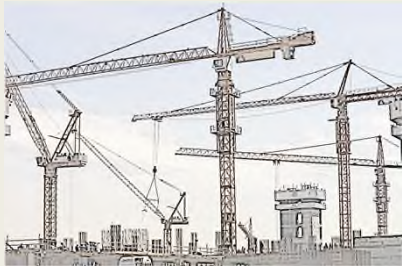


MANAGING GROWTH, OPPORTUNITY, AND BUSINESS ACTIVITIES: COMPLEX ORGANIZATIONAL STRUCTURES AND WHY AND WHEN TO USE THEM



January 17-18, 2019
2019 Nonprofit Organizations Institute
Austin, Texas

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Overview of Presentation

- General exemption principles/brief overview of UBI
- Common reasons to create a more complex structure
- Choice of entity considerations
- Operating in tandem while staying separate
- Case studies

§ 501(c)(3) Core Requirements

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

Business Growth Consideration: Commerciality Doctrine

- Related business conducted in commercial manner as indicia of operating for nonexempt purpose
- Manner of conducting revenue-generating activities results in determination of substantial non-exempt purpose
- Operating with a “distinctly commercial hue”
 - *Direct competition with commercial firms (esp. in same locales)*
 - *Pricing structure designed to produce a profit*
 - *Extensive advertising and use of commercial advertising materials*
 - *Annual accumulated profits*
 - *Lack of charitable donations*

Unrelated Business Taxable Income

- Activities subject to UBIT
 - *Trade or business*
 - *Regularly carried on*
 - *Not substantially related to exempt purposes*

- Primary Exceptions
 - *Volunteer Exception*
 - *Convenience Exception*
 - *Thrift Shop Exception*

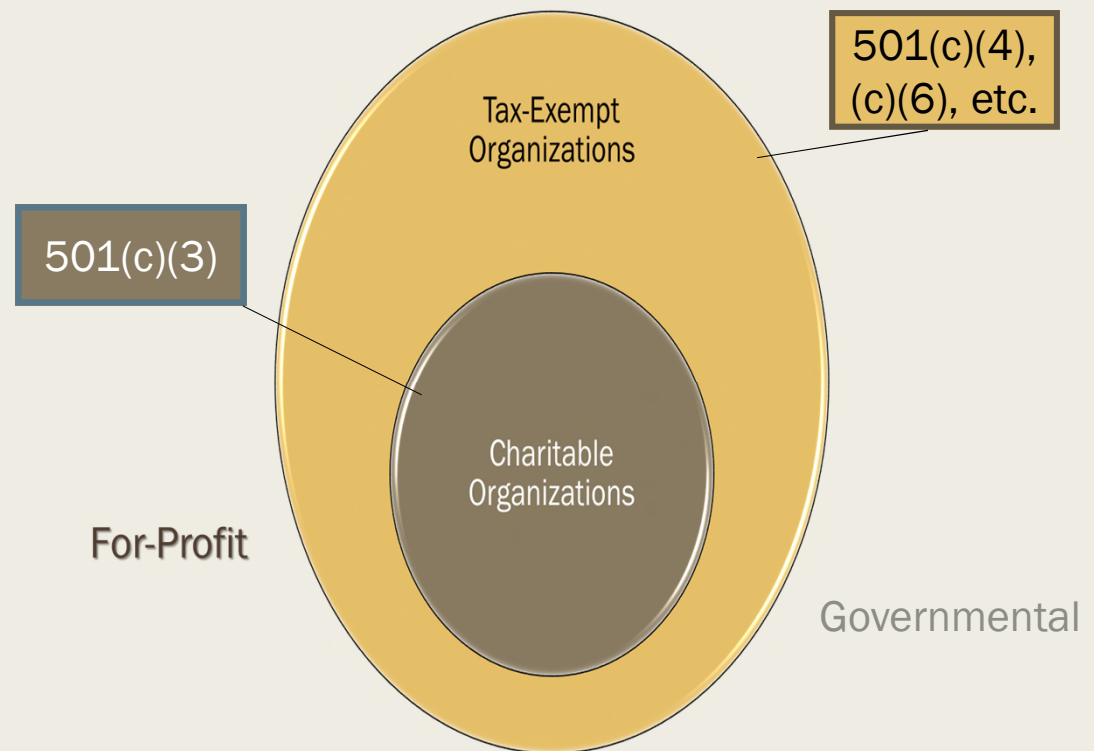
- Notable Exclusion
 - *Passive income*
unless
 - *received from controlled org – then will be UBTI (to the controlling org) to extent payment reduces net unrelated income/increases net unrelated loss of controlled org*

