PRESENTED AT

36th Annual Nonprofit Organizations Institute

January 16, 17-18, 2019
Austin, TX

MANAGING GROWTH, OPPORTUNITY, AND BUSINESS ACTIVITIES: COMPLEX ORGANIZATIONAL STRUCTURES AND WHY AND WHEN TO USE THEM

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MANAGING GROWTH, OPPORTUNITY, AND BUSINESS ACTIVITIES: COMPLEX ORGANIZATIONAL STRUCTURES AND WHY AND WHEN TO USE THEM

I. INTRODUCTION

Whether scaling to increase greater impact, engaging in joint ventures or collaborative efforts with others, needing to address unrelated business income or risk-to-exemption, or seeking to avoid liability, charities often find themselves looking to structure their operations through subsidiaries, affiliates, and other joint venture vehicles. Choosing to create a more complex organizational structure requires an understanding of the general tax exemption and unrelated business principles to understand when such a structure may be needed. Once that determination is made, factors ranging from choice of form, tax status of the vehicle, and ultimately the impact on the parent exempt organization and its tax status must be considered. The discussion below reviews the major legal issues to be analyzed and the structural options to be considered when "building out" a more complex organizational structure.

II. GENERAL TAX EXEMPTION PRINCIPLES

Approaching strategies in a legally compliant manner begins with consideration of the core elements that must be satisfied for an organization to maintain its tax-exempt status.

A. ORGANIZATIONAL TEST

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure, must be organized and operated exclusively for appropriate exempt purposes (religious, charitable, scientific, educational, etc.), must not allow its assets to inure to the benefit of insiders, and must avoid substantial lobbying and political intervention.[1] Pursuant to Reg. 1.501(c)(3)-1(b)(1)(i), an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities that are not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose.[2] Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the federal government, or to a state or local government, for a public purpose.[3]

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

B. OPERATIONAL TEST

For purposes of the operational test, an organization must show that it is (or will be) operated exclusively for exempt purposes.[4] In this context, the word "exclusively" means "primarily."[5] Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in the relevant section of the Code (for purposes of this article, Section 501(c)(3)).[6] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[7] The purpose(s) of the organization must be closely evaluated to determine whether they are exempt and, if non-exempt, whether the non-exempt purpose is substantial. A single non-exempt purpose, if substantial, destroys eligibility for exemption.[8] In determining whether an organization is operated to further a substantial non-exempt purpose, the decision-maker looks to the purposes furthered by an organization's activities rather than the nature of those activities.[9] 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...."[10]

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.[11] The question is whether the trade or business is pursued in furtherance of the organization's purposes. If the trade or business is unrelated to the organization's purposes (i.e. not pursued in furtherance of those purposes) and is a substantial activity, the organization would not be entitled to exemption.[12] This primary purpose test, as it relates to the conduct of a trade or business, is further influenced by the commerciality doctrine discussed below.

1. Private Benefit

The regulations further provide that in order to be organized and operated for one or more exempt purposes, the organization must serve a public rather than a private interest.[13] An organization will be found to serve primarily a private interest, as opposed to a public interest, unless the private interest served is merely incidental to the public interest.[14] 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.[15]

[4] See Section 501(c)(3).
[5] See Reg. 1.501(c)(3)-1(c)(1).
[6] See *id.*
[7] See *id.*
[8] See *id.*; *Better Business Bureau*, 326 U.S. 279 283 (1945).
[9] *B.S.W. Group, Inc.*, 70 TC 352 356-357 (1978).
[10] *Id*.
[11] See Reg. 1.501(c)(3)-1(e)(1).
[12] See Reg. 1.501(c)(3)-1(c)(1).
[13] See Reg. 1.501(c)(3)-1(d)1(ii).
[14] See GCM 37789, 12/18/78.
[15] See GCM 38459, 7/31/80.

Any private interest must be incidental to the public interest both quantitatively and qualitatively.[16] 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.”[17] 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.[18] 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, absent the educational focus being to train students for a single employer.

2. No Private Inurement

Within this broad concept of a prohibition on private benefit is the doctrine of private inurement. The private inurement doctrine is meant to ensure that a tax-exempt organization’s “insiders” (i.e. persons in a position to influence the organization’s affairs) do not use such position to siphon off any of a charity’s income or assets for personal use. Common cases of private inurement revolve around payment of excessive compensation, certain rental arrangements, certain lending arrangements, and the sale of assets for more than fair market value to the organization.

There is an absolute prohibition on allowing assets to inure to the benefit of the organization’s insiders.[19] “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.[20] If such action occurs, the Service may revoke the organization’s tax-exempt status. However, as an alternative measure in the context of public charities and social welfare organizations, the Service can impose intermediate sanctions, with excise taxes assessed directly against the insiders and other decision makers who approved the transaction in question.[21] For example, suppose an insider were paid an excessive salary. Rather than revoke the organization’s tax-exempt status (which would be within its purview), the Service could assess an excise tax sanction against the insider. This would equal 25% of the excess benefit (which, if not corrected in a timely manner, will result in a second tier tax of 200% of the excess benefit), as well as excise tax in the amount of 10% of the excess benefit (not to exceed $20,000) imposed against decision makers of the charity who knowingly participated in the transaction.[22]

[16] See GCM 37789, 12/18/78.
[17] See *id.* (referencing Rev. Rul. 70-186, 1970-1 CB 128); see also Ltr. Rul. 9615030.
[18] See Rev. Rul. 72-559, 1972-2 CB 247; Rev. Rul. 73-313, 1973-2 CB 174.
[19] See Reg. 1.501(c)(3)-1(c)(2).
[20] The concept of “insider” for inurement purposes includes disqualified persons identified under Section 4958(f)(1) for purposes of the intermediate sanction rules, but an “insider” for inurement purposes more broadly includes others who because of a unique position have the ability to influence or control the organization. See *American Campaign Academy*, 92 TC 1053 (1989).
[21] See Section 4958.
[22] See Sections 4958(a)(1); (d)(2).

3. Commerciality Concerns

While it is well recognized that unrelated business activities can generate unrelated business taxable income and potentially risk exempt status, even related business activities can at times prove problematic. If a related business is undertaken in a way that the Service deems to have a "distinctively commercial hue," the organization may risk its exempt status.[23] 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.[24]

The commerciality doctrine uses a counterpart analysis. Among the factors considered are whether the organization sells goods and services to the public for a fee, whether the organization is "in direct competition" with for-profit organizations, whether the organization set prices based on pricing formulas common in the industry, whether the organization utilizes promotional materials normally utilized by for-profit organizations, whether the organization advertises its services in a commercial manner, whether the organization has activities and hours that are basically the same as for-profit enterprises, how the organization calculates payment for its management, and whether the organization receives charitable contributions.[25]

For example, in *Easter House*, the Claims Court considered qualification for exemption of an adoption agency.[26] After reciting the operational test, the court noted that "the key to determining whether an organization, which at first blush might appear to be engaged in commercial activities that would disqualify it from exemption under section 501(c)(3), is qualified for exemption is whether the business purpose of the activities is incidental to the charitable purpose or vice versa."[27] In agreeing with the Service and finding that the business purpose was primary, the court noted the agency's competition with commercial adoption agencies, the accumulation of substantial profits, a fee schedule intended to derive a profit, and a lack of any support from solicitations.[28]

Likewise, in a case frequently cited in the commerciality area, the Seventh Circuit affirmed the determination of the Service and the holding of the Tax Court in holding that an organization operating restaurants and health food stores ostensibly for the purpose of furthering the religious work of the Seventh-Day Adventist Church did not qualify for exemption.[29] There, the court explained that, in considering the effect of substantial commercial purposes on qualification for exemption, a court looks to "various objective indicia" including the "manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits...."[30] The Seventh Circuit noted that the entity was in direct competition with other restaurants, had a price structure set competitively with other businesses and a lack of any below-cost pricing, used

[23] See, e.g., *Airlie Foundation*, 283 F. Supp.2d 58 (D. DC, 2003).
[24] For an in-depth look at the commerciality doctrine, see generally Hopkins, *The Law of Tax-Exempt Organizations*, §4.11 (John Wiley & Sons, Inc., 2011).
[25] See, e.g., *Living Faith, Inc.*, 950 F.2d 365 (CA-7, 1991).
[26] *Easter House,* 60 AFTR2d 87-5119, *aff'd* 846 F.2d 78 (Fed. Cir., 1988).
[27] See *id.* at 60 AFTR2d 87-5124.
[28] See *id.* at 60 AFTR2d 87-5125-26.
[29] See *Living Faith*, *supra* note 25 at 950 F.2d 376-77.
[30] See *id.* at 950 F.2d 372.

promotional materials to enhance sales, and lacked any plans to solicit contributions.[31] Noting that the corporation did not accumulate net profits, the court considered that but one factor that was outweighed by the other "indicia" of commerciality.[32]

In *Airlie Foundation*,[33] the district court for the District of Columbia agreed with the Service that the subject organization failed to qualify for exemption as its activities evidenced a primary commercial purpose. The organization was organized for educational purposes and carried out its mission through organizing, hosting, conducting, and sponsoring educational conferences.[34] The organization additionally provided certain administrative support for environmental studies conducted at its facility. In clearly setting out the commerciality doctrine, the court stated that "[i]n cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose."[35] The court analogized the facts in *Airlie* to the organization in *BSW Group*, noting that the organization did not directly benefit the public (rather, it benefited other organizations that benefited the public) and did not limit its activities to tax-exempt organizations.[36] The court balanced the entity's fee structure and its willingness to subsidize certain attendees (both indicative of a non-commercial purpose) against the nature of the entity's clients (both taxable as well as tax-exempt), competition with commercial organizations, advertising expenditures, and significant revenues derived from weddings and special events, ultimately determining that the entity was organized for a substantial commercial purpose.

