

**PUTTING THINGS TOGETHER:  
SUBSIDIARIES, COMPLEX ORGANIZATIONAL STRUCTURES,  
JOINT VENTURES, AND JOINT FUNDING VEHICLES**

**DARREN B. MOORE**, *Fort Worth*  
Bourland, Wall & Wenzel, P.C.

**JOHN F. CRAWFORD**, *Chicago*  
Ernst & Young LLP

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**I. INTRODUCTION**

Whether scaling to increase greater impact, engaging in joint ventures or collaborative efforts with others, or needing to address unrelated business income or risk-to-exemption, charities often find themselves looking to structure their operations through subsidiaries, affiliates, and other joint venture vehicles. Choosing to “put things together” in one of these manners involves consideration of factors ranging from choice of form, tax status of the vehicle, and ultimately the impact on the exempt organization and its tax status. The discussion below reviews the major legal issues to be analyzed and the structural options to be considered when “building out” various organizational structures.

**II. TAX EXEMPTION PRINCIPLES**

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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

**B. OPERATIONAL TEST**

For purposes of the operational test, an organization must show that it is (or will be) operated exclusively for exempt purposes.<sup>5</sup> In this context, the word “exclusively” means “primarily.”<sup>6</sup> Said differently, an organization will be regarded as operated exclusively for one or

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<sup>1</sup> Portions of this paper originally appeared as part of “Commercial Activities and Subsidiaries: Issues and Choices in Planning,” Darren B. Moore, *Taxation of Exempts*, Volume 28, Issue 4, Copyright 2016 Thomson Reuters/Tax & Accounting, and is reprinted here with permission.

<sup>2</sup> See Reg. 1.501(c)(3)-1(a).

<sup>3</sup> See Reg. 1.501(c)(3)-1(b)(4).

<sup>4</sup> See Reg. 1.501(c)(3)-1(b)(4).

<sup>5</sup> See Section 501(c)(3).

<sup>6</sup> See Reg. 1.501(c)(3)-1(c)(1).

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)).<sup>7</sup> An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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....”<sup>11</sup>

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.<sup>12</sup> 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.<sup>13</sup> This primary purpose test, as it relates to the conduct of a trade or business, is further influenced by the commerciality doctrine discussed below.

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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> Any private interest must be incidental to the public interest both quantitatively and qualitatively.<sup>17</sup> 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.”<sup>18</sup> 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.<sup>19</sup> 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

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<sup>7</sup> See *id.*

<sup>8</sup> See *id.*

<sup>9</sup> See *id.*; *Better Business Bureau*, 326 U.S. 279 283 34 AFTR 5 (1945).

<sup>10</sup> *B.S.W. Group, Inc.*, 70 TC 352 356-357 (1978).

<sup>11</sup> *Id.*

<sup>12</sup> See Reg. 1.501(c)(3)-1(e)(1).

<sup>13</sup> See Reg. 1.501(c)(3)-1(c)(1).

<sup>14</sup> See Reg. 1.501(c)(3)-1(d)1(ii).

<sup>15</sup> See GCM 37789, 12/18/78.

<sup>16</sup> See GCM 38459, 7/31/80.

<sup>17</sup> See GCM 37789, 12/18/78.

<sup>18</sup> See *id.* (referencing Rev. Rul. 70-186, 1970-1 CB 128); see also Ltr. Rul. 9615030.

<sup>19</sup> See Rev. Rul. 72-559, 1972-2 CB 247; Rev. Rul. 73-313, 1973-2 CB 174.

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.<sup>20</sup> "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.<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup>

#### 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.<sup>24</sup>

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.<sup>25</sup>

#### E. COMMERCIALITY CONCERNS

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<sup>20</sup> See Reg. 1.501(c)(3)-1(c)(2).

<sup>21</sup> 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).

<sup>22</sup> See Section 4958.

<sup>23</sup> See Sections 4958(a)(1); (d)(2).

<sup>24</sup> See Reg. 1.501(c)(3)-1(c)(3).

<sup>25</sup> See *Bob Jones Univ.*, 461 U.S. 574 33 AFTR2d 74-1279 (1983).

