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

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OVERVIEW OF PRESENTATION

- Selected choice of entity options
- Choice of entity considerations
- Case study

CHOICE OF ENTITY OPTIONS

- "Wholly owned" organizations
  - Section 501(c)(3) organizations
    - Supporting organizations
      - Type I, II, III (functionally integrated and non-functionally integrated)
  - Other Section 501(c) organizations
  - Single-member limited liability companies
    - Disregarded limited liability companies (LLCs) vs. "check-the-box" LLCs

CHOICE OF ENTITY OPTIONS

- "Wholly owned" organizations (cont.)
  - Taxable subsidiaries
    - State law business corporation vs. nonprofit corporation
      - Stock ownership vs. membership
    - "Check-the-box" LLC
    - S corporations = automatic UBTI

STAND-ALONE SECTION 501(C)(3) ORGANIZATIONS VS. SUPPORTING ORGANIZATIONS

- Use of SOs
  - Generally prefer stand-alone public charity to SOs
    - Can still maintain control over stand-alone public charity without tax restrictions placed on SOs
  - Use as parent entity
    - Which type to use?
      - Generally a parent can only be a Type II or Type III functionally integrated supporting

DISREGARDED SINGLE-MEMBER LLCs VS. SECTION 501(C)(3) ORGANIZATIONS

- Disregarded single-member LLC provides liability protection, separate governance and/or independence but no separate application/990.
- Contributions to disregarded single-member LLC are eligible for charitable contribution deductions.
  - IRS Notice 2012-52
  - However, can create issues for donors/grantors
- State and local sales and property tax exemption
  - Varies by state
  - TX: Disregarded single-member LLC subject to margin/franchise tax, sales tax, use tax, and generally not eligible for property tax exemption

CHOICE OF ENTITY CONSIDERATIONS

- Related vs. unrelated activity
- Size (or expected size) of activity
- Limitations on liability
- Governance
- Independence/culture
- Attracting and compensating employees
- Public perception
- Future partners/investors
- Costs (both $ and time) of forming/maintaining multiple entities
- Exit strategies

RELATED VS. UNRELATED ACTIVITIES

- A substantial nonexempt purpose can jeopardize the tax exempt status of an organization.
- There is no bright-line test to determine when an unrelated business activity becomes so pervasive that it is no longer incidental and instead becomes substantial.
- A facts-and-circumstances determination:
  - **Amount of income derived** from the unrelated business income (UBI) activity in comparison to total income
  - **Amount of expenditures** for the UBI activity in comparison to total expenditures
  - **Amount of time** the organization's employees devote to the UBI activity in comparison to total hours worked

RELATED VS. UNRELATED ACTIVITIES (CONT.)

- Commerciality Doctrine:
  - Related business conducted in commercial manner as indicia of operating for nonexempt purpose
  - Manner of conducting revenue-generating activities = substantial non-exempt purpose
  - 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

RELATED ACTIVITY ENTITY CHOICES

- Operate in existing exempt organization
- Separate for liability protection, governance and/or independence
  - Section 501(c)(3) organization
    - Stand-alone public charity or supporting organization
  - Single-member LLC (disregarded)
  - Other Section 501(c) organization
    - E.g., Section 501(c)(2) title-holding company or Section 501(c)(4) social welfare organization
- Generally do not use taxable corporation

UNRELATED ACTIVITY ENTITY CHOICES

- Operate in existing EO
- Separate for liability protection, governance, independence **OR** to protect against excessive UBTI or commercial activities
  - Single-member LLC (disregarded)
  - Taxable corporation
    - Protects exempt status
    - Requires separate tax return