While the commerciality doctrine is not new, the continuing increase in charitable organizations seeking sustainability through commercial activities, or seeking to operate as social enterprises, has given the commerciality doctrine increased exposure. While greater license may be given to tax-exempt organizations operating social enterprise subsidiaries, it would be unwise to ignore the application of the commerciality doctrine altogether in this context.[37] There is a clear tension that exists between a doctrine that seeks to define charity as acting in a non-commercial manner and the idea of social enterprise, which involves charitable purposes achieved directly through commercial activities. Because the commerciality doctrine is court-created rather than legislatively crafted, no bright line or safe harbor exists to guide the charitable entrepreneur.

The Tax Court has made clear that in determining whether an organization is operated to further a substantial non-exempt purpose, the decision maker is to look to the purposes furthered by an organization's activities rather than the nature of those activities.[38] As a commentator has recently pointed out in this journal, the commerciality doctrine, in looking at the manner in which an organization carries out its activities in order to determine purpose, sets up a logical fallacy

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[31] See *id.* at 950 F.2d 373-374.
[32] See *id.* at 950 F.2d 374.
[33] Note 23, *supra*.
[34] See *id.* at 283 F. Supp.2d 60.
[35] See *id.* at 283 F. Supp.2d 63 (emphasis in original).
[36] See *id.* at 283 F. Supp.2d 65.
[37] See, e.g.,*Council for Bibliographic and Information Technologies*, TC Memo 1992-364 (ignoring the Service's arguments concerning the commercial hue of certain activities noting that the organization at issue was formed by and controlled by a tax-exempt organization). In addition to the fact that the organization was formed by a tax-exempt organization, it should not be overlooked that the organization was providing services that the court viewed as necessary and indispensable exclusively to tax-exempt organizations.
[38] See *B.S.W. Group, Inc*, 70 TC 352 (1978).

where purpose is the lens through which activities are viewed, yet those same activities somehow serve as an indication of purpose.[39] This circular argument is exemplified by the decision in *Living Faith,* in which the court initially noted that it must "focus on 'the purposes toward which an organization's activities are directed,' and not the nature of the activities" but subsequently stated that "[a]n organization's activities ... determine entitlement to tax exemption," and that "[w]hile 'the inquiry must remain that of determining the purpose to which the ... business activity is directed,' the activities provide a useful indicia of the organization's purpose or purposes."[40]

This type of ambiguity creates uncertainty and can lead to disparate results. No clear guidance exists to allow an organization comfort that its operations will show that its charitable or other exempt purpose trumps profit making. Indeed, in the hospital context (another situation in which taxable and tax-exempt organizations exist in the same sector), Congress enacted rules setting forth specific areas in which hospitals must provide demonstrable evidence that charitability trumps profit.[41] Outside of the hospital context, however, exempt organizations are left with the commerciality doctrine, discussions of a "commercial hue," and trying to ascertain indicia of commerciality. Rather than exist in this state of unknown, organizations at risk of violating the commerciality doctrine may choose to spin such activities off into a taxable subsidiary or related organization to avoid such risk.

C. NOT AN ACTION ORGANIZATION / NOT AGAINST PUBLIC POLICY

An action organization-that is, an organization that is attempting to influence legislation by propaganda or otherwise in a more than insubstantial manner, or an organization intervening for or against a candidate for elective public office-is ineligible for exemption as it is not operated exclusively for exempt purposes.[42]

Finally, case law has added to the foregoing elements the requirement that an organization must not be in violation of public policy in order to qualify for exempt status.[43]

III. UNRELATED BUSINESS TAXABLE INCOME ISSUES

Assuming an organization is organized and operated for an exempt purpose but also has one or more activities that do not further the exempt purpose, the charity must analyze whether and to what extent it will be subject to the unrelated business income tax and, further, whether pursuit of the unrelated activities will endanger the charity's exempt status.

A. GENERAL RULES

As addressed above, organizations that are exempt from federal income tax under Section 501(c)(3) 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

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[39] See Chaney, "Commerciality, Charter School Management Organizations, and Social Enterprise," 27 Exempts 5, page 3 (Mar/Apr 2016).
[40] *Living Faith*, *supra* note 25, 950 F.2d at 370, 372.
[41] See Section 501(r).
[42] See Reg. 1.501(c)(3)-1(c)(3).
[43] See *Bob Jones Univ.*, 461 U.S. 574 33 AFTR2d 74-1279 (1983).

though the business is not related to the organization's exempt purpose. If a Section 501(c)(3) organization engages in unrelated business activities, the organization must be cognizant of the generation of unrelated business taxable income (UBTI), including analyzing any exceptions or exclusions that may apply. The organization must take care that such activities do not negatively affect its exempt status by allowing the unrelated business activities to become so substantial they demonstrate the existence of a substantial non-exempt purpose or otherwise far outpace the charity's exempt activities (as discussed below).[44]

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.[45] Section 512(a)(1) 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) 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. Reg. 1.513-1(d)(2) 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.[46] 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.

In *Industrial Aid for the Blind*,[47] the organization oversaw operations that 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 Rev. Rul. 76-37,[48] the Service dealt with an organization that operated a business of 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 UBTI 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.

In Rev. Rul. 73-128,[49] the organization manufactured and sold toy products, hiring unemployed and underemployed individuals to create the products. The Service held that because

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[44] See Reg. 1.501(c)(3)-1(e)(2).
[45] See Reg. 1.513(b); American Bar Endowment, 477 U.S. 105 58 AFTR2d 86-5190 (1986).
[46] See Reg. 1.513-1(d)(2).
[47] 73 TC 96 , acq. 1980-2 CB 1.
[48] 1976-1 CB 148.
[49] 1973-1 CB 222.

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 Rev. Rul. 76-94,[50] the organization operated a grocery store as part of a therapeutic program for emotionally disturbed adolescents. The store was operated at a scale no larger than reasonably necessary for training and rehabilitation of the adolescents and was staffed in large part by the adolescents in the rehabilitation program. For these reasons, 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 comparison, in Rev. Rul. 73-127,[51] 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. Moreover, 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.

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.[52] The Service considered whether income from such ticketed events (i.e. those that were not school-related activities) constituted unrelated business taxable income.[53] The Service noted that the fees charged to the general public were comparable to those charged by commercial facilities and that discounts or free admissions were generally not provided to students. Further, the university's fine arts department was not involved in the selection of or performance of the events, and the entertainers received essentially the same compensation as they would at a for-profit facility. The Service determined that the organization's reputation as an educational institution was of secondary importance, if a factor at all, in attracting attendees. Because the university negotiated with the performers for the amount of their compensation, and because the contract included a non-compete clause (i.e. no performance within a specifically defined and negotiated 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.

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[50] 1976-1 CB 171.
[51] 73-127, 1973-1 CB 221.
[52] See TAM 9147008; GCM 39863, 11/26/91.
[53] See TAM 9147008.

B. Exceptions/modifications

Unrelated business taxable income does not include income from: (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 Section 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").[54] Income and deductions applicable to unrelated business income are subject to additional modifications.[55]

In addition to the exceptions from unrelated business taxable income, certain items of income are excluded altogether. Pursuant to Section 512(b), certain passive income including dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, and certain income from research are excluded from taxation.[56]

C. Unrelated business taxable income and Section 512(b)(13)

As with any tax-exempt entity, a tax-exempt corporate subsidiary is exempt from federal income tax with respect to its related revenue but is subject to taxation on its unrelated business income.[57] To the extent a controlled tax-exempt organization reduces its unrelated business taxable income by making a "specified payment" of passive income to the parent charitable organization, the parent charitable organization will be subject to unrelated business taxable income on such payments.[58] As addressed above, deductible passive payments include rents, royalties, and license fees; however, dividends are not deductible to the controlled entity and therefore not taxable to the parent.[59] To be clear, this rule related to passive income received from a subsidiary bringing UBTI to the parent applies only if the subsidiary is controlled by the parent (which, by virtue of being a subsidiary, is inevitably the case). In this context, "controlled" means that the parent controls 50% or more of the subsidiary by vote or value.[60] Constructive ownership rules apply to prevent the tax-exempt parent from indirectly owning the value of the controlled subsidiary.[61]

A subsidiary taxed as a Subchapter C corporation subsidiary is subject to taxation at corporate rates on its net income. As with a tax-exempt corporate subsidiary, Section 512(b)(13) continues to apply in the context of a controlled corporate subsidiary. Because the C corporation is not subject to the rules on unrelated business taxable income, the rule is applied as if the entity were exempt for purposes of determining whether or not the payments to the parent charitable organization will be unrelated business taxable income.[62]

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[54] See Section 513(a).
[55] Section 512(b).
[56] See Section 512(b).
[57] See Section 512.
[58] See Section 512(b)(13)(C).
[59] See *id.* Note that while the payments are not taxable, they may negatively impact the public support ratio of a publicly-supported parent.
[60] See Section 512(b)(13)(D).
[61] See Section 318.
[62] See Section 512(b)(13)(A).