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.<sup>26</sup> 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.<sup>27</sup>

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.<sup>28</sup>

For example, in *Easter House*, the Claims Court considered qualification for exemption of an adoption agency.<sup>29</sup> 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.”<sup>30</sup> 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.<sup>31</sup>

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.<sup>32</sup> 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...”<sup>33</sup> 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

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<sup>26</sup> See, e.g., *Airlie Foundation*, 283 F. Supp.2d 58 72 AFTR2d 93-5026 (D. DC, 2003).

<sup>27</sup> 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).

<sup>28</sup> See, e.g., *Living Faith, Inc.*, 950 F.2d 365 69 AFTR2d 92-301 (CA-7, 1991).

<sup>29</sup> *Easter House*, 60 AFTR2d 87-5119, *aff’d* 846 F.2d 78 (Fed. Cir., 1988).

<sup>30</sup> See *id.* at 60 AFTR2d 87-5124.

<sup>31</sup> See *id.* at 60 AFTR2d 87-5125-26.

<sup>32</sup> See *Living Faith*, *supra* note 27 at 950 F.2d 376-77.

<sup>33</sup> See *id.* at 950 F.2d 372.

contributions.<sup>34</sup> 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.<sup>35</sup>

In *Airlie Foundation*,<sup>36</sup> 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.<sup>37</sup> 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.”<sup>38</sup> 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.<sup>39</sup> 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.<sup>40</sup> 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.<sup>41</sup> 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

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<sup>34</sup> See *id.* at 950 F.2d 373-374.

<sup>35</sup> See *id.* at 950 F.2d 374.

<sup>36</sup> Note 25, *supra*.

<sup>37</sup> See *id.* at 283 F. Supp.2d 60.

<sup>38</sup> See *id.* at 283 F. Supp.2d 63 (emphasis in original).

<sup>39</sup> See *id.* at 283 F. Supp.2d 65.

<sup>40</sup> 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.

<sup>41</sup> See *B.S.W. Group, Inc.*, 70 TC 352 (1978).

somehow serve as an indication of purpose.<sup>42</sup> 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.”<sup>43</sup>

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 charity trumps profit.<sup>44</sup> 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.

#### F. UNRELATED BUSINESS TAXABLE INCOME AND SECTION 512(b)(13)

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.<sup>45</sup> 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.<sup>46</sup> 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.<sup>47</sup> 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.<sup>48</sup> Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.<sup>49</sup>

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

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<sup>42</sup> See Chaney, “Commerciality, Charter School Management Organizations, and Social Enterprise,” 27 *Exempts* 5, page 3 (Mar/Apr 2016).

<sup>43</sup> *Living Faith*, *supra* note 27, 950 F.2d at 370, 372.

<sup>44</sup> Section 501(r).

<sup>45</sup> See Section 512.

<sup>46</sup> See Section 512(b)(13)(C).

<sup>47</sup> See *id.* Note that while the payments are not taxable, they may negatively impact the public support ratio of a publicly-supported parent.

<sup>48</sup> See Section 512(b)(13)(D).

<sup>49</sup> See Section 318.

were exempt for purposes of determining whether or not the payments to the parent charitable organization will be unrelated business taxable income.<sup>50</sup>

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.<sup>51</sup> 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.<sup>52</sup>

### III. CHOICE OF ENTITY OPTIONS/ATTRIBUTES

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 CORPORATIONS<sup>53</sup>

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. 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).<sup>54</sup> 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.<sup>55</sup> 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

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<sup>50</sup> See Section 512(b)(13)(A).

<sup>51</sup> See Ltr. Rul. 200606047.

<sup>52</sup> Sections 512(c)(1), 701 - 704; Reg. 1.681(a)-2(a).

<sup>53</sup> 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.

<sup>54</sup> See Tex. Bus. Orgs. Code sections 22.001 et. seq.

<sup>55</sup> See *id.* section 22.001(5).

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.<sup>56</sup> 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.<sup>57</sup>

## 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).<sup>58</sup> For-profit corporations are governed by Chapter 21 of the BOC.<sup>59</sup> 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.<sup>60</sup> 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.<sup>61</sup> 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.<sup>62</sup> 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.<sup>63</sup> S corporations operate as flow-through entities with shareholders receiving allocations of income and loss and paying tax at the shareholder level only.<sup>64</sup> C corporations are taxable on their net income at rates of up to 35%.<sup>65</sup> After-tax profits are taxable to the shareholders leading to what is described as double taxation.<sup>66</sup> 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

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<sup>56</sup> See *id.* sections 2.001-002, 2.101-102, 3.003 and 22.054.

