

LLCs as Nonprofit Organizations

LLCs in the World of Nonprofit and Mission-Minded
Organizations

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Defining the Nonprofit Sector

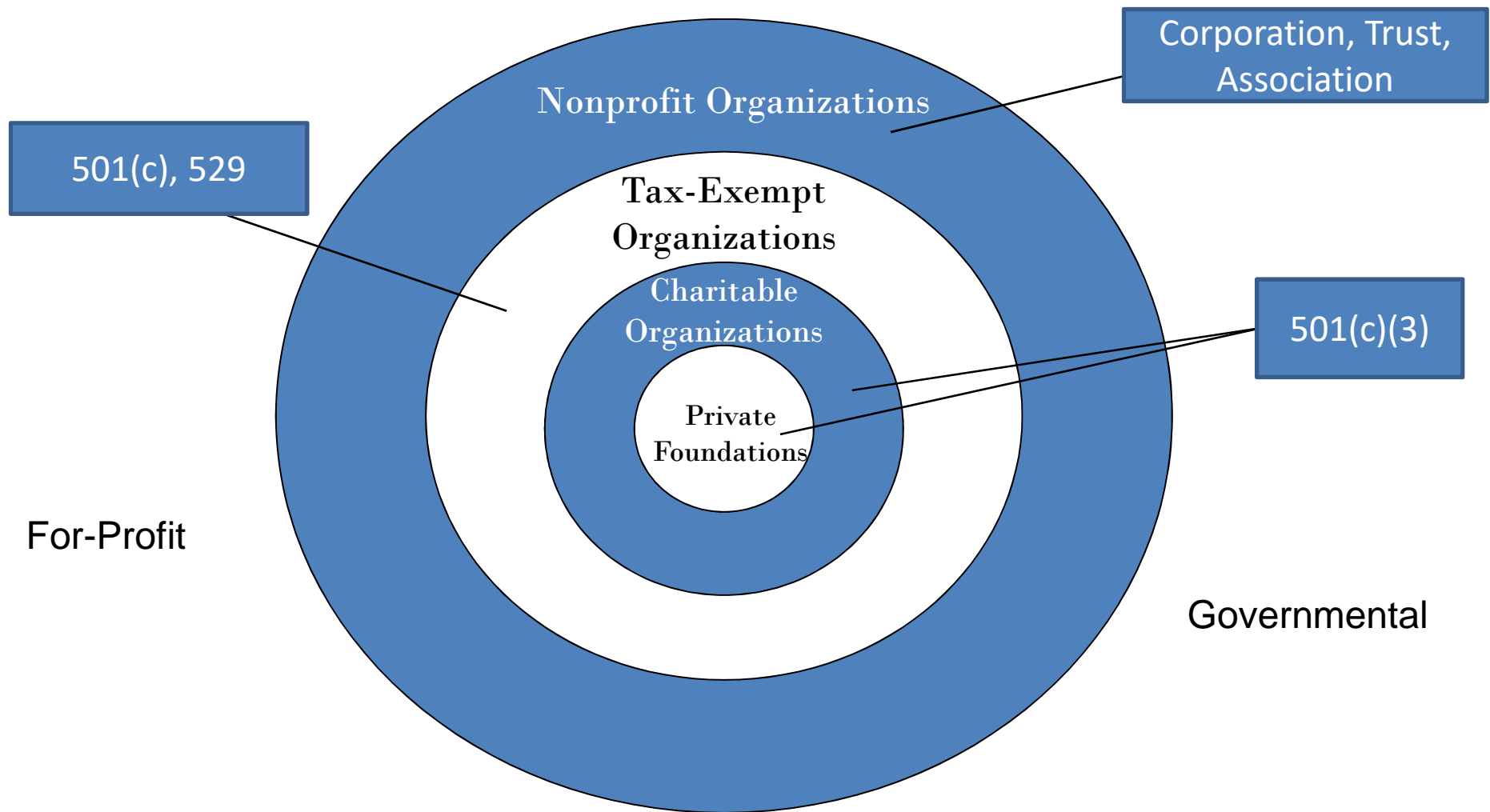
1. Organizations
2. Private (not governmental)
- 3. Non-profit distributing**
4. Self-governing
5. Non-compulsory

