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First You Need to Find It: Accessing New Forms of Capital to Finance Your Work

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Reference Outline on
Commercial Activities of Tax-Exempt Organizations

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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 utilized to varying degrees within the sector as nonprofit 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 around the structure of the activity—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, etc. Once these determinations have been made, the entity will consider ways to make itself more attractive to lenders and/or investors interested in more than a simple financial return or investment and where to find these investors. This paper will not seek to detail all the strategies a nonprofit organization might employ to generate income or all of the myriad legal issues involved in particular structures. The goal of this paper will be to highlight the major issues to be analyzed and the structural concerns to be addressed to put the organization in the position to pursue its income-generating strategies in a legally compliant manner.

II. COMMERCIAL ACTIVITIES AND MAINTENANCE OF TAX-EXEMPT STATUS

A. ORGANIZATIONAL TEST

Approaching strategies in a legally compliant manner begins with an understanding of the core elements that must be satisfied (rules that must be met) for an organization to maintain its tax-exempt status. 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) of the Internal Revenue Code (the "Code"), an organization must have a proper organizational structure, and must be organized and operated exclusively for charitable purposes.[1] Pursuant to Section 1.501(c)(3)-1(b)(1)(i) of the Treasury Regulations ("Regulations"), 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 which 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

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

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 shall be) operated exclusively for exempt purposes. In such context, the word "exclusively" means "primarily."[4] Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in the relevant section of the Code (for purposes of this paper, Section 501(c)(3)).[5] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[6] The purpose(s) of the organization must be closely evaluated to determine if they are exempt or if they are non-exempt, and if non-exempt, whether the non-exempt purpose is substantial. A single nonexempt purpose, if substantial, destroys eligibility for exemption.[7] In determining whether an organization is operated to further a substantial nonexempt purpose, the decision maker is to look to the purposes furthered by an organization's activities rather than the nature of those activities. It is not the nature of the activity itself but whether the activity furthers the organization's exempt purpose that determines eligibility for exemption.[8] 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...".[9]

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.[10] 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 it is a substantial activity, the organization would not be entitled to exemption. In Revenue Ruling 72–369, the Service ruled that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations would not qualify for exemption under Section 501(c)(3) of the Code because it was carrying on a trade or business of a type ordinarily carried on for profit. There was no charitable or educational purpose being advanced; rather, there was an activity that was not in and of itself charitable being provided at cost to nonprofits. If, however, the trade or business is in furtherance (i.e. related) to the purposes of the organization, the organization remains eligible for recognition of exemption. For example, hospitals, colleges, retirement homes, and many other businesses are operated both in the for-profit and nonprofit form.

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[3] *See id.*
[4] *See Better Business Bureau v. United States*, 326 U.S. 279 (1945).
[5] Treas. Reg. §1.501(c)(3)-1(c)(1).
[6] Treas. Reg. §1.501(c)(3)-1(c)(1).
[7] *See id*.
[8] *See B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978).
[9] *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 356-357 (1978).
[10] *See* Treas. Reg. § 1.501(c)(3)–1(e)(1).

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations further provides that to be organized and operated for one or more exempt purposes the organization must serve a public rather than a private interest. An organization will be found to primarily serve a private interest as opposed to a public interest unless the private interest served is merely incidental to the public interest. 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.[11] Any private interest must be incidental to the public interest both quantitatively and qualitatively. 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."[12] 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.[13] 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.

C. NO PRIVATE INUREMENT

Within this broad concept of a prohibition on private benefit is the doctrine of private inurement with the penalty of intermediate sanctions. 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, sale of assets for more than fair market value to the organization, etc.

There is an absolute prohibition on allowing assets to inure to the benefit of the organization's insiders.[14] "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.[15] If such action occurs, the Internal Revenue Service ("Service") may revoke the organization's tax exempt status. However, as an alternative measure, the Service can impose intermediate sanctions which are excise taxes assessed directly against the insiders and other decision-makers who have approved the transaction in question.[16] For example, if an insider were paid an excessive salary, rather than revoke the organization's tax exempt status (which would be within the purview of the Service), an excise tax sanction could

[11] *See* G.C.M. 38459 (July 31, 1980).
[12] *See, e.g.*, Rev. Rul. 70–186; *see also* PLR 9615030 (1996).
[13] *See* Rev. Rul. 72–559; Rev. Rul. 73–313.
[14] *See* Treas. Reg. § 1.501(c)(3)-1(c)(2) for explanation of private inurement prohibition.
[15] 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 v. Comm'r*, 92 T.C. 1053 (1989).
[16] *See* IRC § 4958.

be assessed against the insider in the amount of twenty-five percent (25%) of the excess benefit (which, if not corrected in a timely manner, will result in a second tier tax of two hundred percent (200%) of the excess benefit) as well as excise tax in the amount of ten percent (10%) of the excess benefit (not to exceed $20,000.00) imposed against decision-makers of the charity who knowingly participated in the transaction.[17]

D. NOT AN ACTION ORGANIZATION/NOT AGAINST PUBLIC POLICY

Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes. Finally, case law has appended the foregoing elements with the requirement that an organization must not be volitive of public policy in order to qualify for exempt status.[18]

E. COMMERCIALITY CONCERNS

While it is well-recognized that unrelated business activities can generate unrelated business taxable income (UBTI) and potentially risk exempt status as will be addressed more fully below, even related business activities can at times prove problematic. Where the related business is undertaken in a way the Service deems to have a "distinctively commercial hue," the organization may risk its exempt status.[19] 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. That doctrine looks at factors such as 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.[20] Organizations at risk of violating the commerciality doctrine may choose to spin such activities off into a taxable subsidiary to avoid such risk.