<sup>57</sup> See *id.* section 22.101.

<sup>58</sup> See *id.* sections 2.001, 2.007.

<sup>59</sup> See *id.* sections 21.001 *et seq.*

<sup>60</sup> See *id.* section 2.101.

<sup>61</sup> See *id.* section 21.223.

<sup>62</sup> See *id.* section 3.007(d).

<sup>63</sup> See Section 1361(a)(2).

<sup>64</sup> See Section 1366.

<sup>65</sup> See Sections 11(a)-(b).

<sup>66</sup> See Section 61(a)(7).

corporations are not the preferred option because all income and gain are taxable as unrelated business income to the charitable shareholder.<sup>67</sup> As a result, this article will focus only on C corporations.

## B. LIMITED LIABILITY COMPANIES

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.<sup>68</sup> 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.<sup>69</sup> 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.<sup>70</sup> LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.<sup>71</sup> 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.<sup>72</sup> In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting through 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.

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<sup>67</sup> 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.

<sup>68</sup> See Tex. Bus. Orgs. Code section 101.114.

<sup>69</sup> See Reg. 301.7701-2(c)(2).

<sup>70</sup> See Tex. Bus. Orgs. Code sections 101.001 *et seq.*

<sup>71</sup> See *id.* section 3.001.

<sup>72</sup> See *id.* section 101.251.

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.<sup>73</sup> 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).<sup>74</sup> 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:<sup>75</sup>

(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.

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<sup>73</sup> See Reg. 301.7701-2(c)(2).

<sup>74</sup> See Regs. 301.7701-3(b)(1)(i), 301.7701-3(a).

<sup>75</sup> 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).

(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.

## C. JOINT VENTURE AND FUNDING VEHICLES

As an alternative to a full merger or a partnership (or limited liability company treated as a partnership), in which an organization gives up complete or partial control over its assets, tax-exempt organizations may also choose to enter into other types of contractual arrangements with other organizations.

### *1. Partnerships*

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.<sup>76</sup> The general partnership is considered a separate business entity distinct from its owners.<sup>77</sup> 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.<sup>78</sup> 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.<sup>79</sup>

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.<sup>80</sup> 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.<sup>81</sup> 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%

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<sup>76</sup> See Tex. Bus. Orgs. Code section 152.051(b).

<sup>77</sup> See *id.* section 152.056.

<sup>78</sup> See *id.*, section 152.304.

<sup>79</sup> See Section 701, Section 702.

<sup>80</sup> See Tex. Bus. Orgs. Code section 153.102.

<sup>81</sup> See *id.*, section 3.001.

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.<sup>82</sup> As a result, it is critical for an exempt organization to consider whether the activities being undertaken in the partnership further a charitable purpose.

## 2. *Joint Operating Agreements*

One common arrangement is to enter into a joint operating agreement (JOA) with another tax-exempt organization. Generally, tax exempt organizations do not enter into JOAs with for-profit entities, but there is no specific prohibition against it. This article will not discuss issues arising out of those arrangements. Under the terms of a JOA, the organizations cede certain financial, operational, and governing control to a separate governing body, but the organizations still maintain their separate identities and continue to own their own assets.

This structure allows the organizations to achieve the benefits of a merger or a partnership, such as increased cost efficiencies and the elimination of duplicative efforts, without fully committing to a complete integration. A JOA is often associated with the healthcare industry involving two or more exempt hospitals, but the analysis should apply to other exempt industries as well.

Often the terms of a JOA dictate that the joint financial, operational, and governing activities are conducted in a separate entity, referred to as a joint operating company. Generally, a joint operating company will be formed as nonprofit corporation under state law and will qualify as Section 501(c)(3) organization. Although, the joint operating company can also be formed as a partnership (or limited liability company taxed as a partnership). Because of this, JOA arrangements are often referred to as “virtual mergers.” In some cases, no separate entity will be formed and the JOA will exist simply as a contractual arrangement.