Terminology

Nonprofit Sector

- Nonprofit Sector
 - Civil Society
 - Independent Sector
 - Voluntary Sector
 - Third Sector
 - Nongovernmental Sector (particularly int'l)

Nonprofit vs Charitable Organization



Facts and Figures about Charitable Organizations

- In 2011, over 1.6 million **tax-exempt** nonprofit organizations were registered with the IRS
- About 75% of these make up the “independent sector” – including 501(c)(3)s and (c)(4)s.
 - About 10% are (c)(4)s [examples include the NAACP, the NRA, and the Sierra Club]

Employment & Economic Impact

- 501(c)(3) organizations employ approximately 10% of the workforce.
 - With volunteers, the total workforce would be the equivalent of 14.1 million full-time employees
- Employees of (c)(3)s accounted for 6.6% of wages paid in the U.S. in 2004
 - The average weekly wage for a (c)(3) employee in 2004 was \$627/week (compared to \$669/week in the for-profit sector)
- In 2009, the nonprofit sector accounted for 5.5% of the GDP

Finances

- Total charitable in 2014: \$358.38B
 - 2.1% of GDP
- As of August 2016, charitable orgs that filed 990s reported holding more than \$4.0 trillion in assets
- Most nonprofits, though, are small with more than 40% having total assets of less than \$250,000

1. Proper organizational structure
2. Organized exclusively for charitable or otherwise exempt purposes
3. Operated exclusively for charitable or otherwise exempt purposes
4. No part of net earnings inures to benefit of private individual
5. Not an action organization
6. <<case law>> - not violative of public policy

- “Primary” or “Exclusive” purpose must be charitable (“exclusive” doesn’t mean “sole”)
- Charitable purposes:
 - Advancement of religion
 - Scientific research
 - Advancement of education
 - Promotion of health
 - Relief of poverty
 - Lessening the burdens of government
 - Other social welfare

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?

Organizational

- Look to enabling documents
- Must be organized exclusively for charitable purpose(s)
- May be general or specific

Operational

- Look at actual activities of organization
- Must be operated exclusively for charitable purpose(s)
- May not engage in substantial activities that fail to further charitable purposes

Considerations in Selecting the Vehicle

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

Impact on Exempt Status of Owner/Parent



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

EO as GP/Managing Member

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

EO Control of Charitable Assets:

Favorable Factors

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

EO Control of Charitable Assets: Unfavorable Factors

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

UBTI

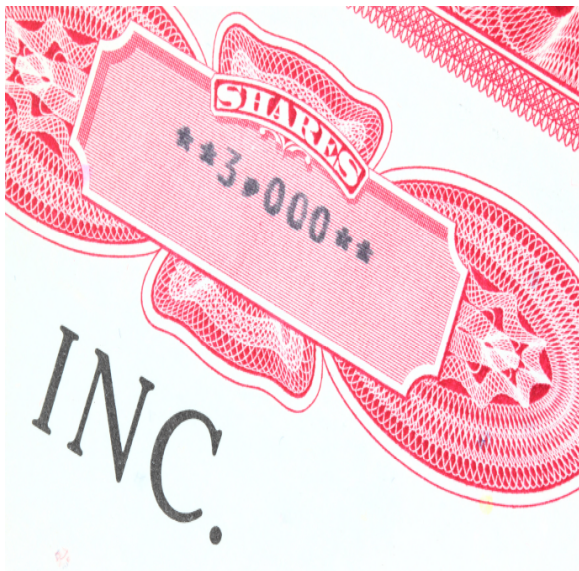
- Trade or business
- Regularly carried on
- Not substantially related to exempt purposes

What's Taxable?

- Volunteer Exception
- Convenience Exception
- Thrift Shop Exception
- Passive income (usually)
 - Royalties: Beware of providing substantial services

What's Not?

UBTI Considerations



- Flow through entities:
Unrelated income flows through to exempt partner
- Corporate entities: Taxed at C corp level; passive payments to EO deductible by C corp and not taxable to EO
unless
- C corp is controlled by EO:
 - 512(b)(13) alters general UBTI rule re passive income (other than dividends)

Controlling the Vehicle

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

Owner Liability for Vehicle



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

Maintaining the Vehicle: Controlled but Separate

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

What are the Major Legal Considerations for Commercial Activities?