III. UNRELATED BUSINESS INCOME TAX (UBIT) ISSUES

Assuming an organization's activities do not further an exempt purpose, the charity must analyze whether and to what extent it will be subject to UBIT and further, whether pursuit of the unrelated activities will endanger the charity's exempt status.

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[17] *See* § 4958(a)(1); (d)(2).
[18] *See Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).
[19] *See, e.g., Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003); *see generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, § 4.10 (John Wiley & Sons, Inc., 10th ed. 2011).
[20] *See, e.g., Living Faith, Inc. v. Commissioner*, 950 F. 2d 365 (7th Cir. 1991).

A. General Rules

As addressed above, organizations that are exempt from federal income tax under Section 501(c)(3) of the Code 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. Where a Section 501(c)(3) organization engages in unrelated business activities, the organization must be cognizant of the generation of UBTI (and analyze any exceptions or exclusions that may apply) and must take care that such activities do not negatively impact its exempt status by allowing the unrelated business activities to become so substantial they demonstrate the existence of a substantial non-exempt purpose or far outpace the charity's exempt activities (the latter of which is discussed below).[21]

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.[22] This includes income when an exempt organization is a partner in a partnership that carries on a trade or business not substantially related to the charity's exempt purposes, regardless of whether or not the income from the trade or business is actually distributed.[23] Section 512(a)(1) of the Code 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) of the Code 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. Section 1.513–1(d)(2) of the Regulations 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. 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.

For example, in Revenue Ruling 76–37, the organization operated a business 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 unrelated business taxable income, 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.

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

In Revenue Ruling 73–128, the organization manufactured and sold toy products employing 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 Revenue Ruling 76–94, the organization operated a grocery store as part of a therapeutic program for emotionally disturbed adolescents. Because the store was operated at a scale no larger than reasonably necessary for training and rehabilitation of the adolescents and because the store was staffed in large part by the adolescents in the rehabilitation program, 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 Revenue Ruling 75–472, the organization—a halfway house—operated a furniture shop as a part of its training and counseling programs for recovering alcoholics. Noting that the shop operations existed to contribute to the organization's exempt purpose, that most of the employees were part of such programs, and that the programs provided training and supervision with all profits applied to the cost of operating the halfway house, the Service determined that the activity was substantially related to the organization's exempt purpose and therefore the gross income resulting from such operations did not constitute unrelated business taxable income.

In *Industrial Aid for the Blind v. Commissioner*, 73 T.C. 96 (1979), acq. 1980-2 C.B. 1, the organization oversaw operations which 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 PLR 9338043 the Service considered a ruling request by an organization that operated a motor vehicle registration office. The office was operated as part of a program for training, rehabilitating, and providing employment opportunities for physically and mentally disabled persons. A majority of the employees were disabled individuals receiving training for skills necessary to work at the office and being given hard to find employment. All income derived from the operation of the motor vehicle registration office was used to further the organization's charitable services to disabled persons. The Service determined that such activities were substantially related to the organization's purposes of providing training and employment opportunities for disabled individuals. As a result, the gross income from the operation of the motor vehicle registration office was determined not to be unrelated business taxable income.

In comparison to the above-cited references, in Revenue Ruling 73–127, 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, 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.

In Technical Advice Memorandum 9147008 (General Counsel Memorandum 39,863), the Service dealt with a fact pattern in which 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. The Service considered whether income from such ticketed events (i.e. those that were not school-related activities) constituted unrelated business taxable income. The Service noted that the fees charged to the general public were comparable to those charged by commercial facilities and that discounts were generally not provided to students. The Service noted that the university's fine arts department was not involved in the selection of or performance of the events. The Service noted that the entertainers received essentially the same compensation as they would at a for-profit facility. The Service noted that the organization's reputation as an educational institution was of secondary importance, if a factor at all, in attracting attendees. Noting that the university negotiated with the performers for the amount of their compensation and that the contract included a non-compete clause (i.e. no performance within X 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

As exceptions to the general rule, UBTI does not include (1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation (the "volunteer exception"); (2) any trade or business carried on by a §501(c)(3) organization primarily for the convenience of its members, students, patients, etc. (the "convenience exception"); or (3) any trade or business that consists of selling merchandise, substantially all of which is received by the organization as donations (the "thrift shop exception").[24] Income and deductions applicable to unrelated business income are subject to the modifications under §512(b).

In addition to the exceptions from unrelated business taxable income, certain items of income are excluded from UBTI treatment. Pursuant to §512(b), dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, and certain income from research is excluded from taxation.[25]

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[24] *See* IRC § 513(a).
[25] *See* IRC § 512(b).

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 subsidiary corporation will be taxable to the extent the controlled organization reduces its unrelated business taxable income by making deductible payments of such passive income to the parent charitable organization.[26] Even to the extent the controlled organization is a Subchapter C corporation that is taxed on its net income, Section 512(b)(13) of the Code 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.[27] In other words, to the extent the controlled subsidiary reduces its taxable income as a result of taking deductions for things such as royalty payments, the receipt of such passive income from the controlling parent will no longer be free of UBTI. It should be noted that deductible passive payments include payments such as rents, royalties, and license fees but do not include dividends as dividends are not deductible to the controlled subsidiary. For purposes of Section 5.12(b)(13), control means that the parent controls 50% or more of the subsidiary by vote or value. Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[28]