For a joint operating company formed as a nonprofit corporation under state law to qualify as a Section 501(c)(3) organization, it generally must meet the “integral part” test, which is generally shown through a parent-subsidiary relationship. The integral part test is met if (1) the entity performs essential services for the exempt organization and the services, if performed by the exempt organization itself, would not be an unrelated trade or business, and (2) the exempt organization exercises sufficient control and close supervision, based on all the facts and circumstances, to establish the equivalent of a parent and subsidiary relationship.<sup>83</sup> Because joint operating companies generally do not provide the requisite parent-like authority over the other organizations’ assets and governing boards, the “integral part” test must be met another way.

The Service has indicated that a joint operating company could qualify for exemption under the integral part test by meeting a facts and circumstances test demonstrating the existence

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<sup>82</sup> See Rev. Rul. 98-15, 1998-1 CB 718, Rev. Rul. 2004-51, 2004-22 IRB 974.

<sup>83</sup> See Rev. Rul. 78-41, 1978-1 C.B. 148; Rev. Rul. 75-282, 1972-2 C.B. 201.

of a parent-subsidary relationship. In 1997, the Service issued a continuing education text<sup>84</sup> that outlined certain factors that would indicate that significant management authority had been delegated to the governing body of the joint operating company. The factors of specific management authority include:

- (1) Authority to establish budgets, including the authority to approve major expenditures, debt, contracts, managed care agreements, and capital expenditures.
- (2) Authority by the governing body of the joint operating company to monitor and audit each participating entity's compliance with its directives.
- (3) Authority to direct services undertaken or not undertaken by the participating entities.
- (4) Authority to enter agreements that bind participating entities, particularly agreements with managed care providers.
- (5) Authority to hire and fire personnel.
- (6) Authority to grant hospital staff privileges.
- (7) Authority to set or approve fees and prices.
- (8) Authority to buy assets for and sell assets of participating entities.
- (9) Authority to re-allocate income among the participating entities to balance income and expenses to assure financial integration and to achieve mutual objectives.

None of these factors is conclusive in establishing a parent-subsidary relationship for purposes of the integral part test, but some of the factors are more heavily considered.

### *3. Affiliations and Other Contractual Arrangements*

For some organizations, even a JOA arrangement may be too limiting. In these cases, organization may choose to affiliate with another organization through another type of contractual arrangement that does not involve giving up certain control to another governing body. In these cases, the organizations will contract with each other to engage in a collaborative fundraising effort, a joint program, or to share in certain services. Despite these collaborative efforts, the organizations remain entirely independent and are only liable for the contractual terms. In other cases, the organizations may choose a closer affiliation by having overlapping boards or shared staffing arrangements, while still remaining independent. The advantage of these types of contractual arrangements is that the organizations maintain their autonomy, but their coordinated efforts allow them to pursue larger or more diverse programmatic offerings and eliminate administrative and organizational redundancies.

## **IV. CONSIDERATIONS FOR CHOICE OF ENTITY**

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<sup>84</sup> 1997 EO CPE Text, *Virtual Mergers, Hospital Joint Operating Agreements*, by Roderick Darling and Marvin Friedlander.

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.

#### A. 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.

##### 1. 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.

##### 2. 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.<sup>85</sup> 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.<sup>86</sup> 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

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<sup>85</sup> See, e.g., Rev. Rul. 98-15, 1998-1 CB 718.

<sup>86</sup> See, e.g., GCM 39005, 12/17/82.

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.<sup>87</sup> 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.<sup>88</sup> 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:

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<sup>87</sup> See GCM 39762, 10/24/88.

<sup>88</sup> See generally Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, (John Wiley & Sons, Inc., 2013) §4.2(h).

(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.

### *3. Limited liability company*

A limited liability company may have a single member (the tax-exempt parent) or multiple members. Where the limited liability company has a single member, the entity is disregarded for federal tax purposes unless an election is made for it to be regarded, in which event it will be treated for tax purposes as a corporation.<sup>89</sup> 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.<sup>90</sup> 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.<sup>91</sup> 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.<sup>92</sup>

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<sup>89</sup> See Reg. 301.7701.3(b)(1)(ii).

<sup>90</sup> See, e.g., Ltr. Rul. 200606047.