- Protect Exempt Status
 - Avoid Private Benefit
 - Avoid Violating Commerciality Doctrine
- Avoid (Manage?) UBTI
- Control and Management of the Activity
- Liability

Private Benefit

- Implicit in requirement that the organization must be operated for charitable (public) purposes
- **“Insubstantial” private benefit:** Occasional economic benefits flowing to persons as an incidental consequence of an organization pursuing its exempt charitable purposes
 - **Qualitative:** Private benefit must be necessary to the exempt activity
 - **Quantitative:** Private benefit must be insubstantial, measured in the context of overall tax-exempt benefit conferred by the activity

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

COMMERCIALITY DOCTRINE

Commerciality Doctrine

- Business activities grow too large in relation to charitable activities such that they become a substantial purpose
- “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
- Infer purpose from activities (IRS considers above “useful indicia”)

New tools for the toolbox

Earned Revenue/
Sliding Fee Models

Social Ventures/
For-Profit Related
Organizations

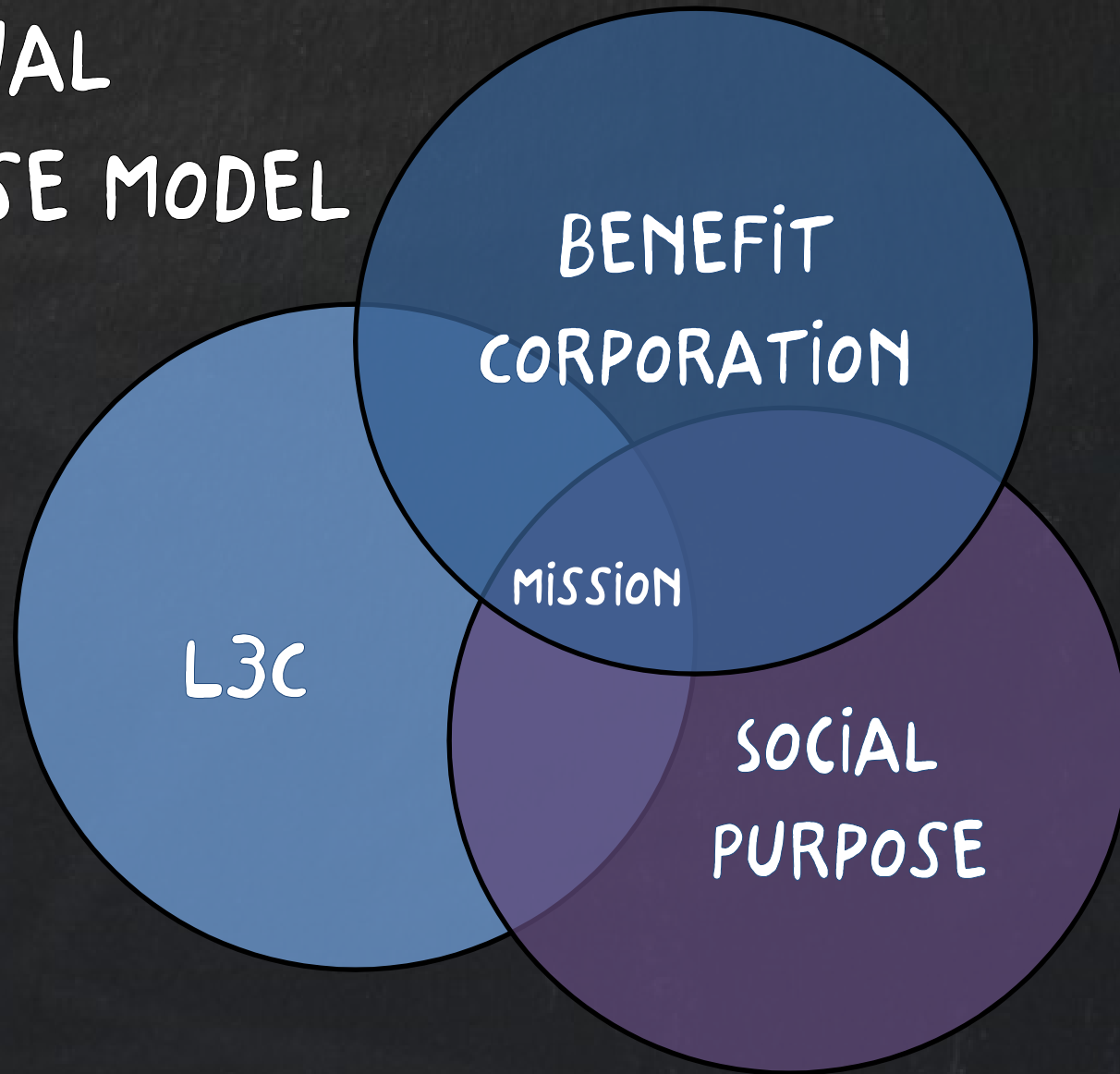
Social Impact
Loans

Fast Pitches,
Incubators,
& Accelerators

