 27 Exempts 5, page 3 (Mar/Apr 2016).

[42] *Living Faith, supra* note 27, 950 F.2d at 370, 372.

[43] Section 501(r).

[44] See Reg. 1.501(c)(3)-1(e)(2) .

[45] See Reg. 1.513(b); *American Bar Endowment*, 477 U.S. 105 58 AFTR2d 86-5190 (1986).

[46] See Reg. 1.513-1(d)(2).

[47] 73 TC 96, *acq.* 1980-2 CB 1.

[48] 1976-1 CB 148.

[49] 1973-1 CB 222.

[50] 1976-1 CB 171.

[51] 73-127, 1973-1 CB 221.

[52] See TAM 9147008; GCM 39863, 11/26/91.

[53] See TAM 9147008.

[54] See Section 513(a).

[55] Section 512(b).

[56] See Section 512(b).

[57] See Section 512(b)(13).

[58] See Section 512(b)(13)(A).

[59] Section 512(b)(13).

[60] Section 512(b)(13)(D).

[61] See Section 512(b)(13)(D)(ii), Section 318.

[62] See Reg. 1.501(c)(3)-1(e)(2).

[63] See, e.g., Reg. 1.501(c)(3)-1(c)(1).

[64] For an in-depth analysis of the commensurate-in-scope test, see Siegel, "Commensurate in Scope: Myth, Mystery or Ghost?-Part One," 20 Exempts 3, page 26 (Nov/Dec 2008), Siegel, "Commensurate in Scope: Myth, Mystery or Ghost?-Part Two," 20 Taxation of Exempts 4, page 8 (Jan/Feb 2009).

[65] 1964-1 (part 2) CB 186.

[66] See Ltr. Rul. 200021056, Ltr. Rul. 8038004 ; TAM 9711003 .

[67] See Rev. Rul. 64-182, *supra* note 65.

[68] The author would like to acknowledge Megan C. Sanders of Bourland, Wall & Wenzel, P.C. for her significant contributions to this section.

[69] See generally Helge, "The Taxation of Cause-Related Marketing," 85 Chi-Kent L. Rev. 883 (2010). Professor Helge's article offers an excellent overview of the application of the unrelated business taxable income rules in the area of cause-related marketing.

[70] See *id*, pages 892-893.

[71] See Reg. 1.513-4(c) .

[72] See, e.g., Cal. Gov. Code section 12599.2.

[73] Royalties are generally excluded from UBI taxation under Section 512(b)(2) and Reg. 1.512(b)-1(b).

[74] See Rev. Rul. 81-178, 1981-2 CB 135.

[75] See, e.g., Rev. Rul. 81-178, 1981-2 CB 135.

[76] Ltr. Rul. 200601033; *Sierra Club Inc.*, 86 F.3d 1526 1532 78 AFTR2d 96-5005 (CA-9, 1996).

[77] See *Sierra Club Inc.*, *id.* at 86 F.3d 1532; Rev. Rul. 81-178, 1981-2 CB 135.

[78] See Rev. Rul. 81-178, 1981-2 CB 135.

[79] See *Sierra Club Inc*, *supra* note 76 at 86 F.3d 1532; Ltr. Rul. 200601033.

[80] See Helge, *supra* note 69, at 922-923.

[81] See Section 513(i); Reg. 1.513-4.

[82] See *id.* (emphasis added).

[83] See Reg. 1.513-4(c).

[84] Reg. 1.513-4(c).

[85] See Section 513(i); Reg. 1.513-4.

[86] See Reg. 1.513-4(c)(2).

[87] See Reg. 1.513-4(f), Example 5.

[88] See Reg. 1.513-4(f), Example 3.

[89] See Reg. 1.513-4(c).

[90] See Section 513(i)(2)(B)(i); Reg. 1.513-4(e)(2).

[91] See Reg. 1.513-4(d).

[92] See Reg. 1.513-4(d)(1).

[93] See Reg. 1.513-4(d).

[94] See Reg. 1.513-4.

