Understanding Complex Nonprofit/For-Profit Structuring

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Introduction: The Social Context

- Commercial opportunities arise with greater frequency
  - Charities embrace commercial techniques, processes, etc.
    1) Should we be more like them
    2) It may not be such a bad thing
    3) In service of what?
    4) How far can we go?
    5) Impact on character of exempt activities
  - Circumstances
    1) Activities evolve and new opportunities emerge
    2) Priorities change
    3) The world changes around us

Introduction: The Social Context (cont'd)

- People
  1) Social entrepreneurs are attracted to/by the nonprofit sector
  2) The commercial sector is not the only destination for business minded people
  3) Board pressures
- Sometimes it's just (or somewhat) about the money
  1) Self-sustaining programs
  2) Additional source of general organizational funding
- Perception
  1) Maintain distinction between core work and ancillary business activities

Introduction: The Legal Context

- Organizational and operational tests
  - Charities must be organized and operated ***exclusively*** for one or more charitable purposes
    1) Exclusively = “primarily”
    2) What about the remainder:
       a) Insubstantial non-exempt activities are OK, but…
       b) UBIT
- No private benefit/inurement
  - Charities may not benefit private interests more than insubstantially
    1) But a little (how much) is ok?
- Public charity v. private foundation distinctions

Related Business Activities

- Business activities may further (be related to) an organization's charitable purposes
  - Vehicle to achieve mission impact
- If it is related we generally don't worry
  - No tax liability
  - No tax reason to spin off
- But…
  - May want to spin off for other reasons
    1) Liability
    2) Optics
    3) Attract additional funding
  - How we conduct the activity matters

Unrelated Business Activities

- Unrelated business activities are generally taxable
- Unrelated business taxable income is income derived from an activity that is
  - a trade or business, i.e., any activity carried on for production of income from
    1) Sale of goods or
    2) Performance of services
  - regularly carried on
    1) not infrequent or intermittent
  - not substantially related to exempt purposes
- Modifications/exceptions: dividends, interest, royalties, rents, capital gains, corporate sponsorships, etc.

How Do I Know When Something is Unrelated?

- Related activities must contribute importantly to the accomplishment of the organization's exempt purposes
  - Check
    1) charitable purposes in governing documents
    2) 1023 representations and disclosures
  - Look to the purpose/benefit of the activity, not the income
- Scale
  - Otherwise related activities may produce UBTI if conducted on a scale larger than reasonably necessary

How Do I Know When Something is Unrelated? (cont'd)

- Watch out for "commercial hue"
  - Overly commercial manner may detract from accomplishment of exempt purposes (& change tax treatment of income)
- Commercial Counterparts
  - Should/does it matter?
- Facts and circumstances determination

Structuring Options For Unrelated Activities

- Do nothing (but pay tax)
  - Limited to insubstantial unrelated activities
  - Doesn’t take exemption risks off the table
  - Internal/external confusion
  - No separate entity to maintain
- Establish a for-profit subsidiary
  - Clarity of purpose
  - Limitation of liability
  - May protect exemption (Corporation v. LLC)
  - Separate entity to maintain

When To Consider Establishing a For-Profit Subsidiary?

- Unrelated activities have expanded
  - Fear of jeopardizing exemption
- Take advantage of good business opportunities
- Attract additional financing to support activity
- Liability protection needs
- Optics
- Balance sheet issues

Choice of Entity

- Traditional Corporation
  - Wholly owned
  - Other investors
- Limited Liability Company
  - Single member
  - Multiple member
- Partnerships
- Newer Corporate Forms
  - L3C
  - Benefit Corporations

Practical Considerations & Traps for the Unwary

- Basic corporate formation issues & expenses
- Control & governance issues
- Structure of on-going relationship
  - Sharing of services & facilities
- Transfer of people & assets
  - Who & what goes (& stays)
  - What form of transfer
  - Capitalization
  - Intellectual Property

Practical Considerations & Traps for the Unwary (cont'd)

- Compensation & benefits
  - Intermediate sanctions
  - Equity?
- Beware of 512(b)(13)
  - Licensing, loans & rent
- Conflicts of Interest
- State tax issues
- Exit

Separate Corporate Identity

- Maintain corporate separateness (avoid “piercing” of the corporate veil)
  - Separately conducted governance & management
  - Separate books & records
  - Avoid corporate confusion in personnel & public dealings
    1) People should wear the right hats
    2) Separate e-mail addresses, letterhead, cards, etc.
  - Separate financial information
  - Avoid co-mingling of assets

Separate Corporate Identity (cont'd)

- Adequate capitalization
- Insurance
- Arm's length relationship with parent (services, facilities, etc.)
  1) Agreements should govern interactions
     a) Fair allocations
     b) Clear terms
     c) No need to get too complicated though

Private Foundation Considerations

- Self-Dealing
- Excess Business Holdings
  - Impact of unrelated business activities generally
  - Subsidiary issues
- Functionally Related Business
- Program Related Investments

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