Creating Subsidiaries of Tax-Exempt Organizations

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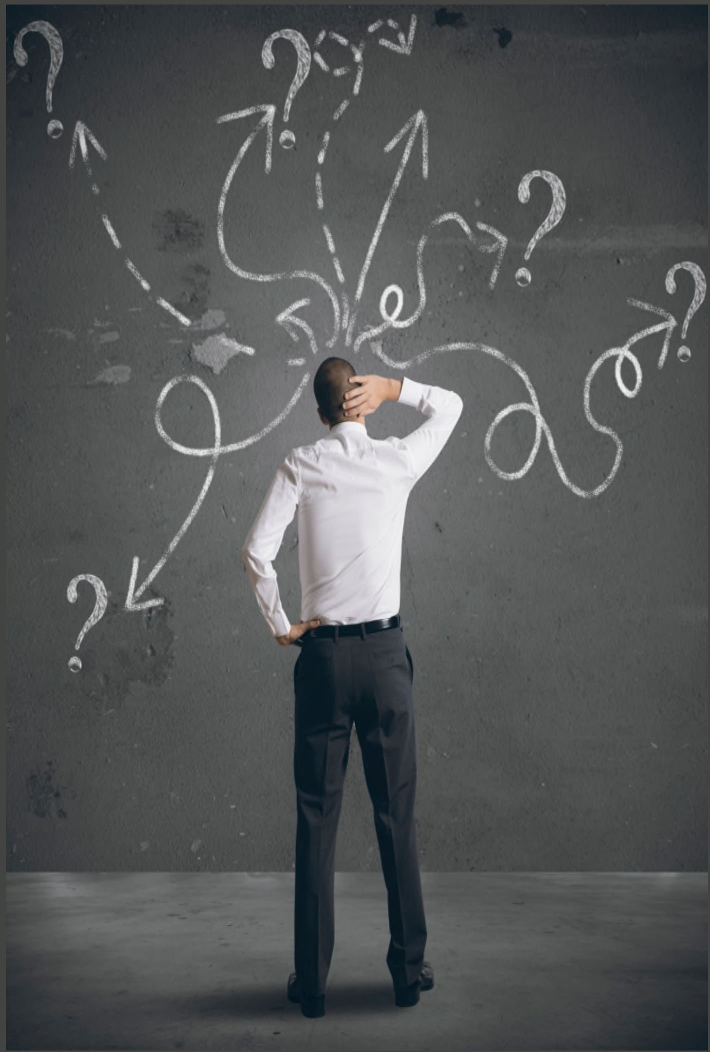
Common Reasons for Creating Subsidiaries

- New/Expanding Business Activity
- Risk Mitigation
- Focused Management of Activity
- Participation in Joint Venture



Key Considerations

- Structural Options
- Tax Implications to Parent
- Managing the Relationship

An Initial Inquiry: Tax-Exempt?

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

Options We'll Explore

1. Nonprofit Corporations

2. For Profit Corporations
   - Benefit Corporation
   - Social Purpose Corporation

3. Partnerships (General and Limited)

4. Limited Liability Companies

Nonprofit Corporation

Where: All 50 States

Purpose: Any lawful purpose (cf. exemption)

Control: Board of Directors (usually)

Duties: Care, loyalty, obedience

Taxation: Eligible for exemption

Funding: Revenues, Grants/Donations, Debt (may create UDFI)

Liability: Limited

Notable: Commerciality concerns

Commerciality Doctrine

Operating with a “distinctly Commercial hue”

- Direct competition with commercial firms (esp. in same locales)
- Pricing structure designed to produce a profit
- Extensive advertising and use of commercial advertising materials
- Annual accumulated profits
- Lack of charitable donations

Limited Liability Company

Where: All 50 States

Purpose: Any lawful purpose

Control: Members or Managers

Duties: Flexible per company agreement

Taxation: Partnership, C Corp, Exempt, Disregarded

Funding: Equity, revenues, debt

Liability: **Limited**

The Exempt LLC: 12 Conditions

- Further member(s)' charitable purpose(s)
- All members must be (c)(3)'s, governmental units/instrumentalities
- Assets only used by/transferred to any nonmember/non-(c)(3)/non-governmental unit/instrumentality for fair market value

The Exempt LLC: 12 Conditions

- Termination provision - charitable use
- Prohibit merging with, or converting into, a for-profit entity.
- Contingency plan if member(s) cease(s) to be an organization described in (c)(3)/ governmental unit/ instrumentality.