<sup>91</sup> See Reg. 301.7701.3(a).

<sup>92</sup> See Rev. Rul. 98-15, 1998-1 CB 718.

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.<sup>93</sup> 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.

## B. 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.<sup>94</sup> Corporations, if exempt under Section 501(c)(3), are eligible for exemption from the Texas Margin Tax.<sup>95</sup> 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.

## C. CONTROL AND MANAGEMENT/OWNER LIABILITY

With respect to control, a tax-exempt organization will generally control its nonprofit subsidiaries through interlocking directorates or serving as the sole member.<sup>96</sup> 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,<sup>97</sup> a majority of the membership interests in a limited liability company, a majority of the partnership interests in a general

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<sup>93</sup> See the immediately preceding discussion of partnerships, notes 141-144, *supra*, and related text.

<sup>94</sup> 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.

<sup>95</sup> See Tex. Tax Code section 171.063(a)(1).

<sup>96</sup> Some states provide for nonprofit corporation issuance of stock which acts as a control mechanism similar to membership.

<sup>97</sup> Unlike S corporations, a C corporation may have multiple classes of stock to effectuate control.

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).<sup>98</sup> 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.<sup>99</sup>

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.<sup>100</sup> The board generally elects officers to handle the day-to-day operations of the corporation.<sup>101</sup> Within the nonprofit context, the organization may elect not to have a board and instead be member-managed.<sup>102</sup> Within the for-profit context, a similar result can be obtained through the use of a shareholders' agreement and direct management by the shareholders,<sup>103</sup> 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.<sup>104</sup> 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.<sup>105</sup> 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.<sup>106</sup> The details of these arrangements are contained in the LLC's company agreement.

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<sup>98</sup> See Section 512(b)(13)(B)(i)(I).

<sup>99</sup> See Section 4942.

<sup>100</sup> See Tex. Bus. Orgs. Code section 21.401.

<sup>101</sup> See *id.*, section 21.417.

<sup>102</sup> See *id.*, section 22.202.

<sup>103</sup> See *id.*, section 21.101(a).

<sup>104</sup> See *id.*, section 21.405.

<sup>105</sup> See *id.*, section 101.251.

<sup>106</sup> See *id.*, sections 101.251-101.253.

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.<sup>107</sup>

Management of a limited partnership is accomplished by the general partner(s).<sup>108</sup> 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.<sup>109</sup> 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.<sup>110</sup> 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.<sup>111</sup>

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).<sup>112</sup> As a result of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.<sup>113</sup> However, the owners/members will continue to have liability for their own conduct, such as guaranteeing corporate obligations

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<sup>107</sup> See *id.*, section 152.203(a).

<sup>108</sup> See *id.*, section 153.152.

<sup>109</sup> See *id.*, section 153.103.

<sup>110</sup> See, e.g., Tex. Bus. Orgs. Code section 101.401.

<sup>111</sup> See *id.*, section 152.002(b).

<sup>112</sup> See Tex. Bus. Orgs. Code section 22.151, section 21.223.

<sup>113</sup> See, e.g., *Willis v. Donnelly*, 199 S.W.3d 262 271 (Tex. 2006).

or their own negligent or otherwise tortious actions.<sup>114</sup> 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.<sup>115</sup> 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.<sup>116</sup> Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to section 21.223 of the BOC.<sup>117</sup> 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.<sup>118</sup>

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.<sup>119</sup>

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.<sup>120</sup> 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.<sup>121</sup> Nevertheless, it is still required that the plaintiff seeking to pierce the corporate veil show that the corporate veil has

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<sup>114</sup> See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App. San Antonio, 2008, no pet.).

<sup>115</sup> See *Castleberry v. Branscum*, 721 S.W.2d 270 272 (Tex. 1986); Tex. Bus. Orgs. Code section 21.223.

<sup>116</sup> See Tex. Bus. Orgs. Code sections 21.223(a)(2) and (b).

<sup>117</sup> 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.

<sup>118</sup> See, e.g., *Latham v. Burgher*, 320 S.W.3d 602 606-07 (Tex. App. Dallas, 2010, no pet.).

<sup>119</sup> 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).

<sup>120</sup> 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).