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 impact its exempt status by allowing such unrelated business activities to become substantial.[29] There is no bright line "upper limit" on the amount of UBTI an organization may generate. However, as UBTI grows, it raises the question as to whether the unrelated business has become a substantial purpose of the organization.[30] Because a single non-exempt purpose, if substantial, is sufficient to destroy exemption regardless of the number of truly exempt purposes, an exempt organization must be mindful of its unrelated business, understanding the risks that the unrelated business may be indicative of a substantial non-exempt purpose. As UBTI grows, the IRS will examine whether an exempt organization's exempt activities are "commensurate in scope" with its financial resources resulting from its business activities. Where the business activities grow so large that they generate revenues that outpace the organization's exempt activities (i.e. the exempt activities and the financial resources are no longer commensurate in scope), the organization risks its exempt status.[31]

The commensurate in scope test was first set forth by the IRS and Revenue Ruling 64-182.[32] According to Revenue Ruling 64-182, a charitable organization that receives a significant amount of unrelated business income faces the question of whether the charitable activities

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[26] *See* IRC § 512(b)(13).
[27] *See id.* at § 512(b)(13)(A).
[28] *See, e.g.*, § 318.
[29] *See* Treas. Reg. § 1.501(c)(3)-1(e)(2).
[30] *See, e.g.*, Treas. Reg. 1.501(c)(3)-1(c)(1).
[31] *See* Rev. Rul. 64-182.
[32] Rev. Rul. 64-182, 1964-1 (part 2) C.B. 186.

carried out by the organization are "commensurate in scope" with its financial resources, including the unrelated business income. Said differently, according to Revenue Ruling 64-482, the question is not strictly speaking what percentage of revenue generated by the organization is unrelated business income but rather whether, considering the financial resources of the organization, the charitable operations of the organization are appropriate.[33] 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 with the question of 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. As a result, an organization may choose to "spin off" one or more unrelated business activities either to a subsidiary organization or a stand-alone organization. Subject to certain exceptions that will be more fully discussed in Section IV. below, this type of "spin-off" frees the organization from generating unrelated business income and the potential risks to its exempt status attendant thereto.

E. Special Focus: Cause-Related Marketing and Corporate Sponsorships[34]

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.[35] 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. Corporate sponsorships, on the other hand, involve a for-profit organization providing funding to the charitable organization with some sort of acknowledgement or recognition ranging from a "mirror acknowledgement" to a substantial return benefit in the form of advertising. 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 most popular forms of cause-related marketing involves a for-profit organization pledging a percentage of sales/revenues/profits to a charity. Many states regulate this type of commercial co-venture activity. Generally, the regulations in this space regulate the commercial co-venturer and require that entity to register. Note that not all states have a commercial co-venturer registration requirement. Where states do have such requirements, care should be taken to ensure that any contract between the charity and 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. 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

[33] *See also* PLR 200021056; PLR 8038004; TAM 9711003.

[34] The author would like to acknowledge Megan C. Sanders of Bourland, Wall & Wenzel, P.C. for her significant contributions to Section III.E.

[35] *See, e.g.*, Terri L. Helge, *The Taxation of Cause-Related Marketing*, 85 Chi-Kent L. Rev. 883, 883 (2010).

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 unrelated business taxable income. For an excellent overview of the unrelated business income tax implications of cause-related marketing, see Terri Lynn Helge, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

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.[36] 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.[37] 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.[38] Critical to note, however, a royalty is passive and cannot include payments for services rendered by the owner of the property.[39] 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).[40] 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.[41] Personal appearances, endorsements, interviews or active participation in publication of a periodical are not considered passive or de minimus, but instead, taking some kind of active role in connection with the license will disallow the income to be treated as royalty.[42]

The minimal quality control rights are important to the charity's protection of the use of its name and logo by the corporate partner; however, at the same time, this presents a double-edged sword, in that 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.[43] 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

[36] Royalties are generally excluded from UBI taxation under IRC § 512(b)(2) and Treas. Reg. § 1.512(b)-1(b).
[37] Rev. Rul. 81-178, 1981-2 C.B. 135.
[38] *See, e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135.
[39] PLR 200601033; Sierra Club Inc. v. Comm'r., 86 F.3d 1526, 1532 (9th Cir. 1996).
[40] Rev. Rul. 81-178*; See* Sierra Club Inc. v. Comm'r., 86 F.3d 1526, 1532 (9th Cir. 1996).
[41] Rev. Rul. 81-178.
[42] PLR 200601033; Sierra Club Inc. v. Comm'r., 86 F.3d 1526, 1532 (9th Cir. 1996).
[43] Helge, *supra* note 86, at 14.

unrelated business income tax, but is instead treated as a charitable contribution to the charity.[44] 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 such person 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.[45]

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 two percent (2%) of the corporation's total payment to the charity.[46] "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.[47] 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.[48] However, if the fair market value of the benefit exceeds 2% of the payment, 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.[49]

For example, an exempt organization which organized an amateur sports team entered into a sponsorship agreement with a pizza chain, under which the pizza chain gave the charity uniforms to the members of its team, including the pizza chain's name and logo, and paid for some of the team's operating expenses.[50] 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.[51] 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.[52]

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.[53] 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

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44 IRC § 513(i); Treas. Reg. § 1.513-4.
45 *Id.* (emphasis added).
46 Treas. Reg. § 1.513-4(c).
47 *Id.*
48 Treas. Reg. § 1.513-4(c).
49 *Id.*
50 Treas. Reg. § 1.513-4(f), Ex. 5.
51 *Id.*
52 *Id.*
53 Treas. Reg. § 1.513-4(c).

of public exposure to the sponsored activity.[54] A payment which is determined to not be a qualified sponsorship will be treated under the general principles of UBI.[55] Benefits to the corporate sponsor will be evaluated separately, which may include advertising, services or privileges to the payor, exclusive provider arrangements, a license to use the charity's intangible assets, or other substantial return benefits.[56]

When there are numerous forms of recognition given to the sponsoring corporation, some may constitute 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.[57] 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.[58]