	For Profit Corporation
Where:	All 50 States
Purpose:	Any lawful purpose
Control:	Board of Directors (usually)
Duties:	Care, loyalty, obedience
Taxation:	Standard corporate tax (Subchapter C)
Funding:	Equity, revenues, debt
Liability:	Limited

For Profit Corporation

Benefit Corporation

Texas (BOC 21.951)

- Produce a public benefit/operate in a "responsible and sustainable manner"
- Specific Public Benefit (required)
- Consider: shareholders, those materially affected, specific public benefits
- Biennial benefit report to shareholders

B Lab Model

- General public benefit
- Specific Public Benefit (permitted)
- Consider: shareholders, workforce, customers, local community, local and global environment, short-term and long-term corporate interests/purposes
- Independent third-party standard
- Annual public report (shareholders)
- Benefit Director

The Social Purpose Corporation

Where: California, Washington, Texas

Purpose (TX): Tracks B Lab Model for "specific public benefit"

Control: Board of Directors

Duties: Care, loyalty, obedience (*may* consider social purposes)

Taxation: Standard corporate tax

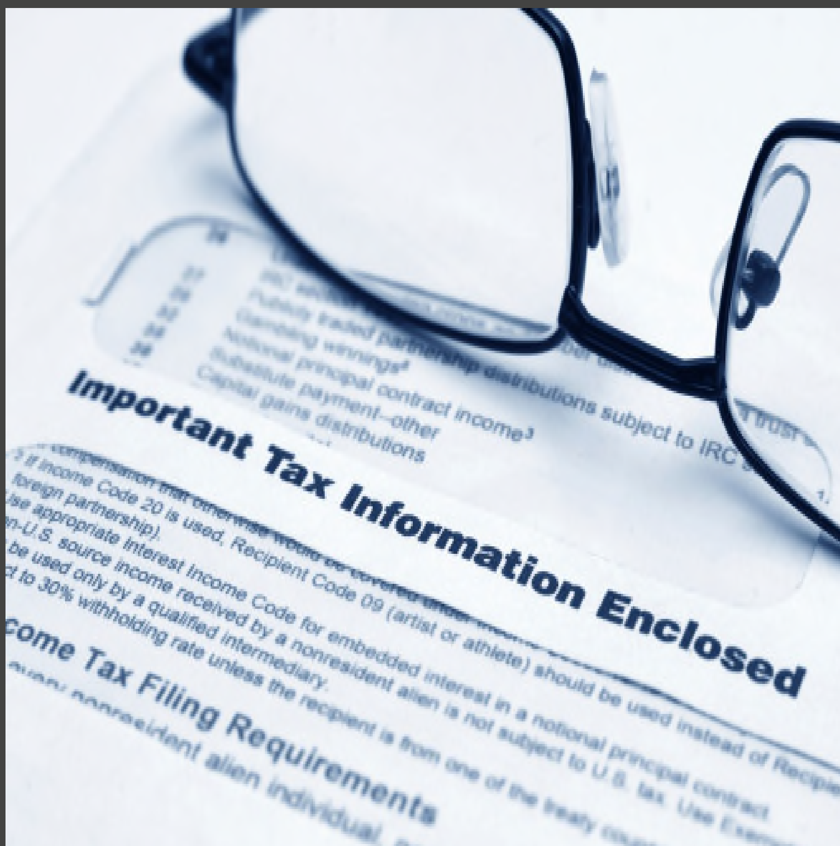
Funding: Equity, loans, revenues, grants

Notable: TX does not require annual report

	General Partnership	Limited Partnership
Where:	All 50 States	All 50 States
Purpose:	Any lawful purpose	Any lawful purpose
Control:	Partners	General Partner(s)
Duties:	Care, loyalty, obedience	Care, loyalty, obedience (GP)
Taxation:	Partnership	Partnership
Funding:	Equity investments, revenues, debt	Equity investments, revenues, debt
Liability:	Unlimited Liability	Limited Liability = Limited Control

Partnerships

Tax Implications of Subsidiaries



- Impact on Exempt Status of the Owner/Parent
- Unrelated Business Taxable Income Issues

Impact on Exempt Status of Owner/Parent

- Flow through entities create most concern
- Corporate entities generally not a concern

See Paper, Section V.A., Page 10

EO as GP/Managing Member of Joint Venture

- Key Consideration: Must *not* lose control of charitable assets
  1. Is the EO's participation substantially related to its exempt purposes?

  2. Does the structure of the venture avoid conflicts between the EO's purpose and the EO's duty to further the private interests of non-exempt partners?

EO Control of Charitable Assets: Favorable Factors

1. Additional GP's/managers obligated to protect interests of non-exempt partners
2. EO has control over major decisions/charitable decisions
3. No obligation to return non-exempt's capital from EO funds
4. Arm's length transactions with partners

EO Control of Charitable Assets: Unfavorable Factors

1. Disproportionate allocation of profits and/or losses in favor of non-exempt organizations
2. Commercially unreasonable loans by EO to partnership
3. Inequitable compensation received for services provided
4. Insufficient capital contribution by non-exempt partners
5. Guarantee of non-exempt partners tax credits/ROI to detriment of exempt organization.

UBTI Considerations

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

<u>unless</u>

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

Subsidiaries and “Control”

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

Parent Liability for Subsidiary

Texas law is very protective of the corporate veil

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

Controlled but Separate

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

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