Section 512(b)(13) does not come into play with respect to a single-member LLC electing to be disregarded for federal income tax purposes because all of its gain and loss are treated as gain and loss of the parent charitable organization directly. Accordingly, to the extent the single-member LLC engages in activities that are unrelated to the purposes of the parent, the parent will have unrelated business taxable income.[63] Likewise, organizations that are flow-through organizations for federal income tax purposes, such as partnerships and multi-member LLCs that are taxed as partnerships, are not taxed at the entity level, so Section 512(b)(13) is inapplicable. Rather, these entities pass through gain and loss to their partners/members regardless of whether or not the income from the trade or business is actually distributed.[64]

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 affect its exempt status by allowing such unrelated business activities to become substantial.[65] There is no bright line "upper limit" on the amount of UBTI an organization may generate. As UBTI grows, however, it raises the question as to whether the unrelated business has become a substantial purpose of the organization.[66] 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 and the resulting income generated may be indicative of a substantial non-exempt purpose. As UBTI grows, the Service will examine whether an exempt organization's exempt activities and expenditures are "commensurate in scope" with its financial resources resulting from its business activities.[67]

The commensurate-in-scope test was first set forth by the Service in Rev. Rul. 64-182.[68] The short 1964 ruling involved a charitable grant-making organization whose income primarily came from rental proceeds. According to Rev. Rul. 64-182, a charitable organization that receives a significant amount of unrelated business income faces the question of whether the charitable activities carried out by the organization are "commensurate in scope" with its financial resources, including the unrelated business income. Said differently, according to Rev. Rul. 64-482, the question is not strictly speaking what percentage of revenue generated by the organization is unrelated business income. Rather it is whether, considering the financial resources of the organization, the extent of the charitable operations (judged by such factors as time, effort, impact, and use of after-tax unrelated business income) of the organization are appropriate.[69] 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.[70] Notwithstanding that the commensurate-in-scope test seems to allow a charitable organization to receive any amount of its

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[63] See Ltr. Rul. 200606047.
[64] Sections 512(c)(1), 701 - 704; Reg. 1.681(a)-2(a).
[65] See Reg. 1.501(c)(3)-1(e)(2).
[66] See, e.g., Reg. 1.501(c)(3)-1(c)(1).
[67] For an in-depth analysis of the commensurate-in-scope test, see Siegel, "Commensurate in Scope: Myth, Mystery or Ghost?-Part One," 20 Exempts 3, page 26 (Nov/Dec 2008), Siegel, "Commensurate in Scope: Myth, Mystery or Ghost?-Part Two," 20 Taxation of Exempts 4, page 8 (Jan/Feb 2009).
[68] 1964-1 (part 2) CB 186.
[69] See Ltr. Rul. 200021056, Ltr. Rul. 8038004; TAM 9711003.
[70] See Rev. Rul. 64-182, supra note 65.

revenue from unrelated business income, a charity should be concerned as its unrelated business income grows about 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. This concern is exacerbated by the lack of a bright line or any clear application of the commensurate-in-scope test. 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 the material on Choosing to Use a New Entity for Commercial Activities, below, this type of "spin-off" frees the organization from generating unrelated business income and insulates against the potential risks to its exempt status.

IV. REASONS TO CREATE A MORE COMPLEX STRUCTURE

A. PROTECT EXEMPT STATUS

1. Primary Purpose

As explained in Section II.B. above, to qualify for exempt status under Section 501(c)(3) of the Code, an organization's primary purpose must be an exempt purpose. In certain instances, an organization may have an exempt purpose but may find itself failing the operational test. Two examples of this are the generation of excessive UBI and violation of the commerciality doctrine. As noted in Section III.D., while there is no bright line "upper limit" on the amount of UBTI that an organization may generate, the Service will consider whether the organization's exempt activities and expenditures are commensurate-in-scope with its financial resources resulting from its unrelated business activities. To avoid failing the operational test as a result of excessive UBI, an organization may choose to spinoff the unrelated business.

Similarly, and organization may be organized and operated for an exempt purpose; however, the organization may begin to conduct its operations in a way that violates the commerciality doctrine discussed at II.B.3. above. Because the commerciality doctrine is a court-created (largely at the instance of the Service) doctrine without clear parameters, an organization that has concerns over its method of operations may choose to ensure protection of its tax-exempt status by spinning those operations into a subsidiary or affiliate.

2. Exploiting For-Profit Benefits

Unlike a nonprofit entity that is subject to the non-distribution constraint and, thus, unable to pay dividends to individual owners or develop an equity-based or profit-sharing incentive plan for employees, a for-profit organization is not so constrained. Thus, if the exempt organization has a project which it believes would be attractive to private investors, this project will need to be conducted through a subsidiary taxable corporation. Similarly, use of a for-profit corporation in such circumstances will allow the organization to utilize equity incentives as it seeks to attract the right talent to the organization.

3. Substantial Lobbying/Political Intervention

Because a charitable organization cannot engage in substantial lobbying and is prohibited from intervening for or in opposition to a candidate for an elected public office, if the leadership of the charitable organization believes its mission can be furthered through engaging in such activities, the organization will need to either find a Section 501(c)(4) social welfare organization with which to affiliate or will need to take steps to create a Section 501(c)(4) organization.[71] While the assets of the charitable organization cannot be transferred in an unrestricted manner to the social welfare (501(c)(4)) organization, the two entities can work alongside one another to further the charity's purposes.[72]

It should be noted that a charitable organization is not allowed to create a political organization under Section 527 of the Code either as a separate segregated fund or a nonconnected committee. In the event there is a need for a political organization as part of the organizational structure, it must be created by the Section 501(c)(4) affiliate. Creating such a separate segregated fund avoids taxation on the political expenditures of the Section 501(c)(4) organization.

4. Non-Charitable Exempt Organization Creating Exempt Affiliate

While the focus of this paper precedes from a starting point of a charitable organization, in the event the starting point is a non-charitable exempt organization (such as a social welfare organization or a trade association), such organization may wish to create a charitable affiliate. For example, a professional organization that is unable to receive tax-deductible charitable contributions, qualify for nonprofit postal permits, issue tax-exempt bonds, or maintain a charitable deferred giving program may choose to create an affiliated foundation. It is not uncommon for such an organization to already be engaged in certain charitable or educational activities. As a result, in these instances the non-charity would spin off its charitable and educational activities into a new affiliated charitable organization that would provide the aforementioned benefits.

B. Reduce UBI

The 2017 Tax Act added Section 512(a)(6)(A) to the Code requiring exempt organizations to calculate UBTI separately for each trade or business. Prior to the introduction of Section 512(a)(6)(A), exempt organizations were able to aggregate the revenue and loss from multiple trades or businesses effectively netting revenue from a profitable unrelated trade or business against a loss from an unprofitable trade or business. This type of netting is no longer allowed. However, a similar result can be obtained by moving all unrelated trades and businesses into a taxable subsidiary. While this will not result in a complete avoidance of UBTI by converting the revenue to passive dividend income (as a result of the application of Section 512(b)(13)), it will allow revenue and loss to be offset across all trades and businesses of the exempt organization, potentially reducing the exempt organization's UBTI exposure.

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[71] For a comprehensive resource on the issues involved in creating or including new entities in a complex organizational structure for the purpose of lobbying and campaign intervention, see Schadler, "The Connection: Strategies for Creating and Operating 501(c)(3)s, 501(c)(4)s, and Political Organizations, 4th ed." (Alliance for Justice, 2018), available at https://bolderadvocacy.org/resource/the-connection-strategies-for-creating-and-operating-501c3s-501c4s-and-political-organizations/ (last visited January 2, 2019).

[72] To the extent assets of the charitable organization are transferred to the Section 501(c)(4) organization other than as a fair market value transfer for goods or services provided by the social welfare organization, the charitable organization must restrict such transfer to be used for specific charitable or educational activities that would be permissible if conducted by the charity itself. The charity should require reports that demonstrate the funds were so used.

C. ASSET PROTECTION

One of the most common reasons for an organization to create a subsidiary or affiliate organization is to minimize liability exposure. An exempt organization with a significant endowment may desire to protect its endowment from its operational activities through the creation of a subsidiary to hold, invest, and manage the endowment funds. An exempt organization may likewise choose to have a subsidiary or affiliate organization hold its real property to isolate its land-owner liability (environmental liability, liability associated with leasing all or a portion of the property to third parties, etc.). Although it will be discussed at Section VI.B. below, it is always important when considering having an affiliate or subsidiary hold real property to note any impact on eligibility for property tax exemption.[73]

D. OTHER RATIONALES

1. International Operations

While a charitable organization may wish to form a subsidiary or affiliate to engage in international operations for liability protection purposes, local laws should always be confirmed to determine whether the organization working in the foreign country must be created under that country's laws.