[95] See *id.* Note that this allocation is separate and apart from the 2% de minimis rule to determine whether there is a substantial return benefit in the first place-in that determination, if the benefit exceeds 2% of the total payment, the entire benefit is treated as a substantial return benefit (the substantial return benefit is not merely the amount of the excess over the 2% of the payment).

[96] See Reg. 1.513-4(d).

[97] See Reg. 1.513-4(f), Example 1.

[98] See Reg. 1.513-4(c)(2).

[99] See Reg. 1.513-4(f), Example (4).

[100] See Section 513(c). Therefore, if the publication as a whole is published at a loss, there would be no taxable UBI due to advertising.

[101] Reg. 1.513-4(c)(2)(v).

[102] See Reg. 1.513-4(f), Example 7. In this example, the statement "This program has been brought to you by M, located at 123 Main Street ... we are proud to have M as a sponsor..." was not an advertisement, but the statement "For your music needs, give them a call today" was considered an advertisement, thus tainting the entire message.

[103] *Am. Coll. of Physicians*, 475 U.S. 834 849-50 57 AFTR2d 86-1182 (1986).

[104] See Reg. 1.513-4(f), Example 11; Ltr. Rul. 200303062.

[105] See Chasin, Ruth, and Harper, "Tax Exempt Organizations and World Wide Web: Fundraising and Advertising on the Internet," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000* (1999), page 74.

[106] See, e.g., *State Police Ass'n of Mass.*, 80 AFTR2d 97-6074 (CA-1 1997).

[107] See Helge, *supra* note 69 at 920.

[108] Reg. 1.501(c)(3)-1(d)(2).

[109] See generally Wexler, "Effective Social Enterprise-A Menu of Legal Structures," Exempt Org. Tax Rev., Dec. 2006, page 565.

[110] This section of the article highlights legal forms most often used and thus will not address certain organizational forms rarely used for separating commercial activities such as a tax-exempt nonprofit unincorporated association, tax-exempt charitable trust, and nonexempt nonprofit corporation.

[111] See Tex. Bus. Orgs. Code sections 22.001 et. seq.

[112] See *id.* section 22.001(5).

[113] See *id*. sections 2.001-002, 2.101-102, 3.003 and 22.054.

[114] See *id.* section 22.101.

[115] See *id*. sections 2.001, 2.007.

[116] See *id*. sections 21.001 *et seq*.

[117] See *id*. section 2.101.

[118] See *id.* section 21.223.

[119] See *id*. section 3.007(d).

[120] See Section 1361(a)(2).

[121] See Section 1366.

[122] See Sections 11(a)-(b).

[123] See Section 61(a)(7).

[124] See Section 512(e)(1). This contrasts sharply with the result for taxable owners, who prefer to avoid C corporation status generally to avoid double taxation.

[125] See Tex. Bus. Orgs. Code section 101.114.

[126] See Reg. 301.7701-2(c)(2).

[127] See Tex. Bus. Orgs. Code sections 101.001 *et seq*.

[128] See *id*. section 3.001.

[129] See *id*. section 101.251.

[130] See Reg. 301.7701-2(c)(2).

[131] See Regs. 301.7701-3(b)(1)(i), 301.7701-3(a).

[132] These twelve conditions can be found in Cray and Thomas, "Limited Liability Companies as Exempt Organizations-Update," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001* (2000).

[133] See Tex. Bus. Orgs. Code section 152.051(b).

[134] See *id*. section 152.056.

[135] See *id*., section 152.304.

[136] See Section 701, Section 702.

[137] See Tex. Bus. Orgs. Code section 153.102.

[138] See *id*., section 3.001.

[139] See Rev. Rul. 98-15, 1998-1 CB 718, Rev. Rul. 2004-51, 2004-22 IRB 974.

[140] See Tex. Bus. Orgs. Code section 3.007(d).

[141] See, e.g., Rev. Rul. 98-15, 1998-1 CB 718.

[142] See, e.g., GCM 39005, 12/17/82.

[143] See GCM 39762, 10/24/88.

[144] See generally Sanders, *Joint Ventures Involving Tax-Exempt Organizations,* (John Wiley & Sons, Inc., 2013) §4.2(h).

