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Section 501(c)(3) Tax-Exempt Entities Forming Affiliations With Other Entities: Benefits, Risks, and Structural Considerations

Executive Summary for Non-Lawyers

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1. Introduction

There are many considerations facing a tax-exempt organization prior to or in connection with forming an alliance or affiliation with another entity. Certain unintended and damaging consequences could result if the tax-exempt organization were deemed to be a single entity with or otherwise not separate from the affiliate, including:

- Complete loss of tax-exempt status, or loss of tax-exempt status under a particular provision (*e.g.*, Section 501(c)(3)) of the Internal Revenue Code ("IRC");
- Increased liability exposure under general corporate law for the liabilities of the affiliate; and
- Increased liability exposure under specific protective laws, such as federal labor and antidiscrimination statutes, including the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, and the Worker Adjustment and Retraining Notification Act.

As a general matter, a tax-exempt entity should be wary of any action or inaction that might be seen as creating an improper relationship or allowing one entity to impermissibly control or dominate another. This holds true regardless of how such an alliance or affiliation is formed or what corporate form the tax-exempt entity has taken.

This article contains a very brief summary of certain legal consequences of certain activities by tax-exempt organizations, including United States federal income tax consequences, and does not present a complete analysis of all consequences, tax or otherwise, that may be relevant to any organization. Legal and/or tax advice should be sought by a tax-exempt entity with respect to its particular situation.

The tax-exempt entity should generally focus on the following areas.

2. Structure and Formation of an Affiliation with a Tax-Exempt Entity

The limited guidance from the Internal Revenue Service ("IRS") indicates that (a) certain organizational forms may be preferable to others with respect to the creation of a tax-exempt

1 A longer version of this summary, with a detailed analysis of the legal principles upon which this summary is based, is available at https://www.probonopartner.org/wp-content/uploads/2016/05/Affiliation-Primer-Unabridged.pdf.

entity and (b) certain structures with respect to forming affiliations are treated differently. In determining the best structure and formation, at a minimum the following points should be considered:

- The nonprofit corporation is the most commonly used and widely accepted form for tax-exempt entities under Section 501(c)(3) of the Internal Revenue Code ("IRC"). Trusts are often used for private foundations. LLCs are not commonly used for tax-exempt organizations.

- In forming an affiliation with another entity, the tax-exempt entity should try to avoid serving as a general partner in a limited partnership because the IRS generally disfavors such arrangements and requires additional standards to be met in order to maintain tax-exempt status. Sole proprietorships should also generally be avoided for the conduct of a for-profit activity because a sole proprietorship is characterized as part of the parent organization, which would result in the treatment of a for-profit sole proprietorship and its non-profit parent as one entity for tax purposes.

- In forming an affiliation with another entity, the tax-exempt entity should consider the joint venture structure, including the formation of a limited liability company, which has become increasingly popular. In addition, the traditional corporate structure of parent-subsidiary also may be appropriate and would allow each entity to have a distinct tax-exempt or for-profit designation. Treatment of LLCs, partnerships, and corporations under state tax law will also be a consideration.

- As a general matter, all organization documents, including bylaws and formation documents (*e.g.*, articles/certificate of incorporation) should clearly state the tax-exempt entity's permitted purpose and explicitly disallow non-permitted purposes. Further, any affiliation or new entity created by a tax-exempt entity must be created for a bona fide purpose, with a reasonable business justification for doing so, and not merely to avoid certain tax treatment or tax regulation or to avoid possible liability or scrutiny under law (*e.g.*, to avoid the reach of federal anti-discrimination laws).

- The tax-exempt entity must be vigilant to ensure that the affiliation will not result in the diversion of the nonprofit's assets for a private purpose, in order to not violate the doctrines of private inurement and private benefit.

3. **<u>Establishing Separate Operations following the Affiliation</u>**

The following factors are relevant in determining whether a tax-exempt entity will be recognized as separate from its affiliate. A tax-exempt entity should consider each of these factors in terms of its application to nonprofit's operations and tax-exempt purpose. Where applicable and to the extent reasonably possible, a tax-exempt entity should endeavor to:

- Observe all partnership or corporate formalities of separate existence;

- Maintain separate books and records;

- Keep all assets separate from other entities and avoid any co-mingling of funds;

- Conduct its activities in its own name;

- Pay the salaries of its own employees, provide separate health insurance benefits, maintain separate unemployment and workers' compensation accounts, and generally avoid centralized control over labor relations (including personnel decisions such as hiring and firing);

- Avoid the perception of interrelated operations and common management;

- Maintain independent management;

- Use its own stationery, invoices, and checks, and not allow other entities to use such items;

- Hold itself out as a separate entity;

- Maintain separate accounts with banking institutions, vendors, customers, etc.;

- Maintain separate financial statements and tax reporting;

- Pay its own liabilities out of its own funds and deposit its own receipts into its own accounts;

- Dedicate all funds of the tax-exempt entity to the exempt purpose, including providing that the organization's assets be distributed for an exempt purpose upon the dissolution of the organization;

- Maintain a sufficient number of employees and operating assets in light of its contemplated business operations;

- Maintain adequate capital in light of its contemplated business operations (particularly with respect to parent-subsidiary relationships);

- Avoid guaranteeing or becoming obligated for the debts of any other entity or holding out the nonprofit's credit as being available to satisfy the obligations of others;

- Avoid acquiring obligations of its partners, members, or shareholders;

- Avoid pledging its assets or making loans or advances for the benefit of any other entity; and

- Avoid excessive overlap of board members and corporate officers, and have separate meetings of the respective entities' boards and officers.

Where there are shared assets or liabilities between the entities or where the entities engage in affiliate transactions, a tax-exempt entity should make every effort to:

- Allocate fairly and reasonably any shared expenses, revenues, or cost-savings (*e.g.*, overhead for shared office space) based on actual use and fair market value;

- Ensure any rental payments made are ordinary and necessary expenses and are calculated based on actual use at fair market value (although charging the tax-exempt entity less than fair market value rental may be allowable under certain circumstances);
- Keep detailed records of any payments for shared expenses, revenues, or cost-savings and any payments made between affiliates;
- Maintain an arm's-length relationship with its affiliates;
- Ensure that the tax-exempt entity's assets are not diverted for a private purpose, in order to not violate the doctrines of private inurement and private benefit; for example, avoid any pass through to the affiliate (or stakeholders) of profits or other benefits that could be viewed as excessive or private inurement;
- Correct any known misunderstanding regarding its separate identity; and
- With respect to parent-subsidiary relationships, limit the parent's day-to-day involvement in and control of the subsidiary's operations.

The legal principles governing affiliated organizations are highly technical. If you have any questions about the matters discussed in this article, please contact the Pro Bono Partnership.

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