2. Distinct Activities/Management Focus

In addition to the potential need to spin off activities to protect exempt status, even where exempt status may not be at risk, an exempt organization may choose to separate different related businesses in which it is engaged into separate entities. This type of separation allows each entity to apply for grants from the same grant maker who may be willing to fund these separate businesses but would be unwilling or unable to double a grant to the single exempt organization. Further, operating an active business requires focused dedication to the business activities and skill in managing the business operations. That level of focus and specialized skill may not exist on the tax-exempt organization's board or within its senior management. Even in instances where it does exist, the business activities create the risk of loss of focus and disciplined attention to the organization's exempt purpose and primary exempt activities. Spinning off the business activities allows each board and management team to focus on the activities of the organization he or she serves, maximizing that organization's purposes, and to do so consistent with the fiduciary duties owed by the individual to the organization and/or its shareholders.

3. Efficiencies

Particularly where the structure has multiple organizations (either taxable or tax-exempt), it may be beneficial to create a single holding company for the various taxable organizations or a single parent company for the various tax-exempt organizations. Aggregating the organizations in this way allows for certain services to be moved into the holding company (with respect to the taxable entities) or the parent company (with respect to the tax-exempt entities) to improve

[73] For example, while a subsidiary could qualify for property tax exemption in Texas applicable to charitable organizations under Section 11.18 of the Texas Property Tax Code, the same would not be true for religious organizations or educational organizations under Sections 11.20 and 11.21, respectively.

efficiencies. For example, services such as property management, accounts receivable, accounts payable, and similar services may be performed for all of the applicable entities.

V. COMMONLY USED ENTITIES AND THEIR KEY ATTRIBUTES[74]

Nonprofit entities have many organizational options when considering growth and expansion. Once the charitable organization has determined the need to create a separate entity to house operating activities, the decision makers must consider the legal form and understand the options available. This section of the article will introduce the primary options. The article will use Texas as its basis; however, these entity choices are available and the decision points largely the same in other states.

A. NONPROFIT CORPORATION

Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code (BOC).[75] 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.[76] 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.[77] While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. While nonprofit corporations in Texas do not have shareholders, they may have one or more members that operate to control the organization in a way analogous to for-profit shareholders.[78]

B. FOR-PROFIT CORPORATION

Standard business corporations in Texas may be formed under Texas law for any lawful purpose or purposes (unless otherwise provided by the BOC).[79] For-profit corporations are governed by Chapter 21 of the BOC.[80] 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

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[74] This section of the article highlights legal forms most often used and thus will not address certain organizational forms rarely used for separating commercial activities such as a tax-exempt nonprofit unincorporated association, tax-exempt charitable trust, and nonexempt nonprofit corporation.
[75] See Tex. Bus. Orgs. Code sections 22.001 et. seq.
[76] See *id.* section 22.001(5).
[77] See *id*. sections 2.001-002, 2.101-102, 3.003 and 22.054.
[78] See *id.* section 22.101.
[79] See *id*. sections 2.001, 2.007.
[80] See *id*. sections 21.001 *et seq*.

their purposes.[81] 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.[82] Through the BOC and the development of Texas case law, the laws regarding the operation and management of corporations are well established and provide a relatively clear operational structure for the entity. Texas statutory law with respect to corporations was modified in 2013 to provide that a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation's certificate of formation.[83] This includes the very small step Texas has taken toward hybrid entities such as the benefit corporation provided for in other states. The corporation may also include in its certificate of formation a provision that the board of directors and officers of the corporation shall consider any social purpose specified in the certificate of formation in discharging the duties of directors or officers under the BOC.

Taxable corporations are classified as regular C corporations or S corporations. Absent an affirmative S corporation election, a taxable corporation is taxed as a C corporation.[84] S corporations operate as flow-through entities with shareholders receiving allocations of income and loss and paying tax at the shareholder level only.[85] C corporations are taxable on their net income at rates of up to 35%.[86]After-tax profits are taxable to the shareholders leading to what is described as double taxation.[87] However, a tax-exempt shareholder will not be taxed on income distributed to it unless such income is classified as UBTI to the tax-exempt shareholder. For purposes of an entity that will be owned solely or in part by a charitable organization, S corporations are not the preferred option because all income and gain are taxable as unrelated business income to the charitable shareholder.[88] As a result, this article will focus only on C corporations.

C. LIMITED LIABILITY COMPANIES

The limited liability company (LLC) form was originally enacted as a hybrid entity combining features of corporations and partnerships. It is a single entity in which all of the owners (called members) have liability protection from the operations of the LLC.[89] For federal tax purposes, however, it is treated as a partnership unless an affirmative election is made to be taxed as a corporation or unless it has but a single member, in which event it is disregarded absent an election to be treated as a corporation.[90] 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.

[81] See *id*. section 2.101.
[82] See *id.* section 21.223.
[83] See *id*. section 3.007(d).
[84] See Section 1361(a)(2).
[85] See Section 1366.
[86] See Sections 11(a)-(b).
[87] See Section 61(a)(7).
[88] See Section 512(e)(1). This contrasts sharply with the result for taxable owners, who prefer to avoid C corporation status generally to avoid double taxation.
[89] See Tex. Bus. Orgs. Code section 101.114.
[90] See Reg. 301.7701-2(c)(2).

In Texas, for example, LLCs are governed by the BOC and specifically Chapter 101.[91] LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.[92] Instead of bylaws, the LLC normally has an operational document called a company agreement (sometimes alternatively called an operating agreement or regulations) which is a hybrid of bylaws (for the corporation) and a partnership agreement (in a partnership).

The operational aspects of LLCs are flexible under Texas law. Unlike corporations, which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual board of director meetings, election of officers, evidence of authorization of corporate acts, minute books, etc.), LLCs require much less with regard to "maintenance" of the entity. LLCs can be member-managed or manager-managed.[93] 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 resolutions, meeting minutes, or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence a particular person's authority to act on behalf of the LLC. Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple representations. Furthermore, LLC members and managers are not required to have annual meetings. These attributes cause the LLC to be an attractive form of business, especially for those that desire a lower-maintenance option to the rigidities of corporate law. Nevertheless, for protection of the separate status necessary to avoid having activities of the subsidiary attributed to the parent tax-exempt organization, some level of documented formality should be followed.

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

The LLC is unique in that it can be classified as a disregarded entity, a partnership, or an association (taxed as a corporation) for federal income tax purposes. If the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded. That means that the LLC does not need to separately apply for tax-exempt status (discussed below), but rather will effectively take on the tax attributes of its parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.[94] If there are two or more owners of the LLC, the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (taxed as a corporation).[95] The ability to be treated as a partnership for federal income tax purposes can be advantageous to an LLC in that it allows the LLC to take advantage of flexibility in partnership taxation (discussed

[91] See Tex. Bus. Orgs. Code sections 101.001 *et seq*.
[92] See *id*. section 3.001.
[93] See *id*. section 101.251.
[94] See Reg. 301.7701-2(c)(2).
[95] See Regs. 301.7701-3(b)(1)(i), 301.7701-3(a).

below) while still retaining limited liability for all of its owners in a single entity. While this is a common benefit to LLCs, tax-exempt organizations participating in a multi-member LLC should be cautious about being taxed as a partnership for the reasons addressed with respect to partnerships below (i.e., the income may flow through as unrelated business income and the activities of the partnership may affect the exempt status of the tax-exempt member).

Should a single-member LLC wish to apply for exemption from federal income tax (as opposed to being a disregarded entity), or should the LLC have multiple members and wish to be recognized as exempt, separate conditions apply. The Service has indicated that it will recognize the Section 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (discussed below) and meets 12 additional conditions:[96]

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

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

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

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

(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.

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[96] These twelve conditions can be found in Cray and Thomas, "Limited Liability Companies as Exempt Organizations-Update," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001* (2000).

(10) The organizational language must contain an acceptable contingency plan in the event one or more members cease at any time to be an organization described in Section 501(c)(3) or a governmental unit or instrumentality.

(11) The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

(12) The LLC must represent that all its organizations document provisions that are consistent with state LLC laws and are enforceable at law and in equity.

VI. CONSIDERATIONS FOR CHOICE OF ENTITY

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

A. PRIMARY PURPOSE OF NEW ENTITY

An analysis of the choice of form should always include an examination of the impact the form of subsidiary or affiliate organization will have on the exempt status of the parent. This analysis depends, in large part, on whether the affiliate's activities are related or unrelated to the parent's exempt purposes. An initial question, which should be answered prior to creating any sort of subsidiary or affiliate structure, is whether the new organization will be taxable or tax-exempt. The answer to this question begins with the reason for creating the entity—whether one of the reasons discussed in Section III above or otherwise. Eligibility for exemption depends on the organization meeting specific requirements for exemption, including having an exempt purpose. 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 Section 501(c)(3) status, the Code lists the purposes that qualify as "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 . . .." Each of these purposes is a term of art with regulations and rulings setting forth and clarifying what it takes to qualify.