To make this allocation, the organization must determine the fair market value of any non-monetary portion of the substantial return benefit, determined at the time the benefit is provided to the sponsor.[59] 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.[60] 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.[61]

Any payment, or portion of a payment, that is determined to not be a qualified sponsorship is evaluated under the general rules of unrelated business income. 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 UBI from those payments.[62]

For example, a tax exempt organization that conducts an annual college football bowl game sold the right to broadcast the game to commercial broadcasters.[63] 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

[54] IRC § 513(i)(2)(B)(i); Treas. Reg. § 1.513-4(e)(2).
[55] Treas. Reg. § 1.513-4(d).
[56] *Id.*
[57] Treas. Reg. § 1.513-4(d).
[58] Treas. Reg. § 1.513-4.
[59] *Id.* Note that this allocation is separate and apart from the 2% de minimus 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).
[60] Treas. Reg. § 1.513-4(d).
[61] *Id.*
[62] Treas. Reg. § 1.513-4(d)(1).
[63] Treas. Reg. § 1.513-4(f), Ex. (4).

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 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.

a. Use or Acknowledgement

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.[64] A mere "use or acknowledgement" may include: (1) exclusive sponsorship arrangements; (2) logos and slogans which 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.[65] Logos or slogans which are an established part of the company's identity are not considered to contain qualitative or comparative descriptions.[66]

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.[67] The corporation also gave the organization prizes to be awarded at the event.[68] 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.[69] The organization also re-named the event to include the sponsor's name.[70] These activities constituted acknowledgement of the corporate sponsorship, and thus were not considered substantial return benefits, nor taxable to the organization as UBTI.[71]

Exclusive *sponsorship* arrangements are not considered substantial return benefits; this 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.[72] However, an exclusive *provider* arrangement, 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

64 IRC § 513(i); Treas. Reg. § 1.513-4.
65 *Id.*
66 Treas. Reg. § 1.513-4(c)(2).
67 Treas. Reg. § 1.513-4(f), Ex. 1.
68 *Id.*
69 *Id.*
70 *Id.*
71 *Id.*
72 Treas. Reg. § 1.513-4(c)(2).

sponsorship.[73] 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.[74]

Further, 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.[75] However, if the charity provides complimentary admission passes and special VIP treatment to the employees of the sponsor, this is considered a return benefit, and will be considered substantial if the value of this benefit exceeds 2% of the sponsor's total payment.[76]

b. Advertising

Advertising is a form of a substantial return benefit, which 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.[77] According to the Supreme Court, it is possible to have related advertising, by "coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments."[78] 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".[79] 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.[80] If a single message contains both advertising and an acknowledgment, the entire message is treated as an advertisement.[81] For example, a message stating the sponsor's name, phone number and location is considered an acknowledgement, but if that same message in any way prompts the consumer to choose that company over others, it will be considered an advertisement.[82]

The posting of a link to the contributor's website constitutes an acknowledgement of its sponsorship[83]; however, there is 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

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[73] *Id.*
[74] *Id.*
[75] Treas. Reg. § 1.513-4(f), Ex. 3.
[76] *Id.*
[77] IRC § 513(c). Therefore, if the publication as a whole is published at a loss, there would be no taxable UBI due to advertising.
[78] United States v. Am. Coll. of Physicians, 475 U.S. 834, 849-50 (1986).
[79] Treas. Reg. § 1.513-4(c)(2)(v).
[80] *Id.*
[81] *Id.*
[82] Treas. Reg. § 1.513-4(f), Ex. 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.
[83] Treas. Reg. § 1.513-4(f), Ex. 11; PLR 200303062.

a simple link.[84] Where the Treasury Regulations leave open the distinction between advertisements and allowed uses and acknowledgements, the courts may be inclined to take a more common sense approach, and consider a message to be an advertisement if it merely *looks* like an advertisement or is possible for a consumer to view it as an endorsement.[85] The sponsorship rules unfortunately were not designed with these web activities in mind, so they do not address 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.[86]

IV. CHOOSING TO USE A NEW ENTITY

In the event commercial activities are operated with a "distinctively commercial hue," UBTI is undesirable, or the activity is creating a substantial amount of UBI, the charity should consider whether the activities can be conducted in a subsidiary or separate entity. Once the charitable organization has determined the need to create a separate entity to house operating activities, the decision-makers must understand the options available. This section of the paper will introduce the primary options.

A. A BRIEF OVERVIEW OF THE OPTIONS

Nonprofit entities have many organizational options for their mission-driven activities.

1. Nonprofit Corporation

Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code ("BOC").[87] 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.[88] 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.[89] 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

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[84] IRS FY 2000 CPE Text on Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet, at 74.

[85] *See, e.g.,* State Police Ass'n of Mass. V. Comm'r., 125 F.3d 1,6-7 (1st Cir. 1997).

[86] *See* Helge, Terri Lynn, Suzanne N. Smith and William H. Caudill, NUTS AND BOLTS OF UNRELATED BUSINESS INCOME TAX, at 13.

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

[88] *See id.* at § 22.001(5).

[89] *See id*. at §§ 2.001-002, 2.101-102, 3.003 and 22.054.

shareholders, they may have members which operate to control the organization in a way analogous to for-profit shareholders.[90]

2. For-Profit Corporation

For-profit corporations are domestic entities formed under Texas law for any lawful purpose or purposes (unless otherwise provided by the BOC).[91] 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.[92] 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.[93] For-profit corporations are governed by Chapter 21 of the BOC.[94] 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.[95] Once the corporation has been created through filing a certificate of formation with the Texas Secretary of State's office, a corporate liability shield protects the owners. Through the BOC and the development of Texas case law, the laws regarding the operation and management of corporations are well established and provide a relatively clear operational structure for the entity.