DISREGARDED ENTITY VS. TAXABLE ENTITY

Disregarded entity

Exempt organization (EO)
Reports 100% of disregarded entity

100%: Income and activities

Disregarded entity

Revenue	$200k
Expenses	($100k)
Net income	$100k

C corporation

EO
No flow-through
Tax-free dividend

100%

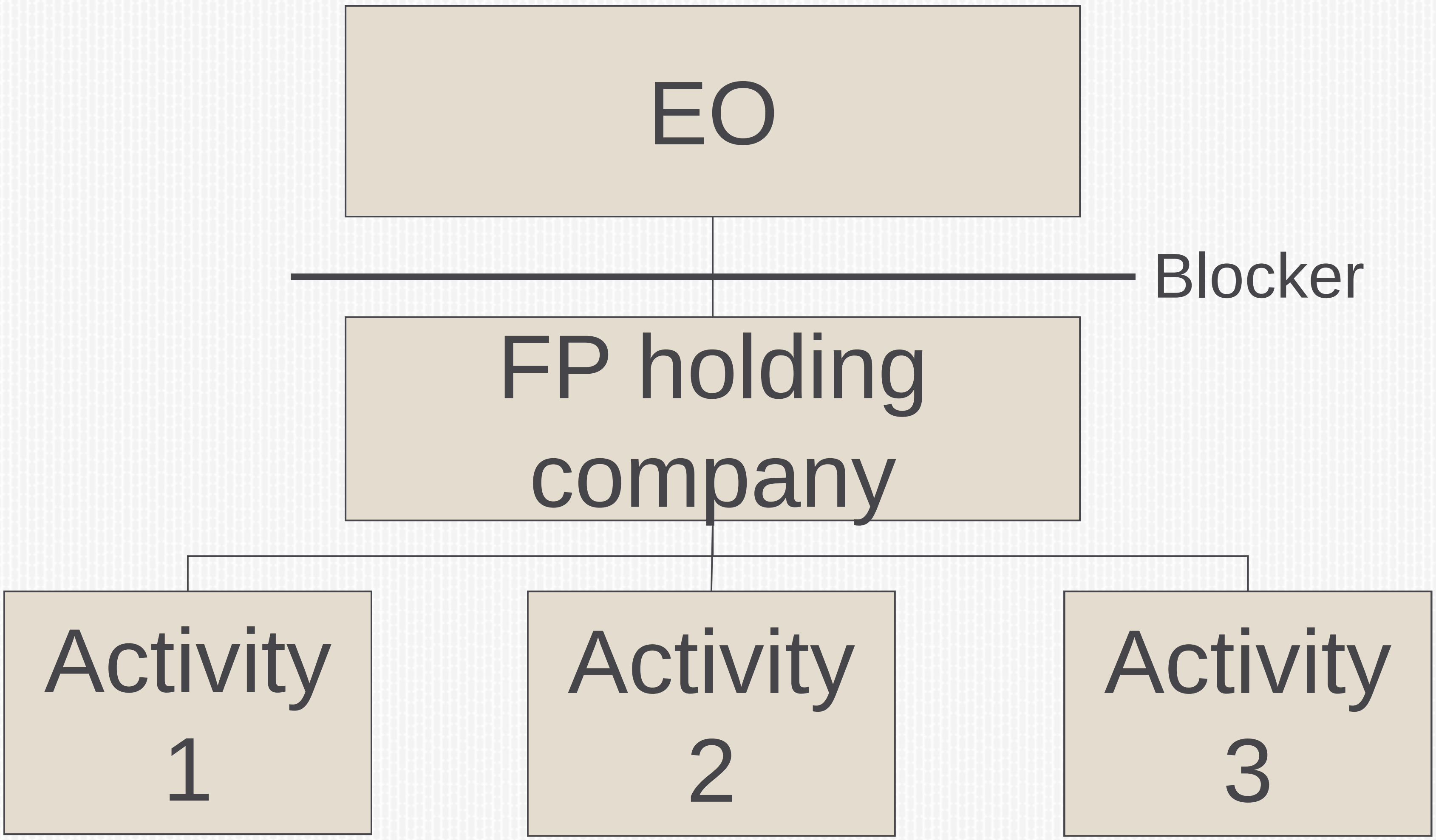
C corporation

Revenue	$200k
Expenses	($100k)
Net income	$100k
Tax paid	$35k
Net	$65k

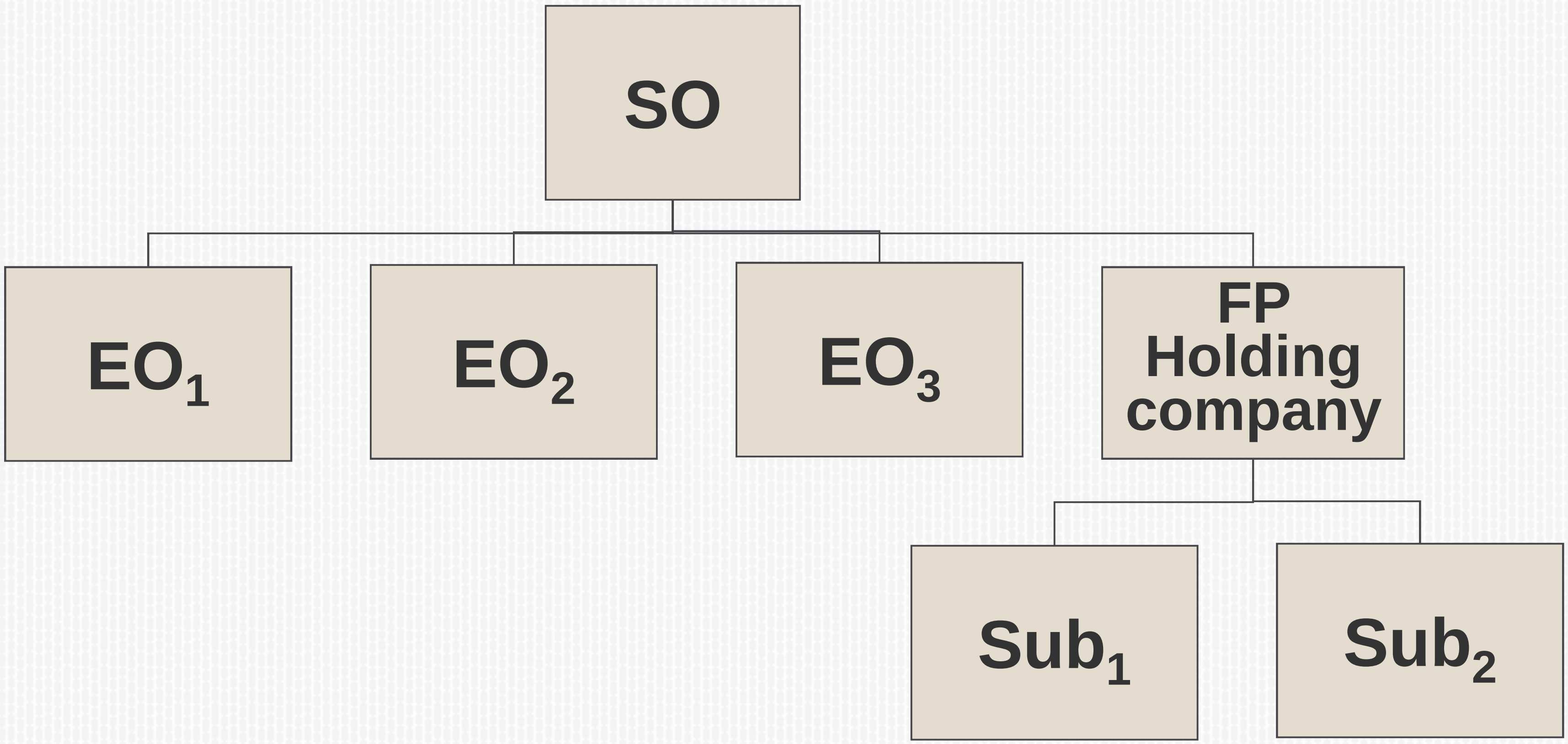
OTHER CONSIDERATIONS

- Section 512(b)(13)
  - Interest, annuities, royalties and rents (specified payments) received from or accrued by a **controlled organization** is UBTI (to the controlling entity) to the extent the specified payment reduces the net unrelated income of the controlled organization (or increases net unrelated loss).
  - Control – 50% of stock/profits interest/beneficial interests (constructive ownership rules apply)

MULTIPLE UNRELATED ACTIVITIES WHOLLY OWNED CONSOLIDATED GROUP



RELATED AND UNRELATED USE OF CONSOLIDATED GROUP AND SUPPORTING ORGANIZATION



OTHER CONSIDERATIONS

Separate entity — issue of separateness

- Particularly important if unrelated activity
- Facts and circumstances analysis
  - Need for bona fide business purpose
  - Observation of corporate formalities
  - Maintain separate books and records
  - Board of directors
  - Officers
  - Employees
  - Facilities/website
- Historical focus — separate board of directors
- Focus is now on day-to-day activities
  - Good facts: PLRs 201503018, 201406019 and 200602039
  - Bad facts: TAM 200908050 and PLR 201408030

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

OTHER CONSIDERATIONS

- Transfer pricing (TP) — Section 482
  - This refers to the pricing of transactions between related parties
    - General principle: arm's-length transaction
  - Section 482 provides, in part:
    - In the case of two or more organizations owned or controlled directly or indirectly by the same interests, the IRS Commissioner may allocate gross income, deductions, credits or allowances between or among such organizations if he or she determines that such allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations.
  - TP rules apply equally to transactions conducted within the US between for-profit and tax-exempt parties.
  - State tax authorities have generally adopted Section 482 principles.