[145] See Reg. 301.7701.3(b)(1)(ii).

[146] See, e.g., Ltr. Rul. 200606047.

[147] See Reg. 301.7701.3(a).

[148] See Rev. Rul. 98-15, 1998-1 CB 718.

[149] See the immediately preceding discussion of partnerships, notes 141-144, *supra,* and related text.

[150] See Section 512.

[151] See Section 512(b)(13)(C).

[152] See *id.* Note that while the payments are not taxable, they may negatively impact the public support ratio of a publicly-supported parent.

[153] See Section 512(b)(13)(D).

[154] See Section 318.

[155] See Section 512(b)(13)(A).

[156] See Ltr. Rul. 200606047 .

[157] Sections 512(c)(1), 701 - 704; Reg. 1.681(a)-2(a).

[158] See Tex. Tax Code sections 171.1011, 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 article), each of the entity types is subject to the Texas Margin Tax.

[159] See Tex. Tax Code section 171.063(a)(1).

[160] Some states provide for nonprofit corporation issuance of stock which acts as a control mechanism similar to membership.

[161] Unlike S corporations, a C corporation may have multiple classes of stock to effectuate control.

[162] See Section 512(b)(13)(B)(i)(I).

[163] See Section 4942.

[164] See Tex. Bus. Orgs. Code section 21.401.

[165] See *id*, section 21.417.

[166] See *id*, section 22.202.

[167] See *id.*, section 21.101(a).

[168] See *id*., section 21.405.

[169] See *id*., section 101.251.

[170] See *id.*, sections 101.251-101.253.

[171] See *id.*, section 152.203(a).

[172] See *id*., section 153.152.

[173] See *id.*, section 153.103.

[174] See, e.g., Tex. Bus. Orgs. Code section 101.401.

[175] See *id*., section 152.002(b).

[176] See Tex. Bus. Orgs. Code section 22.151, section 21.223.

[177] See, e.g., *Willis v. Donnelly*, 199 S.W.3d 262 271 (Tex. 2006).

[178] See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App. San Antonio, 2008, no pet.).

[179] See *Castleberry v. Branscum*, 721 S.W.2d 270 272 (Tex. 1986); Tex. Bus. Orgs. Code section 21.223.

[180] See Tex. Bus. Orgs. Code sections 21.223(a)(2) and (b).

[181] 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*, *supra* note 177, pages 271-273.

[182] See, e.g., *Latham v. Burgher*, 320 S.W.3d 602 606-07 (Tex. App. Dallas, 2010, no pet.).

[183] See 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), 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. den.) as the minority view).

[184] See e.g. 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*, No. CGC-04-436186, Superior Court of California, City of San Francisco).

[185] See, e.g., State Bar of Texas, Committee on Pattern Jury Charges, *Texas Pattern Jury Charges-Business, Consumer, Insurance, Employment* (State Bar of Texas, 2014), PJC 108.2.

[186] 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).

[187] See, e.g., Presser, *Piercing the Corporate Veil* (Thompson-West, 2004), section 1.6; See also Peregrine, *supra* note 184, Such separation is discussed more fully below.

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

[189] See Tex. Bus. Orgs. Code section 101.114.

[190] See Tex. Bus. Orgs. Code section 101.002.

[191] See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App., San Antonio, 2008, no pet.).

[192] See generally, Miller, "Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities," 43 Tex. J. Bus. L. 405, pages 420-24 (2009).

[193] See, e.g., *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468 474 (Tex. App., Dallas, 2008, pet. den.).

[194] See Tex. Bus. Orgs. Code section 152.303(a).

[195] See *id*., section 153.152.

[196] See *id.*, section 153.102.

[197] See *id*., section 153.103.

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

[199] See 13 CFR section 1.120.100(b) (2012).

[200] See Tex. Bus. Orgs. Code sections 22.302 and 22.304.

[201] Modification or release of restrictions will either be accomplished under the terms of the Uniform Prudent Management of Institutional Funds Act or pursuant to a *cy pres* proceeding.

[202] See Section 731(b).

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