Assuming the organization will have an appropriate exempt purpose and will avoid the prohibitions on private inurement, excessive lobbying, and political intervention described above, additional factors should be considered when making the determination whether to operate a commercial enterprise as a tax-exempt or taxable subsidiary. Such considerations include the necessity of tax exemption (i.e., avoidance of federal income tax); whether the parent will capitalize the subsidiary on its own, through donations to the subsidiary, or through outside investors; the ability to pay compensation, including a share of the profits; the need for exemption for government or other contracts; and the branding and intellectual property issues at play.[97]

[97] See generally Wexler, "Effective Social Enterprise-A Menu of Legal Structures," Exempt Org. Tax Rev., Dec. 2006, page 565.

1. Exempt

If the primary purpose of the new entity is exempt and the entity will otherwise qualify as exempt (by satisfying the various eligibility requirements described above), the entity will typically be organized as a nonprofit corporation or as a limited liability company that is disregarded for federal tax purposes. While an exempt organization may be organized as an unincorporated association or a charitable trust, absent unique circumstances entity types are not typically utilized in a complex organizational structure.[98]

a. Nonprofit Corporation

A nonprofit corporation can be used to create an affiliate that will qualify under Section 501(c)(3) or under some other section of 501(c) of the Code. In the former instance, the organization can either seek recognition as a supporting organization under Section 509(a)(3) (common in the complex organization planning process) or can seek recognition of exempt status under Section 509(a)(1) or 509(a)(2) as a traditional public charity or based on the projection of its own public support. The determination of whether to operate as a supporting organization or as a "standalone" public charity will depend upon whether the organization can qualify as a standalone public charity (based on purpose or public support). If it can, such status is generally preferable as it avoids the necessity to satisfy the various rules and restrictions applicable to supporting organizations (particularly board composition requirements to satisfy the relationship test and restrictions based on control of disqualified persons and/or receipt of funds from disqualified persons in certain instances).[99] However, use of supporting organizations in a complex organizational structure is common. For example, endowment foundations of public charities are often formed as Type I supporting organizations. Functionally integrated Type III supporting organizations may be used to separate important, but not core, activities that but for the supporting organization performing such activities, the parent (supported) organization would have to conduct such activities directly. Finally, both Type II and Type III supporting organizations may be used in the complex organizational structure as the parent of an integrated system. While it may sound counterintuitive that the supporting organization would be the parent as opposed to the subsidiary, in this structure the supporting organization provides management services, including budgeting, payroll, and various oversight services to the members of the organizational structure.[100]

In the event the affiliate will qualify under a different subsection of 501(c), a nonprofit corporation will typically be used, though the language of the nonprofit corporation's governing documents will be tailored to the applicable subsection. For example, if the organization is to be a Section 501(c)(4) social welfare organization, there generally will be no express prohibition on intervening in campaigns. If the organization is to be a Section 501(c)(6) trade or business

[98] An example of when a charitable trust could be utilized is for the holding of an endowment fund intended to support the primary charity.
[99] The specific rules and restrictions related to supporting organizations are beyond the scope of this paper.
[100] For an in-depth overview of a supporting organization serving as the parent of a complex organizational structure, see White, "Parent Organizations in Exempt Healthcare Systems Can Be Supporting Organizations," 5 Taxation of Exempts 3 (Nov./Dec. 1993). For an overview of the use of Type II supporting organizations in a complex organizational structure, see Thomas, "Type II Supporting Organizations: Relationship Issues and Complex Organizational Structures," *The Tax Advisor* (June 1, 2016).

association, the organizational documents will typically provide for membership and specify the purpose of the organization as seeking to improve one or more lines of business. Finally, if the purpose of the affiliate is to hold real property, the organizers have the option of utilizing a property holding subsidiary—either a Section 501(c)(2) organization (having one owner) or a Section 501(c)(25) organization (having up to 35 owners or beneficiaries). Each of these organizations must have specific provisions in the governing documents to satisfy the applicable subsection of the Code.[101]

Generally, a subsidiary organization that is organized as a corporation (whether it is exempt from federal income tax or not) will not negatively affect the tax-exempt status of the parent charitable organization as long as a separation is maintained between the entities. Maintaining such a separation will be discussed below. Note, however, that if the parent charitable organization is a private foundation, care must be taken with respect to transfers from the parent to an exempt corporate subsidiary (for capitalization of the subsidiary or otherwise) to understand whether the contribution will cause the subsidiary to fail the public support test and result in the subsidiary being treated as a private foundation, necessitating expenditure responsibility.

b. Limited Liability Company

A single-member limited liability company may also be utilized where the new entity will have an exempt purpose. As a single-member LLC, the entity will be 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.[102] When treated as a disregarded entity, the LLC has no independent tax filing or information filing requirement, but rather its income and loss and activities are considered part of the exempt parent and are reported on the exempt parent's Form 990.[103] As a result, if the activities undertaken in the disregarded single-member LLC are unrelated to the activities of the parent, not only do they create UBTI, but they risk the parent's exempt status to the extent they become large enough to be considered a substantial purpose. Accordingly, a disregarded single-member LLC is not an appropriate choice for substantial unrelated business activities.

One of the most common reasons tax-exempt organizations utilize the single-member LLC is risk mitigation (which will be discussed in more detail below). Where the entity is carrying on higher risk activities, it may want to shield its endowment form those activities. Likewise, where an organization desires to isolate liabilities arising from the ownership of real property, it may want to isolate the real property in a single-member LLC. In either event, it could handle these actions itself, and thus, there is no added federal tax issue by using a disregarded entity. However, caution is advised to determine whether using the single-member LLC will create more tax liability at the state level as will be discussed at Section VI.B.—particularly under the margin tax and property tax—than foregoing the separate entity and purchasing additional insurance or utilizing an entity such as a nonprofit corporation that itself seeks and gains recognition of its own exemption. Finally, a tax-exempt organization may choose to utilize a single-member LLC when participating in partnerships. Exempt organizations must be aware in such instances that UBTI

[101] A word of caution for a charity considering using a property holding 501(c)(2) or 501(c)(25) organization—neither is eligible for property tax exemption under Texas law and, thus, should only be used where property tax exemption is not otherwise available.
[102] See Reg. 301.7701.3(b)(1)(ii).
[103] See, e.g., Ltr. Rul. 200606047.

will be passed through to the partners. To the extent a disregarded entity is being used as a partner, that UBTI will be the UBTI of the exempt organization. However, where the partnership is engaged in a related activity, the use of a single-member LLC to serve as a partner provides liability protection to the exempt parent. An example of this is a tax-exempt organization participating in a limited partnership that will construct or manage low income housing eligible for low income housing tax credits.[104]

An LLC with multiple members may choose to be taxed as a corporation or a partnership.[105] Again, if it is taxed as a corporation, the rules set forth above apply. If, on the other hand, as is more common, it is taxed as a partnership, the partnership rules above apply, with each member receiving its allocation of gain and loss while the activities of the LLC will be aggregated with the activities of the tax-exempt organization in determining eligibility for exempt status.[106]

If a tax-exempt organization is a member of a multi-member LLC that is taxed as a partnership, the organization will have to be concerned about the activities of the partnership being aggregated with its own, including activities of the LLC that are unrelated to the exempt purposes of the exempt organization. It will also, however, need to be sensitive to concerns of private benefit and private inurement when it is serving as a managing partner in the same way as if it were serving as a general partner of a limited partnership.[107] 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. Non-Exempt

a. For-Profit Corporation

If the purpose of the new entity is not exempt under Section 501(c) of the Code, the new entity will generally be structured as a for-profit corporation. This structure will protect the parent's exempt status (as described in more detail below) while allowing the parent to control the new entity through stock ownership. It is critical to note that the new corporation should be classified as a subchapter C corporation, as a subchapter S corporation's income, deductions, and losses pass through to its shareholders and under Section 512(e) of the Code, as charity's shareholders will have UBTI in relation to an S corporation's income regardless of the source of the income (passive or active). Further, a private foundation parent must be mindful of the private foundation prohibitions, specifically the prohibitions against excess business holdings and against jeopardizing investments. Both prohibitions are inapplicable to the extent the foundation is able to treat its investment in the subsidiary as a program-related investment.

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[104] See Ltr. Rul. 9736039 (regarding income derived from participation in a low-income housing tax credit partnership).
[105] See Reg. 301.7701.3(a).
[106] See Rev. Rul. 98-15, 1998-1 CB 718.
[107] See the immediately preceding discussion of partnerships, notes 141-144, *supra*, and related text.

b. Limited Liability Company

As an alternative to a for-profit corporation, the charity may choose to form the new entity as a limited liability company. As previously discussed, a limited liability company with a single member is disregarded for federal income tax absent an affirmative election to be taxed as a corporation under the "check the box" regulations. Assuming the activities being placed in the new entity are non-exempt, a disregarded LLC should not be used unless the activities are insubstantial (which would, nevertheless, result in UBTI to the parent). Rather, the LLC should check the box and elect C corporation status.

B. STATE TAXES

The charity forming a subsidiary or related organization should consider the impact of state taxes. State income taxes (where they exist), property taxes, and other state taxes of course vary from state to state. This article will not seek to analyze those variations. Because the author is a Texas practitioner, and because Texas is unique in its state taxes, its tax rules will be discussed.