OTHER CONSIDERATIONS: EXIT STRATEGIES

- Sale/merger or liquidation
  - Single-member LLCs
    - Since the LLC is disregarded for tax purposes, no tax impact
  - Exempt organizations
    - Generally no gain or loss should be recognized
  - Taxable corporations (state law nonprofit and business corporations)
    - Asset sale versus stock sale to unrelated party
      - Stock sale: Gain or loss on sale of stock by EO parent generally excluded from UBTI treatment under Section 512(b)(5).
      - Asset sale: Taxable event to the for-profit subsidiary
    - Liquidation/merger into parent
    - Issues related to Affordable Care Act Provision 9010 — Health Insurance Providers Fee

MERGER/LIQUIDATION OF TAXABLE SUBSIDIARY INTO EXEMPT PARENT

- Treated as a "liquidation" of subsidiary for tax purposes
- General rule: no gain or loss recognized by parent (Section 332(a)) or subsidiary (Section 337(a)) where the parent owns at least 80% of subsidiary stock (by vote **and** value)
- Special rule: where parent is exempt organization, gain or loss will be recognized by taxable subsidiary upon the transfer unless parent (a) is subject to UBTI and (b) uses the property in an unrelated trade or business *immediately* after the distribution. *See* Reg. Section 1.337(d)-4
- Limitation on losses under Reg. Section 1.337(d)-4(d)

CHOICE OF ENTITY OPTIONS

- Joint Ventures/Joint Operating Agreements
- Affiliations and Contractual Arrangements

PARTNERSHIPS/LLCS: 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

- Additional GP's/managers obligated to protect interests of non-exempt partners
- EO has control over major decisions/charitable decisions
  - Ability to initiate actions to protect exempt status
- No obligation to return non-exempt's capital from EO funds
- Arm's length transactions with partners

EO CONTROL OF CHARITABLE ASSETS: UNFAVORABLE FACTORS

- Disproportionate allocation of profits and/or losses in favor of non-exempt organizations
- Commercially unreasonable loans by EO to partnership
- Inequitable compensation received for services provided
- Insufficient capital contribution by non-exempt partners
- Guarantee of non-exempt partners tax credits/ROI to detriment of exempt organization.
- Effective control granted to affiliate of for-profit partner through long-term management contract

JOINT OPERATING AGREEMENTS (JOAS)

- JOAs
  - Organizations cede certain financial, operational, and governing control to a separate governing body, but the organizations still maintain their separate identities and continue to own their own assets
    - Often called a "Virtual Merger"
- Advantages
  - Increased cost efficiencies
  - Elimination of duplicative efforts
  - Maintain ownership of own assets
- Disadvantages
  - No complete integration
  - Terms or arrangement may be complex

JOINT OPERATING AGREEMENTS (JOAS)

- Structure – Joint Operating Company
  - Nonprofit corporation
  - LLC/Partnership
  - Contractual

- Exempt Status Issues
  - Integral Part Test
  - Facts and Circumstances Test

AFFILIATIONS AND OTHER CONTRACTUAL ARRANGEMENTS

- Purpose
  - Maintain independence
    - Only liable for the contractual terms
    - Closer Affiliations
      - Overlapping boards
      - Shared staffing arrangements
- Common Examples
  - Collaborative fundraising effort
  - Joint program
  - Shared services

AFFILIATIONS AND OTHER CONTRACTUAL ARRANGEMENTS

- Advantages
  - Larger or more diverse programmatic offerings
  - Eliminate administrative and organizational redundancies
- Disadvantages
  - Never fully integrated – may cause disagreements between the parties

CASE STUDIES

CASE STUDY #1

- A public charity, which is operated entirely by volunteers, engages in activities that promote the beautification of public parks and green spaces. It is considering starting a new lines of business where it will sell flowers, plants, and related garden items to the general public. Consider the following facts:
  - Initially, PC will conduct the venture only through its own volunteers.
  - PC believes that this could turn into a large business.
  - PC may consider partners in the future to expand the business if successful.
- What type of structure should PC consider?

CASE STUDY #2

- An exempt hospital is considering starting a new medical supply distribution business. Consider the following facts:
  - Initially, hospital will only distribute to related entities that are part of its system. However, in the future, it may expand the business to unrelated entities.
  - Hospital believes that this could turn into a large business.
  - Hospital is also considering starting or purchasing ancillary businesses.
  - Hospital may consider investors or partners in the future to expand the business if successful.
  - Hospital also may consider a sale of the entity in the future.
- What type of entity structure should hospital consider?

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