Commensurate-In-Scope Test

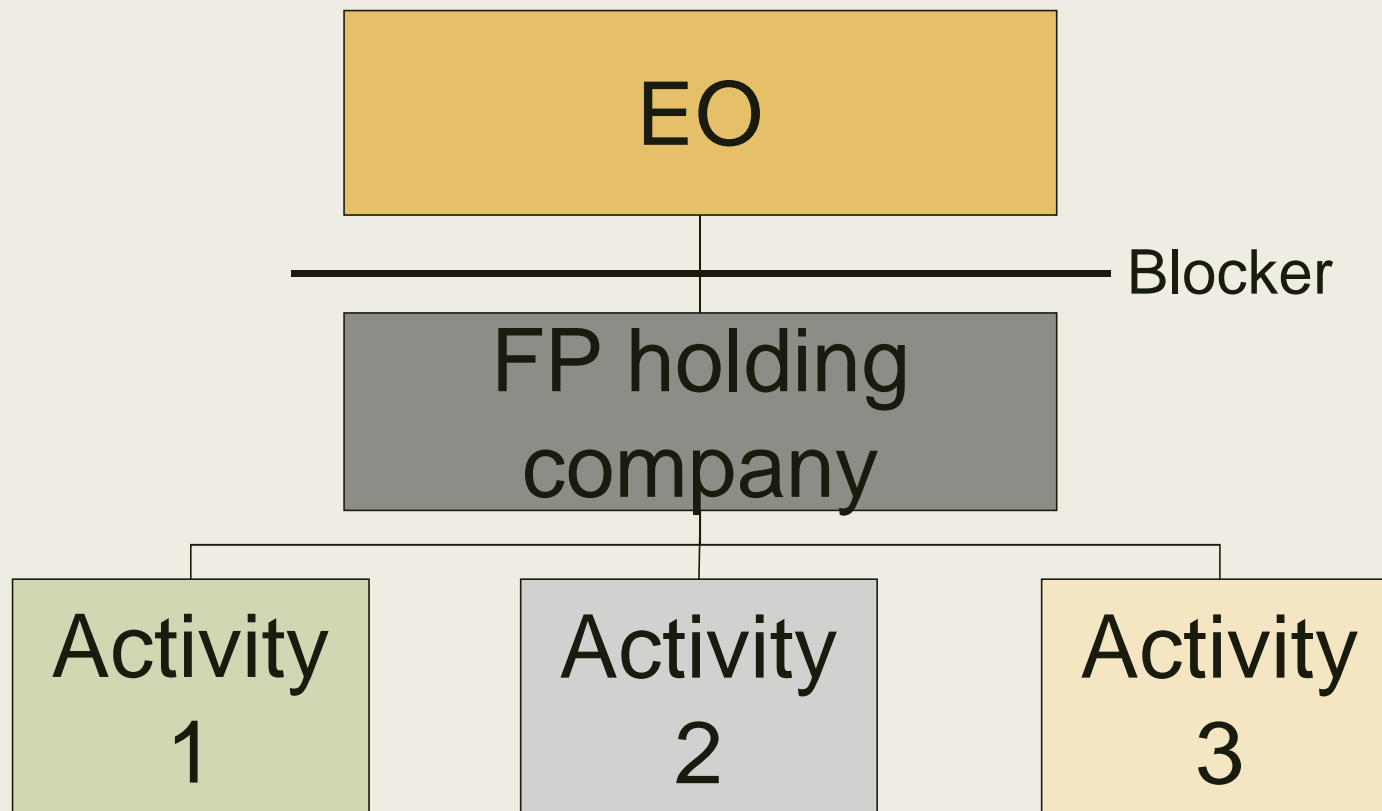
- Where unrelated business activities grow so large they outpace the exempt activities, risk loss of exempt status
- No bright-line test to determine when an unrelated business activity no longer incidental
- A facts-and-circumstances determination:
 - *Amount of income derived from UBI activity in comparison to total income*
 - *Amount of expenditures for the UBI activity in comparison to total expenditures*
 - *Amount of time the org's employees devote to the UBI activity in comparison to total hours worked*