The Texas Margin Tax is a tax on an entity's revenue less the greatest of (1) total revenue times 70%; (2) total revenue minus cost of goods sold; (3) total revenue minus compensation; or (4) total revenue minus $1 million.[108] Corporations, if exempt under Section 501(c)(3) or under certain other subsections of 501(c), are eligible for exemption from the Texas Margin Tax.[109] Likewise, passive entities (as defined under Texas Tax Code section 171.0003) are not subject to the Texas Margin Tax. However, taxable corporations, limited liability companies that are operating businesses (regardless of whether they are disregarded for federal income tax purposes), general partnerships owned by other filing entities, and limited partnerships are subject to the Texas Margin Tax.

Although requests have been made that the Texas Comptroller treat the disregarded entity of a charitable organization as exempt from margin tax and sales and use tax, the Comptroller has declined to do so noting that a disregarded entity is nevertheless regarded for Texas tax purposes and the single member LLC must therefore file its annual franchise report and pay tax as due and is further not entitled to exemption from the sales and use tax.[110] Thus while a charitable organization may operate certain activities within the charitable entity and have those activities be free of Texas taxes, as soon as those activities are moved into a disregarded entity, they become taxable. As a result, in Texas, state taxes should be taken into consideration in determining whether a subsidiary organization should be created as a nonprofit corporation or LLC (taxed as a corporation) that will obtain exemption under Section 501(c)(3) and therefore be eligible for exemption from Texas taxes as well. This is particularly true if the organization is anticipated to have total revenue significantly in excess of $1 million.

[108] See Tex. Tax Code sections 171.1011, 171.001(a). Certain exceptions apply to the imposition of the Texas Margin Tax that are not applicable to this discussion. For example, where all owners of a general partnership are natural persons, the general partnership will not be subject to the Texas Margin Tax. Where an entity is involved (such as is discussed in this article), each of the entity types is subject to the Texas Margin Tax.
[109] See Tex. Tax Code section 171.063(a)(1).
[110] *See* Comptr. Ltr. Rul. 200106900L (June 21, 2001).

In addition to the Texas Margin Tax, Texas property tax must also be considered. The property tax provisions of Texas law do not tie exemption to federal exemption, and property tax exemptions are viewed restrictively under Texas law. An organization seeking to qualify its property for exemption must find specific authorization in Article VIII of the Texas Constitution and must further satisfy the specific qualification requirements set forth in the Texas Property Tax Code.[111] Generally speaking, the Texas Property Tax Code exempts property based on the activities of the owner of the property (i.e., leasing property to an exempt organization will not qualify a property for exemption absent specific provisions of the Texas Property Tax Code).[112] An exception to the general rule that property must be used by the owner for its own exempt purposes can be found in Section 11.18(f)(1) of the Texas Property Tax Code, which provides that a charitable organization must "use its assets in performing the organization's charitable functions or the charitable functions of another charitable organization." This provision provides flexibility for a carefully tailored charitable subsidiary to hold property to be used for the parent's activities. Note that this provision only applies with respect to charitable organizations as such term is defined in Texas Property Tax Code § 11.18(d) and, thus, does not apply to religious organizations or educational organizations.[113]

Use of a single member LLC to hold real property otherwise exempt while held by the charity directly is problematic. Because a single member LLC is regarded for state law purposes, and because the Texas Property Tax Code does not refer to LLCs in describing available exemptions, property held by a single member LLC (which would be common for risk mitigation purposes) would not be eligible for exemption absent a successful argument for equitable ownership.[114] Additionally, organizations exempt under Section 501(c)(2) or (c)(25) as property holding organizations are not eligible for property tax exemption (perhaps counterintuitively).

C. CONTROL AND MANAGEMENT/OWNER LIABILITY

With respect to control, a tax-exempt organization will generally control its nonprofit subsidiaries through interlocking directorates or serving as the sole member.[115] 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,[116] a majority of the membership interests in a limited liability company, a majority of the partnership interests in a general partnership, or serving as the general partner in a limited partnership. Of course, shareholders' agreements,

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[111] See *North Alamo Water Supply Co. V. Willacy County Appraisal Dist.*, 804 S.W.2d 894 (Tex. 1991); *First Baptist/Amarillo Foundation v. Potter County Appraisal Dist.*, 813 S.W.2d 192 (Tex. App.—Amarillo 1991, no writ.); *Op. Tex. Att'y. Gen. No. JM-682 (1987).*

[112] One such example is property leased by a charitable organization to an institution of higher education. Tex. Prop. Tax Code Section 11.18(q).

[113] *See* Tex. Tax Code Section 11.18.

[114] In a paper delivered for the 14th Annual State Bar of Texas Governance of Nonprofit Organizations Course (August 25-26, 2016), the author queried whether a claim for equitable ownership could be made by the charitable parent of a single member LLC noting the "Texas Attorney General has opined that it is likely a court would determine that the principles of equitable ownership are applicable to an entity seeking a charitable tax exemption under Tex. Tax Code § 11.18. Tex. Att'y Gen. Op. No. GA-1092 (Dec. 8, 2014); *see also* Galveston Cent. Appraisal Dist. V. TRQ Captain's Landing, *423 S.W.3d 374 (Tex. 2014); AHF-Arbors at Huntsville I, LLC v. Walker Cnty. Appraisal Dist.*, 410 S.W.3d 831 (Tex. 2012).

[115] Some states provide for nonprofit corporation issuance of stock which acts as a control mechanism similar to membership.

[116] Unlike S corporations, a C corporation may have multiple classes of stock to effectuate control.

operating agreements, and partnership agreements may be used to vary these rules as to operational control.

While control may be effectuated through these measures, control is not always desirable. As referenced above, where a tax-exempt organization controls (by vote or value) another tax regarded organization, passive income received from the controlled organization (other than dividends) will be taxable as unrelated taxable income of the tax-exempt parent organization to the extent they reduce the unrelated business taxable income (or its analog in the for-profit setting).[117] Furthermore, a private foundation together with its disqualified persons may not own more than 20% of the voting interest in a business entity that is controlled by the private foundation or one or more of its disqualified persons unless the subsidiary entity is a program-related investment or generates only passive income.[118]

Part of understanding the ability of the tax-exempt parent to control the organization is understanding the management structure of the subsidiary organization. Corporations (whether for-profit or nonprofit) are generally governed by a centralized board of directors that manages the affairs of the corporation.[119] The board generally elects officers to handle the day-to-day operations of the corporation.[120] Within the nonprofit context, the organization may elect not to have a board and instead be member-managed.[121] Within the for-profit context, a similar result can be obtained through the use of a shareholders' agreement and direct management by the shareholders,[122] though both of these latter two situations is less common.

If the corporation at issue is a nonprofit corporation, its board of directors will be elected by its member(s), if the organization has one or more members, or will be self-perpetuating. (From a control standpoint, though, the governing documents may require that a majority of the board always be appointed by the parent organization or consist of directors who are related to the parent organization.) Within the for-profit context, the shareholders elect the directors.[123] As a result, the tax-exempt parent, unless the corporation is managed by its members or its shareholders, will not have direct involvement either in the governance decisions or in the day-to-day operations. Rather, the input into those matters will be given through the election of the board. Depending on the purpose of the subsidiary, it is not uncommon that the organizations have some overlap of officers as well as board members; the extent of that overlap and the need to maintain some separation will be discussed below.

Limited liability companies under Texas law may be member-managed or manager-managed.[124] 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.[125] The details of these arrangements are contained in the LLC's

[117] See Section 512(b)(13)(B)(i)(I).
[118] See Section 4942.
[119] See Tex. Bus. Orgs. Code section 21.401.
[120] See *id,* section 21.417.
[121] See *id,* section 22.202.
[122] See *id.,* section 21.101(a).
[123] See *id*., section 21.405.
[124] See *id*., section 101.251.
[125] See *id*., sections 101.251-101.253.

company agreement. Within the limited liability company context, fiduciary duties may be limited or modified in the company agreement.[126]

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 above, this is one of the primary rationales for forming a subsidiary. Therefore, the question becomes what type of liability protection is created by the use of a subsidiary when the parent retains some level of formal control?