For-profit corporations are classified as C corporations or S corporations. Absent an affirmative S corporation election, a taxable corporation is taxed as a C corporation.[96] C corporations are taxed at the corporate level while S corporations operate as pass through entities with shareholders receiving allocations of income and loss and paying tax at the shareholder level only. For purposes of an entity that will be owned solely or in part by a charitable organization, S corporations are not the best option because all income and gain are taxable as unrelated business income to the charitable shareholder.[97] As a result, this paper will focus only on C corporations.

C corporations are taxable on their net income at rates of up to 35%.[98] After-tax profits are taxable to the shareholders leading to what is described as double taxation.[99] 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.

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[90] *See id.* at § 22.101.
[91] *See id*. at §§ 2.001; 2.007.
[92] *See id*. at § 3.007(d).
[93] *See id*.
[94] *See id*. at § 21.001 *et seq*.
[95] *See id*. at § 2.101.
[96] *See* IRC § 1361(a)(2).
[97] This is a quite different result than taxable owners who would prefer to avoid C corporation status generally to avoid double taxation.
[98] *See* IRC § 11(a)-(b).
[99] *See id.* at § 61(a)(7).

3. Partnership

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

a. General Partnership

A general partnership is an association of two or more persons to carry on the business for profit as owners.[100] The general partnership is considered a separate business entity distinct from its owners.[101] General partnerships are the easiest entities to set up and dissolve among multiple owners. No state law filing is required to set up a general partnership. In fact, a general partnership could exist based on an oral partnership agreement between the parties, though this is not advised. In a general partnership, all partners are liable for partnership obligations unless otherwise agreed by the claimant or provided by law.[102] 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.[103]

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 liabilities for partnership obligations along with one or more limited partners who are liable only to the extent of their partnership account, absent the limited partner also serving as the general partner or the limited partner's participation in control of the business.[104] The general partner or general partners will have control of the day-to-day operational aspects of the partnership and any other matters allowed the general partner as set forth in the partnership agreement. In most cases, the general partner will be a corporation, limited liability company, or another limited partnership because the general partner is ultimately liable for all the debts and obligations of the limited partnership. The limited partners will be either individuals or entities. As addressed above, limited partners have no liability for the operations of the limited partnership unless they participate in the management of the business in their capacity as a limited partner (as opposed to in their capacity as a co-general partner or as an employee) or otherwise guarantee the debts of

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[100] *See* Tex. Bus. Orgs. Code § 152.051(b).
[101] *See id*. at § 152.056.
[102] *See id*. at § 152.304.
[103] *See* IRC § 701-702.
[104] *See* Tex. Bus. Orgs. Code § 153.102.

the partnership. Participation for purposes of imposing liability is addressed below at Section V.E.

A limited partnership is a state-created entity, and in order for the limited partnership to be created and the limited partners to receive liability protection, the limited partnership must file a certificate of formation with the Secretary of State.[105] The limited partnership should have a limited partnership agreement clearly setting out the rights and obligations of the partners, including the responsibilities of the general partner and the matters on which the limited partners will have control or a vote regarding the operations of the limited partnership. The structure of the limited partnership is flexible and can provide that the general partner will have control over almost all of the operational aspects of the limited partnership with the ability to only be removed "for cause" or by supermajority of the limited partners. In this fashion, a 1% owner, a 0.5% owner, or even a 0% owner may serve as the general partner and control the operations of the limited partnership. As with general partnerships, limited partnerships are flow-through entities for federal taxation purposes and are not taxed at the entity level. In addition to the flow-through status for tax purposes, a charitable organization will also receive its share of unrelated business taxable income generated by the partnership and, pursuant to the aggregate approach taken by the IRS, the partnership activities will be considered as if undertaken directly by the partner for purposes of determining the exempt status of the organization.[106] As a result, it is critical for an exempt organization to consider whether the activities being undertaken in the partnership further a charitable purpose.

4. Limited Liability Company

The limited liability company ("LLC") was originally enacted as a hybrid entity combining features of corporations and partnerships. It is a single entity in which all of the owners (called members) have liability protection from the operations of the LLC.[107] However, for federal tax purposes, it is treated as a partnership unless an affirmative election is made to be taxed as a corporation or unless it has a single member, in which event it is disregarded absent an election to be treated as a corporation.[108] Therefore, it combines the benefits of limited liability of a corporation for all the owners of the LLC while retaining tax advantages of a partnership. This has caused it to be a popular entity choice. LLCs are governed by the Business Organizations Code and specifically Chapter 101.[109] LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.[110] 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

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[105] *See id*. at § 3.001.
[106] *See* Rev. Rul. 98-15; Rev. Rul. 2004-51.
[107] *See* Tex. Bus. Orgs. Code § 101.114.
[108] *See* Treas. Reg. § 301.7701-2(c)(2).
[109] *See* Tex. Bus. Orgs. Code § 101.001 *et seq*.
[110] *See id*. at § 3.001.

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

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

The LLC is unique in that it can be classified as a disregarded entity, a partnership, or an association (taxed as a corporation) for federal income tax purposes. Where the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-exempt status (discussed below) but rather will effectively take on the tax attributes of its parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.[112] If there are two or more owners of the LLC, then the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (taxed as a corporation).[113] Being able to be treated as a partnership for federal income tax purposes can be advantageous to an LLC in that it allows it to take advantage of the flexibility in the partnership tax area discussed above while still retaining limited liability for all of its owners in a single entity. While this is a common benefit to LLCs, tax-exempt organizations participating in a multi-member LLC should be cautious about being taxed as a partnership for the reasons addressed under Section III.C. above (i.e. the income may flow through as unrelated business income and the activities of the partnership may affect the exempt status of the tax-exempt member).