Common Reasons to Create a More Complex Structure: Protect Exempt Status

- *Substantial non-exempt purpose*
- *Exploiting for-profit benefits*
- *Substantial lobbying/political intervention*
- *Non-charitable exempt organization creating exempt affiliate*



Common Reasons to Create a More Complex Structure: Reduce UBI



Common Reasons to Create a More Complex Structure (cont'd)

- Asset Protection/risk management
 - *Texas law very protective of corporate veil*
 - *Contractual obligations: alter ego/sham to perpetrate a fraud*
 - *Torts: injustice or inequity if separate corporate existence recognized*
- Other Rationales
 - *International Operations*
 - *Focused Management of Distinct Activity*
 - *Efficiencies*

Considerations for Choice of Entity

- Primary Purpose of New Entity
 - *Exempt vs. non-exempt*
- State Taxes
- Source of Capitalization
- Exit strategies

Considerations for Choice of Entity: Primary Purpose of New Entity - Exempt

- Nonprofit Corporation
 - *Section 501(c)(3) organizations*
 - 509(a)(1) or 509(a)(2)
 - 509(a)(3): Supporting organizations: Type I, II, III - FI/NFI
 - *Other Section 501(c) organizations*
- Single Member LLC
- Exempt LLC

Stand-Alone Section 501(c)(3) Organizations vs. Supporting Organizations

- Stand-alone public charity (509(a)(1) or (a)(2))
 - *Maintain governance control without restrictions on SOs*
- Supporting organizations (509(a)(3))
 - *Use when cannot meet tests for stand-alone status*
 - *Which type to use?*
 - True subsidiary: Type I
 - Affiliate: Type II
 - Parent: Type II or Type III (functionally integrated)

Disregarded Single-Member LLCs vs. Section 501(c)(3) Organizations

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

Considerations for Choice of Entity: Primary Purpose of New Entity – Non-exempt

■ Taxable subsidiaries

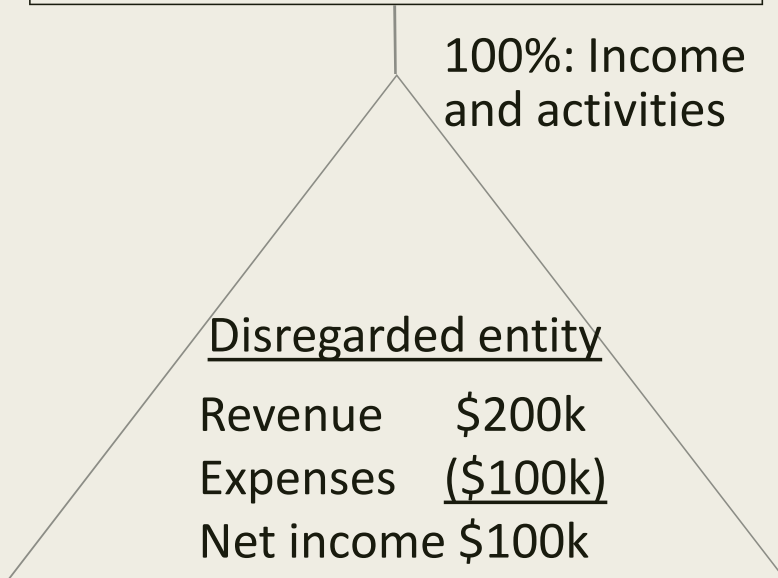
- *State law business corporation vs. nonprofit corporation*
 - Stock ownership vs. membership
- *“Check-the-box” LLC*
- *S corporations = automatic UBTI*

Disregarded Entity vs. Taxable Entity

Disregarded entity

Exempt organization (EO)
Reports 100% of disregarded entity

100%: Income and activities



C corporation

EO
No flow-through
Tax-free dividend

100%

| <u>C corporation</u> | |
|----------------------|---------------|
| Revenue | \$200k |
| Expenses | (\$100k) |
| Net income | <u>\$100k</u> |
| Tax paid | \$35k |
| Net | \$65k |