A corporation, whether nonprofit or for-profit (and whether taxable or tax-exempt), provides a liability shield (sometimes called a corporate veil) to its owners (or members, as the case may be).[127] As a result of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.[128] 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.[129] The exception to this general rule applies when the court "pierces the corporate veil," effectively finding that the corporate entity should be disregarded because the subsidiary corporation is the alter ego of the parent or because the corporation has been used as a sham to perpetrate a fraud.[130] Under either scenario, pursuant to Texas statutory law, a shareholder will not be held liable for contractual obligations of the subsidiary corporation unless there is a finding that the shareholder used the corporation to perpetrate an actual fraud for the direct personal benefit of the shareholder.[131] Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to section 21.223 of the BOC.[132] 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.[133]

Because of the standard set by section 21.223, piercing the corporate veil in Texas poses a significant hurdle. While case law indicates that the relationship between the shareholder and the corporation must be reviewed in its totality to determine whether there is an alter ego relationship, failure to follow corporate formalities is not a basis to hold a shareholder liable for an obligation of the corporation pursuant to section 21.223(a)(3) of the BOC. The majority of courts in Texas have chosen to exclude corporate formalities as a factor altogether in determining veil piercing, though at least one court has interpreted the provision to mean it cannot be the only basis on which an alter ego is predicated.[134]

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[126] See, e.g., Tex. Bus. Orgs. Code section 101.401.
[127] See Tex. Bus. Orgs. Code section 22.151, section 21.223.
[128] See, e.g., *Willis v. Donnelly*, 199 S.W.3d 262 271 (Tex. 2006).
[129] See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App. San Antonio, 2008, no pet.).
[130] See *Castleberry v. Branscum*, 721 S.W.2d 270 272 (Tex. 1986); Tex. Bus. Orgs. Code section 21.223.
[131] See Tex. Bus. Orgs. Code sections 21.223(a)(2) and (b).
[132] See *SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory as running counter to the standards of Section 21.223); see also *Willis, supra* note 177, pages 271-273.
[133] See, e.g., *Latham v. Burgher*, 320 S.W.3d 602 606-07 (Tex. App. Dallas, 2010, no pet.).
[134] See Miller, Governing Persons and Owners in Action: Liability Protection and Piercing the Veil of Texas Business Entities, *State Bar of Texas, Essentials of Business Law Course: The Lifecycle of a Business*, (March 2014), page 4 (citing *Burchinal v. P.J. Trailers-Seminole Mgmt. Co., LLC*,372 S.W.3d 200 217 (Tex. App., Texarkana 2012, no pet.) and a string of cases for the majority rule and comparing *Schlueter v. Carey*, 112 S.W.3d 164 170 (Tex. App., Fort Worth, 2003, pet. den.) as the minority view).

A final note: While piercing the corporate veil is a difficult task in Texas and corporate formalities are either not a factor (majority view) or not the only factor (minority view), that rule is based on a specific Texas statute and applies to contractual obligations or matters relating to or arising out of contractual obligations. Where tax-exempt organizations are utilizing subsidiaries formed as corporations in other states, care should be taken to determine what law will apply and the veil-piercing rules under that law.[135] Likewise, section 21.223 and the high standards contained therein do not technically apply to non-contractual obligations that do not arise out of contractual obligations. Said differently, the statutory standard is not directly applicable to tort causes of action. The proposed instructions for piercing the corporate veil in tort cases provided by the Texas Pattern Jury Charges omit reference to showing actual fraud.[136] 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).[137]

Whether creating the subsidiary in a state with less-rigid veil-piercing laws, or because tort claims are often treated differently than contractual claims for veil-piercing purposes (including in Texas), the parent organization should be mindful of maintaining sufficient separation to avoid a piercing result. Some of the factors that should be observed are avoiding complete overlap of directors, officers, and employees; ensuring that the subsidiary is appropriately capitalized to meet its needs; dealing in arm's-length transactions between the subsidiary and the parent; allowing the subsidiary to carry out its own decision making; maintaining separate meetings; keeping separate minutes; maintaining separate bank accounts; etc.[138] 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."[139]

A Texas limited liability company also provides a liability shield to its owners.[140] BOC sections 21.223-21.226 apply equally to limited liability companies.[141] (The sections addressed above providing the strict standard for piercing the corporate veil in the corporate context.) Thus, members may participate in management and retain the liability shield, unlike the limited partnership context. As with corporations, members and managers of LLCs will continue to be liable if they guarantee obligations of the LLC as well as for their own tortious conduct.[142] As in the corporate context, owning all of the interests of a limited liability company or failing to follow corporate formalities are not justifications for finding alter ego. Accordingly, in Texas the corporate shield for the LLC is equally as strong as the corporate shield for a corporation. In line

[135] See e.g. Peregrine, "The Return of Alter Ego," Health Lawyers Weekly, American Health Lawyers Association (2007) (discussing *Network for Good v. United Way of the Bay Area*, No. CGC-04-436186, Superior Court of California, City of San Francisco).
[136] See, e.g., State Bar of Texas, Committee on Pattern Jury Charges, *Texas Pattern Jury Charges-Business, Consumer, Insurance, Employment* (State Bar of Texas, 2014), PJC 108.2.
[137] 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).
[138] See, e.g., Presser, *Piercing the Corporate Veil* (Thompson-West, 2004), section 1.6; see also Peregrine, *supra* note 135. Such separation is discussed more fully below.
[139] *Lucas v. Texas Indus. Inc.*, 696 S.W.2d 372 (Tex. 1984).
[140] See Tex. Bus. Orgs. Code section 101.114.
[141] See Tex. Bus. Orgs. Code section 101.002.
[142] See, e.g., *Sanchez v. Mulvaney*, 274 S.W.3d 700 712 (Tex. App., San Antonio, 2008, no pet.).

with the cautionary note above, tax-exempt organizations creating LLC subsidiaries in states other than Texas should understand what law applies, as many states do not have statutes that cover veil piercings in the context of LLCs and may apply more lenient veil-piercing theories under common law.[143]

D. CAPITALIZATION (FUNDRAISING)

A factor in determining the choice of form for the subsidiary is how it will be capitalized. Appropriate capitalization is critical for showing that the organization is an authentic business entity separate from its parent for tax purposes as well as to avoid veil-piercing arguments in the tort (non-contractual) context. If it is to be capitalized by invested capital from private investors, it will need to be structured as a for-profit entity (C corporation, LLC, partnership) whereas if it is to be capitalized by donated capital, it should be structured as an exempt organization (typically a nonprofit corporation). To the extent the organization will seek private investors, it should be mindful of securities laws, which are beyond the scope of this article. Likewise, if the organization is seeking loans or guarantees from the Small Business Administration, it will need to be structured as a for-profit entity.[144]

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

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

E. TRANSFER PRICING ISSUES[145]

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

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[143] See generally, Miller, “Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities,” 43 Tex. J. Bus. L. 405, pages 420-24 (2009).
[144] See 13 CFR section 1.120.100(b) (2012).
[145] The author gratefully acknowledges John F. Crawford for contributing these thoughts on transfer pricing in an article co-authored, Moore and Crawford, “Putting Things Together: Subsidiaries, Complex Organizational Structures, Joint Ventures, and Joint Family Vehicles,” *35th Annual Nonprofit Organizations Institute*, (January 2018).

for-profit subsidiary sells goods to a parent tax-exemption organization, the cost of those goods paid by the parent to the subsidiary is the transfer price.

The transfer pricing rules are set forth in Section 482 and the Treasury Regulations promulgated thereunder.[146] Specifically, Section 482 provides that the IRS can allocate items of gross income, deductions, credits, or allowances between controlled entities to "clearly reflect the income" of such organizations. In principle, a transfer price should match either what the seller would charge an independent, arm's length customer, or what the buyer would pay an independent, arm's length supplier. Unrealistic transfer prices can be used to shift the tax burdens (whether it be income tax or UBTI) between a tax-exempt organization and its controlled entities.

The regulations broadly define "control" for purposes of the Section 482 rules.[147] Control includes "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised."[148] Thus, this definition includes transactions between one or more tax-exempt organizations or between a tax-exempt organization and a for-profit entity.

For determining whether the transaction meets the "arm's length standard" for purposes of Section 482, the regulations list certain methods that may be used and vary among different types of transactions.[149] Under these methods, certain services can be reimbursed at "cost" if certain conditions are met.[150] While a full analysis of the transfer pricing methods is beyond the scope of this article, the transfer pricing rules should be considered when "putting things together" in an organizational structure, whether it be complex or simply two entities.

F. DISSOLUTION/LIQUIDATION ISSUES

At the opposite end of the spectrum from capitalization is distribution of assets upon the winding down of the subsidiary. To the extent the subsidiary is a tax-exempt organization, winding down is relatively straightforward. The subsidiary follows the rules set out in state law. In Texas, the BOC requires adopting a plan of dissolution followed by returning contributions held on condition of return and then transferring assets to one or more tax-exempt organizations.[151] Typically, this will mean transferring the assets from the subsidiary to the parent tax-exempt organization. To the extent the subsidiary holds restricted funds and the parent will not be in a position to satisfy the restrictions, the subsidiary will need to seek release or modification of the restriction(s).[152]

If the subsidiary is a taxable corporation, Sections 336 and 337 require the subsidiary to recognize gain or loss when the appreciated or depreciated property is distributed in complete liquidation or sold in connection with complete liquidation. This results in tax being paid at the

[146] States have generally followed the principles of Section 482.
[147] See Reg. Section 1.482-1A(a)(3).
[148] See *id*.
[149] See Reg. Section 1.482-1 through 1.482-9.
[150] See Reg. Section 1.482-9 and Rev. Proc. 2007-13.
[151] See Tex. Bus. Orgs. Code sections 22.302 and 22.304.
[152] Modification or release of restrictions will either be accomplished under the terms of the Uniform Prudent Management of Institutional Funds Act or pursuant to a *cy pres* proceeding.

subsidiary level. To the extent the subsidiary is a pass-through organization (a partnership or an LLC taxed as a partnership), liquidation is generally a non-taxable event.[153]

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.[154]

VII. MANAGING THE RELATIONSHIP

Regardless of the choice of form used for the subsidiary, it is imperative that the relationship between the parent and the subsidiary be maintained in such a way as to demonstrate the "separateness" of the two organizations. This factor is critical not only for liability purposes (avoiding having the corporate veil pierced) as discussed above, but often even more critically for tax purposes (ensuring that the activities of the subsidiary are not attributed to the parent). The Service has concluded that the activities of a separately incorporated subsidiary will not ordinarily be attributed to the parent exempt organization absent facts providing clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent.[155] In considering these issues, the Service has looked to whether the subsidiary has been organized for a bona fide business purpose as opposed to being a mere sham or instrumentality of the parent and whether the parent is so involved in the operational control of the subsidiary that the subsidiary is merely an instrumentality of the parent.[156] To maintain separation and avoid attribution of the subsidiary or affiliated organization's activities to the parent, tax-exempt organizations should consider the factors set forth in the sections below.