[111] *See id*. at § 101.251.
[112] *See* Treas. Reg. § 301.7701-2(c)(2).
[113] *See id*. at §§ 301.7701-3(b)(1)(i); 301.7701-3(a).

Should a single member LLC wish to apply for exemption from federal income tax (as opposed to being a disregarded entity) or should the LLC have multiple members and wish to be recognized as exempt, separate conditions apply. The IRS has indicated that it will recognize the 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (which will be discussed below) and meets 12 additional conditions as follows[114]:

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

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

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

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

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

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

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.

[114] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

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.

5. Hybrids: L3C's and Benefit Corporations

Low-Profit Limited Liability Corporations (L3C's) and Benefit Corporations are hybrid entities that are taxable in the same ways as LLCs and C corporations (respectively), yet are structured in a way so as to embed social purposes within the organizations. This structure is intended to help attract capital from private foundations looking to make program-related investments or from individuals desiring a social return on investment. Texas does not have statutory law recognizing L3C's or Benefit Corporations. However, there is nothing in the limited liability company law that would prohibit a limited liability company from structuring itself in a way that would be classified as an L3C in a state that recognized L3C's, and Texas statutory law with respect to corporations was modified in 2013 to provide that a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation's certificate of formation. The corporation may also include in the certificate of formation a provision that the board of directors and officers of the corporation shall consider any social purpose specified in the certificate of formation in discharging the duties of directors or officers under the BOC.[115] Accordingly, the benefits of the L3C and Benefit Corporation may be achieved in Texas, though those designations are not utilized. Because these entities are structurally similar to LLCs and C corporations, they will not be separately discussed unless there is a distinction worth noting.

B. TAXABLE OR TAX-EXEMPT

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

> "Corporations, in any community chest, fund, or foundation, or organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual,

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

> no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

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

C. SELECTING THE STRUCTURE

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

1. Impact on Exempt Status

a. Corporations

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

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

b. Partnerships

Partnerships risk negatively impacting the exempt status of a tax-exempt organization partner. Specifically, the unrelated business income is passed through to the partners and the tax-exempt organization would get its allocation. Further, the aggregate approach is used to consider the activities of the partnership along with the activities of the exempt organization in considering satisfaction of the operational test for ongoing exempt status.[116]

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

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

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

1. Limited contractual liability of the exempt partner;

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

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

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

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

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

7. Absence of profit as a primary motivation;

8. Arm's length transactions with partners;

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

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

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

The unfavorable factors are as follows:

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

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

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

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

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

6. A profit motivation by the exempt organization; and

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

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

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 (see Section 1 above). In the event it is treated as a disregarded entity, it has no independent tax filing or information filing requirement, but rather its income and loss and activities are considered to be part of the exempt parent and are reported on the exempt parent’s Form 990. As a result, if the activities undertaken in the disregarded single-member LLC are unrelated to the activities of the parent, not only do they create unrelated business taxable income, but they risk the parent’s exempt status to the extent they become large enough to be considered a substantial purpose. Accordingly, a disregarded single-member LLC is not an appropriate choice for substantial unrelated business activities.

Where the LLC has multiple members, the LLC may choose to be taxed as a corporation or a partnership. Again, if it is taxed as a corporation, the rules set forth at Section 1 above apply. If, on the other hand, as is more common, it is taxed as a partnership, the partnership rules at Section 2 above apply with each member receiving its allocation of gain and loss while the activities of the LLC will be aggregated with the activities of the tax-exempt organization in determining eligibility for exempt status.[117]

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

2. Unrelated Business Taxable Income

A tax-exempt nonprofit corporate subsidiary is exempt from federal income tax with respect to its related revenue. However, like any other tax-exempt organization, it will be taxed on its unrelated business income. To the extent a controlled tax-exempt subsidiary reduces its unrelated business taxable income by making deductible payments of passive income to the parent charitable organization, the parent charitable organization will be subject to unrelated business taxable income on such payments.[118] Deductible passive payments include payments such as rents, royalties, and license fees. Dividends are not deductible to the controlled subsidiary and therefore not taxable to the parent. To be clear, this rule related to passive income received from a subsidiary being UBTI to the parent only applies where the subsidiary is controlled by the parent. In this context, controlled means that the parent controls 50% or more of the subsidiary by vote or value. Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[119]

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

[117] *See* Rev. Rul. 98-15.
[118] *See* IRC § 512(b)(13).
[119] *See id*. at § 318.

purposes of determining whether or not the payments to the parent charitable organization will be unrelated business taxable income.[120]

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

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

3. Texas Margin Tax

All of the organizational options identified in Section III above are subject to the Texas Margin Tax.[121] Corporations, if exempt under Section 501(c)(3), are eligible for exemption from the Texas Margin Tax.[122] Likewise, passive entities (as defined under Texas Tax Code § 171.0003) are not subject to the Texas Margin Tax. However, taxable corporations, limited liability companies that are operating businesses (regardless of whether they are disregarded for federal income tax purposes), general partnerships owned by other filing entities, and limited partnerships are subject to the Texas Margin Tax. Generally, Texas state tax issues will not be the determinative factor as between organizational types, though it may play a factor in determining whether the organization should be created as a nonprofit corporation or LLC (taxed as a corporation) that will obtain exemption from Section 501(c)(3) and therefore be eligible for exemption from Texas taxes as well.