Program-Related
Investments (PRIs)

Pay for Success
(Social Impact
Bonds)

THE DUAL PURPOSE MODEL





THE PARADIGM PROJECT

— est. 2008 —

NO
POLITICS

NO SUBSTANTIAL
PURPOSE TO
PROFIT

PRIMARY PURPOSE:
CHARITABLE OR
EDUCATIONAL



THE L3C MODEL

WHERE: 8 STATES

PURPOSE: ONE OR MORE CHARITABLE/EDUCATIONAL PURPOSES

CONTROL: MEMBERS OR MANAGERS

**DUTIES: FLEXIBLE PER COMPANY AGREEMENT;
HOWEVER, PURPOSE IS FIXED**

TAXATION: SAME AS STANDARD LLC

**FUNDING: EQUITY INVESTMENTS, REVENUES, DEBT;
GRANTS (PRIS FROM PRIVATE FOUNDATIONS)**

SPECIAL FOCUS: FOCUSED CONSIDERATION OF PURPOSE

THE L3C SOCIAL ENTERPRISE



THE BENEFIT CORPORATION MODEL

WHERE: 31 STATES AND D.C.; UNDER CONSIDERATION IN 7 OTHERS

PURPOSE: PUBLIC BENEFIT (GENERAL/SPECIFIC)

TAXATION: STANDARD CORPORATE TAX RULES

FUNDING: EQUITY, LOANS, REVENUES, GRANTS

THE BENEFIT CORPORATION SOCIAL ENTERPRISE

DUTIES: CARE, LOYALTY, OBEDIENCE

MODEL ACT MANDATE - CONSIDER:

SHAREHOLDERS, WORKFORCE,
CUSTOMERS, LOCAL COMMUNITY,
LOCAL AND GLOBAL ENVIRONMENT,
SHORT-TERM AND LONG-TERM
CORPORATE INTERESTS/PURPOSES

DELAWARE ACT MANDATE - BALANCE:

PECUNIARY INTERESTS OF
SHAREHOLDERS, BEST INTERESTS OF
THOSE MATERIALLY AFFECTED BY
CORPORATION'S CONDUCT, SPECIFIC
PUBLIC BENEFIT