A. BUSINESS PURPOSES

While no one factor determines whether separateness of the entities will be respected for tax purposes, the inquiry begins with whether the subsidiary or affiliated organization has been created for a valid business purpose. In the exempt organization context, "business purpose" is not synonymous with a trade or business but rather a "real and substantial purpose or activity."[157] While reducing federal income tax for the parent is not a satisfactory business purpose, protecting the parent's tax-exempt status, protecting the parent's assets from liability risk, and the other purposes set forth in Article III above will constitute proper business purposes.[158] As a result, properly identifying the purpose for the creation of the subsidiary at the outset (including documenting that purpose in minutes of the parent) is helpful. Likewise, demonstrating that the subsidiary is properly capitalized, retains insurance on its property, and takes other measures to conduct its activities demonstrates that it has a business purpose. Finally, 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, and by using letterheads and business cards that show the separate identities of the two parties.

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[153] See Section 731(b).
[154] See, e.g., Tex. Bus. &. Com. Code section 24.006(a) (allowing a creditor to pursue recovery against a shareholder receiving a distribution from an insolvent corporation).
[155] See GCM 39598, 2/4/87.
[156] See *id*.
[157] *Id.*
[158] See *Nat'l Investors Corp. v. Hoey*, 144 F.2d 466 (2nd Cir. 1944) (holding that a reduction of federal income tax is not a business purpose); PLR 9033069 (ruling that protecting assets from business risk is a proper purpose); see also Hill, "Separation is the Key to Using Complex Structures in Exempt Organizations," 6 Exempts 5 (March/April 1995).

B. CORPORATE FORMALITIES

Although failing to observe corporate formalities is not a basis for contractual veil-piercing under Texas law, observing corporate formalities is important to maintaining separation for purposes of avoiding attribution. Observing corporate formalities further cements in the minds of those involved in the current and subsidiary the differences between the two organizations. The parent exempt organization and the subsidiary organization should have separate bank accounts and separate books, avoiding the comingling of funds. The subsidiary should have reasonable capitalization for meeting its day-to-day needs and expenses, plus 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). The organizations should have separate board meetings and keep separate minute books.

C. SHARED DIRECTORS AND OFFICERS

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. There will always be tension in this area between the desire for the parent to have control of the subsidiary and the need to show separation. Including different officers or outside directors or requiring only a minority of directors from the parent serving on the subsidiary board while also requiring a supermajority vote in certain instances are all methods for maintaining control while maintaining separation. The greater the percentage of shared directors and officers, the greater the scrutiny by the Service. Thus, a complete overlap of the two boards should be avoided to allow each board to focus on the specific delineated purposes of the organization. This allows individual directors to satisfy their 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.

Having a complete overlap of officers makes it extremely difficult to demonstrate that the parent is not involving itself in the activities of the subsidiary on a day-to-day basis.[159] Officers of the subsidiary should report to the subsidiary's board of directors/board of managers. Because it is the same individuals involved, differentiating when they are acting on behalf of one entity or the other is impractical. Thus, in the event there are overlapping boards, the officers should not be overlapping, and in the event there are overlapping officers, there should be outside directors.

D. SHARED EMPLOYEES

While it is common to share employees between affiliated organizations, there must be some method (and documentation of such method) to demonstrate each organization is paying for the cost of the employee in relation to the time that the employee is spending on that organization's matters.[160] If the subsidiary is not to have employees of its own, a management services agreement or administrative services agreement may be used to effectively lease employees from the parent to the subsidiary. In the event the subsidiary is not a charitable organization, the agreement should

[159] See Ltr. Rul. 8606056 (attributing the activities of the subsidiary to the exempt parent where there was a complete overlap of officers and directors).

[160] To the extent there are two charitable organizations, one charitable organization may donate services of its employees to another charitable organization, though this should, nevertheless, be documented.

be at arm's-length with the subsidiary paying an amount that is at least equal to the cost of the employee (compensation and benefits). Note that in the event the parent makes a profit on this, there could be UBTI implications. If the employee is to be shared between the two entities, an employee sharing agreement may be more appropriate. In such instance, it is important to have a reasonable and consistently applied method of allocating costs and that such method be documented. Typically, this means not only having a written agreement but requiring the employees to keep timesheets. If percentages are used, those percentages should be "trued up" on a consistent basis and at least quarterly.

Where an employee works for two or more of the affiliated entities, a common paymaster may be used to minimize payroll tax. Under a common paymaster scenario, the affiliated organizations designate a common paymaster in writing (with such designation to be kept with the accounting and payroll records). The common paymaster is responsible for keeping the payroll books and records, for remitting payroll taxes (although affiliated corporations will be jointly and severely reliable for any failure to remit payroll taxes), and responsible for paying FUTA.[161] The common paymaster is also responsible for issuing the employees' W-2s.

Common paymasters can only be used by related corporations that each pay an employee who is employed by at least two organizations concurrently. For purposes of the common paymaster rules, organizations are related for a particular calendar quarter if they satisfy any of three tests at any time during the quarter: (1) either 50% or more of the members of one corporation's board of directors (or applicable governing body) are members of the other corporation's board of directors (or applicable governing body), or the holders of 50% or more of the voting power to select the board of directors for one organization are also holders of 50% or more of the voting power to select the board of directors for the other organization; (2) 50% or more of the officers of one corporation are also officers of the other corporation; or (3) 30% or more of the employees of one corporation are also employees of the other corporation.

While it is not required that affiliated organizations utilize a common paymaster, it should be noted that if a common paymaster is not used and each employer pays the employee separately, the employer would be subject to FICA up to the maximum amount of FICA with respect to each employer instead of cumulatively. Although the employee can take a credit for the excess over the maximum way space, that credit is not available to the employers.

E. SHARED PROPERTY

In addition to sharing employees, affiliated organizations can also share facilities, equipment, and other property. As with shared employees, documentation of these arrangements is critical, and in the event one of the parties is not a charity, it is necessary that party pay at least fair market value for its use of any property provided by the charity. Contracts between affiliated organizations (particularly where the exempt organization is the parent and the subsidiary is not a charitable organization) should be at arm's-length and costs should be allocated based on a reasonable and consistently-applied method. 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

[161] If the charitable organization is the common paymaster and other affiliated organizations are not charitable organizations, the charity should ensure that it does not overlook paying FUTA. Although it is not liable for FUTA, the other entities will be.

value for the space. For example, if a specific facility is utilized by both a parent and a subsidiary with the parent exempt organization employees being 60% of the total workforce and the subsidiary employees being 40% of the total workforce, the parties may choose to allocate square footage on that percentage basis. However it is determined, the subsidiary must pay fair market value for its usage (again, unless the subsidiary is a charitable organization and the parent is donating the facility). If the affiliate is controlled by the parent such that Section 512(b)(13) of the Code related to UBTI comes into play because the parent exempt organization is receiving lease payments from the subsidiary that would have otherwise been excluded from UBTI, the parent should consider whether it can offset such revenue from the subsidiary against its deductible expenses, including the costs of providing the space or equipment.

F. Other Inter-Company Transactions

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, and such other agreements as may be applicable. The goal in both documentation and implementation is to avoid the parent controlling the day-to-day activities of the subsidiary.

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 UBTI rules). In either event, the arrangement should be in writing. In the event the subsidiary is not a charitable organization, fair market value must be paid by the subsidiary. If the name is to be licensed, the parties should nevertheless take care to make the names of the entities distinguishable. The exempt parent may furnish all of the subsidiary's capital as donations (charitable subsidiary), equity contributions (for-profit subsidiary), or via market rate loans (non-charitable exempt organizations).

VIII. CONCLUSION

While a single structure may be appropriate in many instances, often a particular structure cannot house all of the activities to be engaged in by the organization or prudence dictates that it should not house all of the activities. Whether this is because of liability issues, tax issues, management issues, or for some other reason, understanding the options that can be employed to build a more complex organizational structure to manage growth, opportunity, and business activities is required. However, just as important as understanding the reasons for using a more complex structure and the options involved is the need to ensure separateness. A properly tailored structure housing different activities in different entities for different purposes and maintaining appropriate separateness can be a key driver in an organization fulfilling its mission.

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