<sup>121</sup> 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.

been used to promote injustice or inequity (i.e., injustice or inequity will result if the separate corporate existence is recognized).<sup>122</sup>

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.<sup>123</sup> 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."<sup>124</sup>

A Texas limited liability company also provides a liability shield to its owners.<sup>125</sup> BOC sections 21.223-21.226 apply equally to limited liability companies.<sup>126</sup> (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.<sup>127</sup> 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.<sup>128</sup>

Neither general partnerships nor limited partnerships are subject to the veil-piercing standards because there is not a corporate liability shield to pierce.<sup>129</sup> In the context of the general partnership, absent agreement otherwise in the partnership agreement, partners are jointly and severally liable for partnership obligations.<sup>130</sup> 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

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<sup>122</sup> 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).

<sup>123</sup> 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.

<sup>124</sup> *Lucas v. Texas Indus. Inc.*, 696 S.W.2d 372 (Tex. 1984).

<sup>125</sup> See Tex. Bus. Orgs. Code section 101.114.

<sup>126</sup> See Tex. Bus. Orgs. Code section 101.002.

<sup>127</sup> See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App., San Antonio, 2008, no pet.).

<sup>128</sup> 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).

<sup>129</sup> See, e.g., *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468 474 (Tex. App., Dallas, 2008, pet. den.).

<sup>130</sup> See Tex. Bus. Orgs. Code section 152.303(a).

assumed joint and several liability for partnership debts and obligations.<sup>131</sup> 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.<sup>132</sup> 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.<sup>133</sup> 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.<sup>134</sup>

#### D. 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.<sup>135</sup>

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).

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<sup>131</sup> See *id.*, section 153.152.

<sup>132</sup> See *id.*, section 153.102.

<sup>133</sup> See *id.*, section 153.103.

<sup>134</sup> 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.

<sup>135</sup> See 13 CFR section 1.120.100(b) (2012).

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.

#### E. TRANSFER PRICING ISSUES

When analyzing structuring options, transfer pricing issues need to be considered. Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities. While transfer pricing is generally thought to apply to cross-border transactions, it also applies to transactions between tax-exempt organizations and their subsidiaries. For example, if a for-profit subsidiary sells goods to a parent tax-exemption organization, the cost of those goods paid by the parent to the subsidiary is the transfer price.

The transfer pricing rules are set forth in Section 482 and the Treasury Regulations promulgated thereunder.<sup>136</sup> Specifically, Section 482 provides that the IRS can allocate items of gross income, deductions, credits, or allowances between controlled entities to “clearly reflect the income” of such organizations. In principle, a transfer price should match either what the seller would charge an independent, arm’s length customer, or what the buyer would pay an independent, arm’s length supplier. Unrealistic transfer prices can be used to shift the tax burdens (whether it be income tax or UBTI) between a tax-exempt organization and its controlled entities.

The regulations broadly define “control” for purposes of the Section 482 rules.<sup>137</sup> Control includes “any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.”<sup>138</sup> Thus, this definition includes transactions between one or more tax-exempt organizations or between a tax-exempt organization and a for-profit entity.

For determining whether the transaction meets the “arm’s length standard” for purposes of Section 482, the regulations list certain methods that may be used and vary among different types of transactions.<sup>139</sup> Under these methods, certain services can be reimbursed at “cost” if certain conditions are met.<sup>140</sup> While a full analysis of the transfer pricing methods is beyond the scope of this article, the transfer pricing rules should be considered when “putting things together” in an organizational structure, whether it be complex or simply two entities.

#### F. 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

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<sup>136</sup> States have generally followed the principles of Section 482.

<sup>137</sup> See Reg. Section 1.482-1A(a)(3).

<sup>138</sup> See *id.*

<sup>139</sup> See Reg. Section 1.482-1 through 1.482-9.

<sup>140</sup> See Reg. Section 1.482-9 and Rev. Proc. 2007-13.

organizations.<sup>141</sup> 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).<sup>142</sup>

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.<sup>143</sup>

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.<sup>144</sup>

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<sup>141</sup> See Tex. Bus. Orgs. Code sections 22.302 and 22.304.

<sup>142</sup> 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.

<sup>143</sup> See Section 731(b).

<sup>144</sup> 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).