SPECIAL FOCUS: ACCOUNTABILITY & TRANSPARENCY

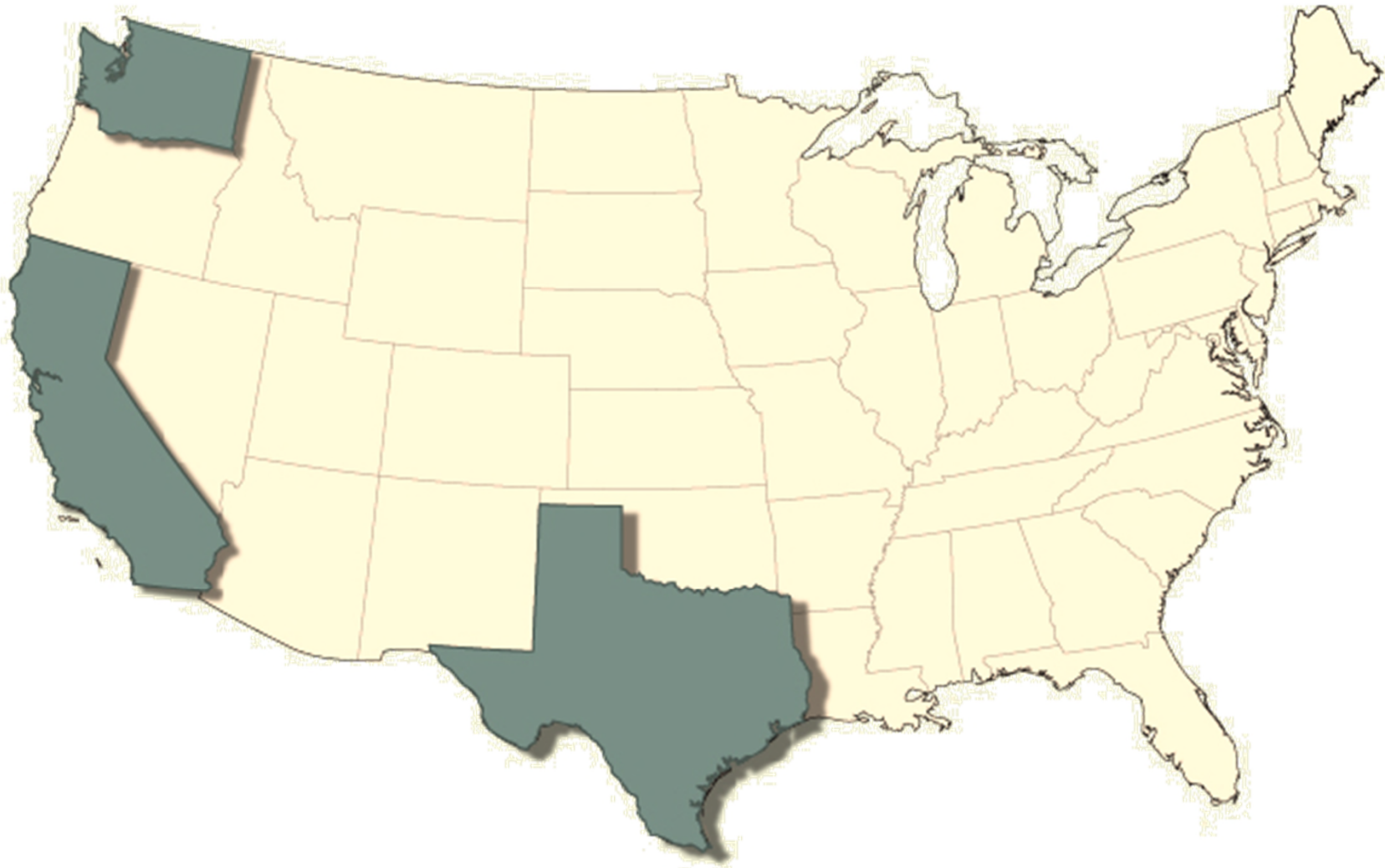
MODEL ACT

INDEPENDENT THIRD-PARTY
STANDARD
ANNUAL PUBLIC REPORT
(SHAREHOLDERS AND ONLINE)
BENEFIT DIRECTOR

DELAWARE ACT

BOARD-ADOPTED MEASUREMENT
STANDARDS
AT LEAST BIENNIAL PUBLIC REPORT
(SHAREHOLDERS)

THE BENEFIT CORPORATION SOCIAL ENTERPRISE



THE SOCIAL PURPOSE CORPORATION MODEL

WHERE: CALIFORNIA, WASHINGTON, TEXAS

**PURPOSE (TX): TRACKS BENEFIT CORPORATION MODEL
ACT 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

SPECIAL FOCUS: WA & CA REQUIRE ANNUAL REPORT

THE SPC SOCIAL ENTERPRISE



DECLARATION OF INTERDEPENDENCE

We envision a global economy that uses business as a force for good.

This economy is comprised of a new type of corporation – the B Corporation –
Which is purpose-driven and creates benefit for all stakeholders, not just shareholders.

As B Corporations and leaders of this emerging economy, we believe:

That we must be the change we seek in the world.

That all business ought to be conducted as if people and place mattered.

That, through their products, practices, and profits, businesses should aspire
to do no harm and benefit all.

To do so requires that we act with the understanding that we are each
dependent upon another and thus responsible for each other and
future generations.