4. Control & Management

With respect to control, a tax-exempt organization controls its nonprofit subsidiaries through interlocking directorates or serving as the sole member. For-profit subsidiaries are controlled through owning a majority of the voting interests, which typically means owning a majority of the stock in a C corporation,[123] a majority of the membership interests in a limited liability company, a majority of the partnership interests in a general partnership, or the general partner in a limited partnership. Of course, shareholders agreements, operating agreements, and partnership agreements may be used to vary these rules as to operation control.

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[120] *See id*. at § 512(b)(13)(A).
[121] *See* Tex. Tax Code § 171.001(a); certain exceptions apply to the imposition of the Texas Margin Tax that are not applicable to this discussion. For example, where all owners of a general partnership are natural persons, the general partnership will not be subject to the Texas Margin Tax. Where an entity is involved (such as is discussed in this paper), each of the entity types is subject to the Texas Margin Tax.
[122] *See* Tex. Tax Code § 171.063(a)(1).
[123] Unlike S corporations, a C corporation may have multiple classes of stock to effectuate 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).[124] Furthermore, private foundations may not own more than 20% of a business entity that is controlled by the private foundation or one or more of its disqualified persons unless the subsidiary entity is a program-related investment or generates only passive income.[125]

Part of understanding the ability of the tax-exempt parent to control the organization is understanding the management structure of the subsidiary organization. Corporations (whether for-profit or nonprofit) are generally governed by a centralized board of directors who manage the affairs of the corporation.[126] The board generally elects officers to handle the day-to-day operations of the corporation.[127] Within the nonprofit context, the organization may elect not to have a board of directors and rather be member-managed.[128] Within the for-profit context, a similar result can be obtained through the use of a shareholders' agreement and direct management by the shareholders.[129] However, each of these latter two situations is less common.

If the corporation at issue is a nonprofit corporation, its board of directors will be elected by its member(s) (if the organization has one or more members) or will be self-perpetuating, though from a control standpoint the governing documents may require that a majority of the 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.[130] As a result, the tax-exempt parent, unless the corporation is managed by its members or its shareholders, will not have direct involvement either in the governance decisions or in the day-to-day operations. Rather, the input into those matters is accomplished through the election of the board. Depending on the purpose of the subsidiary, it is not uncommon that the organizations have some overlap of officers as well as board members; the extent of that overlap and the need to maintain separateness will be discussed below.

Limited liability companies under Texas law may be member-managed or manager-managed.[131] 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.[132] The details of these arrangements are contained in the LLC's company agreement.

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[124] *See* IRC § 512(b)(13)(B)(i)(I).
[125] *See id*. at § 4942.
[126] *See* Tex. Bus. Orgs. Code § 21401.
[127] *See id.* at § 21.417.
[128] *See id.* at § 22.202.
[129] *See id.* at § 21.101(a).
[130] *See id*. at § 21.405.
[131] *See id*. at § 101.251.
[132] *See id.* at §§ 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 to have a clear understanding among the partners of their ownership interest, their sharing of profit and losses, their obligation (if any) to contribute additional capital, the sharing of management among the partners, the ability of a partner to withdraw from the partnership or to cause the dissolution of the partnership, the restrictions on transfer of partnership interest, and the ability to incur debt or other liabilities for the partnership. Absent agreement otherwise, each partner will have equal rights in the management of the business of the general partnership with the ability to bind the partnership.[133]

Management of a limited partnership is accomplished by the general partner(s).[134] One of the features of a limited partnership, as discussed above, is the general rule that limited partners do not participate in the operation or activities of the limited partnership (absent falling within the laundry list provided by the Business Organizations Code) or similar type of activities.[135] However, limited partners may have the ability in the partnership agreement to remove and replace the general partner, similar to the ability to remove and replace members of a board of directors in the corporate setting or the manager(s) in the limited liability company setting. This ability may be without cause, for cause, by a super-majority vote, etc. There is also no prohibition on a limited partner creating a subsidiary entity to serve as the general partner, such as the tax-exempt parent serving as the limited partner in a partnership but creating a single-member LLC to serve as the general partner. This type of layered structure requires careful attention to ensure that corporate roles are respected.

Regardless of the organizational type, the governing persons owe fiduciary duties to the entity that they govern and, where for profit, to the owners. Within the limited liability company context, these fiduciaries may be limited or modified.[136] In the partnership context there may be an agreement to set parameters around the fiduciary duties of care and loyalty; however, those duties may not be completely eliminated and the parameters may not be manifestly unreasonable.[137]

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 Section II above, this is one of the primary rationales for forming a subsidiary. Therefore, the question becomes what type of liability protection is created by the use of the subsidiary?

A corporation, whether nonprofit or for-profit (and whether taxable or tax-exempt) provides a liability shield (sometimes called a corporate veil) to its owners (or members, as the

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[133] *See id.* at § 152.203(a).
[134] *See id*. at § 153.152.
[135] *See id.* at § 153.103.
[136] *See, e.g.*, Tex. Bus. Orgs. Code § 101.401.
[137] *See id*. at § 152.002(b).

case may be).[138] As a result of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.[139] 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.[140] The exception to this general rule is when the court "pierces" the corporate veil, effectively finding that the corporate entity should be disregarded because the subsidiary corporation is the alter ego of the parent or because the corporation has been used as a sham to perpetrate a fraud.[141] Under either scenario, pursuant to Texas statutory law, a shareholder will not be held liable for contractual obligations of the subsidiary corporation unless there is a finding that the corporation was used by the shareholder to perpetrate an actual fraud for the direct personal benefit of the shareholder.[142] Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to Section 21.223 of the Business Organizations Code.[143] 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.[144]

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 Business Organizations Code. The majority of courts have chosen to exclude corporate formalities as even a factor in determining veil piercing, though at least one court has interpreted the provision to mean it cannot be the only basis on which an alter ego is predicated.[145]

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.[146] 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

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[138] *See* Tex. Bus. Orgs. Code § 22.151, § 21.223.