State Tax: Franchise, Sales

- Exempt from franchise & sales tax based on federal exemption:
 - *Nonprofit corporations exempt under 501(c)(3), (4), (8), (10), or (19)*
- Exempt from franchise tax (not sales tax) based on federal exemption:
 - *Nonprofit corporations exempt under 501(c)(5), (6), or (7);*
 - *Corporations (for-profit and nonprofit) exempt under 501(c)(2), (16), or (25)*
- Disregarded single-member LLC cannot qualify for exempt status based on parent's exemption (Comp. Ltr. Rul. 200106899L)

State Tax: Property

- Not directly tied to federal exemption
- Generally, qualifying organization must own and use property for exempt activities
 - *Exception: charitable org may use assets in performing charitable functions of another charitable org (11.18(f)(1))*
 - *Likely exception: equitable ownership (Tex. Att'y Gen. Op. No. GA-1092)*
- Charitable, religious, educational property tax exemptions all reference corporations and associations – *NOT LLCs*

Considerations for Choice of Entity: Dissolution/Liquidation Issues

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

Merger/Liquidation of Taxable Subsidiary into Exempt Parent

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

Managing the Relationship

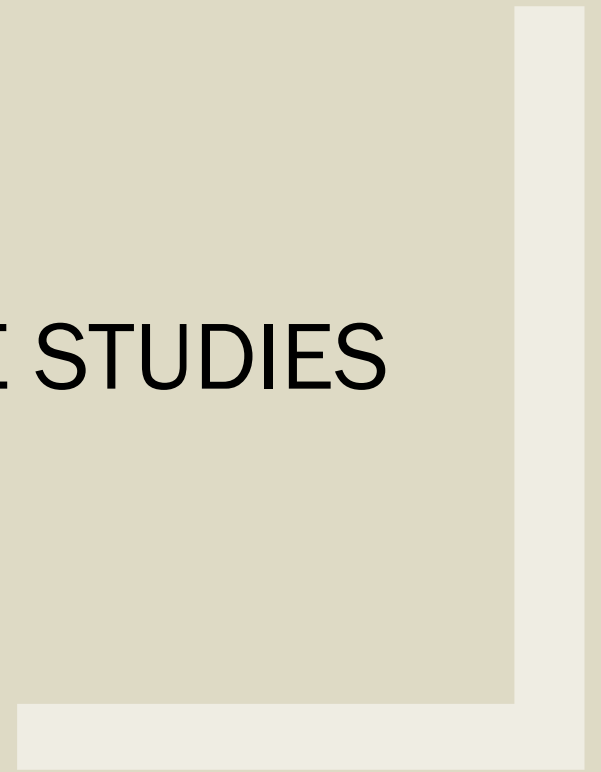
Maintaining Appropriate Separateness

- Particularly important if unrelated activity
- Facts and circumstances analysis
 - *Bona fide business purpose*
 - *Corporate formalities*
 - *Separate books and records*
 - *Distinct governance (BOD/Officers)*
 - *Arm's-length transactions*

Sharing Employees, Facilities, or Equipment

- Lease employees under Services Agreement
- Share employees
 - *Should have employees keep timesheets (or use another reasonable method)*
 - *Consider using common paymaster if satisfy the affiliation requirements to lessen FICA tax*
- Share facilities and equipment:
 - *Allocate based on a reasonable and consistently applied method (square footage, actual costs, etc.)*

CASE STUDIES



Case study #1

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

Case study #2

- A public charity that operates a resource facility for the homeless and two night shelters is considering starting a new business to provide janitorial services. Consider the following facts:
 - *Initially, the janitorial services will only be provided to related entities that are part of the charity's network. However, in the future, it may expand the business to unrelated entities.*
 - *Charity believes that this could turn into a large business.*
 - *Charity is also considering starting or purchasing ancillary businesses.*
 - *Charity may consider investors or partners in the future to expand the business if successful.*
 - *Charity also may consider a sale of the janitorial business in the future.*
- What type of entity structure should hospital consider?

The information set forth in this presentation should not be considered legal advice, because every fact pattern is unique.

The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

Non-lawyers are advised to consult an attorney before undertaking any issues addressed herein.