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

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

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

[142] *See* Tex. Bus. Orgs. Code § 21.223(a)(2) and (b).

[143] *See SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory as running counter to the standards of Section 21.223); *see also Willis*, 199 S.W.3d at 271-273.

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

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

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

statutory standard is not directly applicable to tort causes of action. The proposed instructions for piercing the corporate veil and tort cases provided by the *Texas Pattern Jury Charges* omit reference to showing actual fraud.[147] 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).[148]

Because a tax-exempt organization may find itself creating a subsidiary in another state (or having another state's laws apply to the conduct of a subsidiary) and because tort claims are treated slightly differently than contractual claims under Texas law, the parent organization should be mindful of maintaining sufficient separateness to avoid a piercing result. Separateness is discussed in Section VI below; however, some of the factors that should be observed are avoiding complete overlap of directors, officers, and employees ensuring that the subsidiary is appropriately capitalized to meet its needs; dealing in arms-length transactions between the subsidiary and the parent, allowing the subsidiary to carry out its own decision making, maintaining separate meetings, separate minutes, separate bank accounts, etc.[149] 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."[150]

A limited liability company also provides a liability shield to its owners.[151] Pursuant to Section 101.002 of the Business Organizations Code, Sections 21.223-21.226 of the Business Organizations Code (those sections addressed above providing the strict standard for piercing the corporate veil in the corporate context) apply equally to limited liability companies. Thus, members may participate in management and retain the liability shield, unlike the limited partnership context. As with corporations, members and managers of LLCs will continue to be liable if they guarantee obligations of the LLC as well as for their own tortious conduct. As within the corporate context, owning all of the interests of a limited liability company or failing to follow corporate formalities are not justifications for finding alter ego. Accordingly, in Texas the corporate shield for the LLC is equally strong as the corporate shield for a corporation. In line with the cautionary note above, tax-exempt organizations creating LLC subsidiaries in states other than Texas should understand what law applies, as many states do not have statutes that do not cover veil piercings in the context of LLCs and may apply more lenient veil-piercing theories under common law.[152]

Neither general partnerships nor limited partnerships are subject to the veil-piercing standards because there is not a corporate liability shield to pierce.[153] In the context of the general partnership, absent agreement otherwise in the partnership agreement, partners are

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

[148] *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).

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

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

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

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

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

jointly and severally liable for partnership obligations.[154] This is one of the primary dangers of the general partnership and motivation for having a carefully drafted partnership agreement that specifies who has authority to bind the partnership and under what circumstances. Within the limited partnership context, there is likewise no need to pierce the corporate veil to reach limited partners because the limited partnership has one or more general partners who have joint and several liability for partnership debts and obligations.[155] Limited partners will be liable only if they also serve as a general partner or participate in control of the business in such a way that a third party believes the limited partner is a general partner and relies on that.[156] Participation in control of the business must be something more than the following non-exhaustive list of activities set out in Section 153.103 of the Business Organizations Code[157]:

(1) acting as:

  (A) a contractor for or an officer or other agent or employee of the limited partnership;
  (B) a contractor for or an agent or employee of a general partner;
  (C) an officer, director, or stockholder of a corporate general partner;
  (D) a partner of a partnership that is a general partner of the limited partnership; or
  (E) a member or manager of a limited liability company that is a general partner of the limited partnership;

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

  (A) the winding up or termination of the limited partnership;
  (B) an election to reconstitute the limited partnership or continue the business of the limited partnership;

[154] *See* Tex. Bus. Orgs. Code § 152.303(a).
[155] *See id*. at § 153.152.
[156] *See id.* at § 153.102.
[157] *See id*. at § 153.103.

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

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

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

Because partners in a general partnership and general partners in a limited partnership have joint and several liability for partnership debts and obligations, a tax-exempt organization participating in a partnership should consider the use of a corporate or LLC subsidiary to serve as the general partner in its place to avoid exposing the parent to unnecessary liability. In such instance, the tax-exempt organization would have the strong Texas corporate shield as a protection for its assets.[158]

6. Capitalization (Fundraising)

A factor in determining the choice of form for the subsidiary is how the subsidiary will be capitalized. Appropriate capitalization is critical for showing that the organization is an authentic business entity separate from its parent for tax purposes as well as to avoid veil-piercing arguments in the tort (non-contractual) context. If it is to be capitalized by invested

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

capital from private investors, it will need to be structured as a for-profit entity (C corporation, LLC, partnership) whereas if it is to be capitalized by donated capital, it will need to be structured as an exempt organization (typically a nonprofit corporation). To the extent the organization will seek private investors, it should be mindful of securities laws, which are beyond the scope of this paper. Likewise, if the organization is seeking loans or guarantees from the Small Business Administration, it will need to be structured as a for-profit entity.

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

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

7. Distribution/Liquidation Issues

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

In the event the subsidiary is a taxable corporation, Sections 336 and 337 of the Internal Revenue Code will require the subsidiary to recognize gain or loss when the appreciated or depreciated property is distributed in complete liquidation or sold in connection with complete liquidation. This results in tax being paid at the subsidiary level. To the extent the subsidiary is a pass-through organization (partnership or LLC taxed as a partnership), liquidation is generally a non-taxable event.[159]

In addition to the issues addressed above, the tax-exempt parent should ensure that the subsidiary's debts have been paid or provision has been made for those debts so that the distribution may not be tracked back to the parent entity under the Texas Uniform Fraudulent Transfer Act.[160]

D. MANAGING THE RELATIONSHIP

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

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

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

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

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

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

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

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[159] *See* IRC § 731(b).

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

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

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

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

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

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

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

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

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

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