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

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TABLE OF CONTENTS

I. INTRODUCTION 3

II. GENERAL TAX EXEMPTION PRINCIPLES 3

A. ORGANIZATIONAL TEST 3

B. OPERATIONAL TEST 4

1. Private Benefit 4

2. No Private Inurement 5

3. Commerciality Concerns 6

C. NOT AN ACTION ORGANIZATION / NOT AGAINST PUBLIC POLICY 8

III. UNRELATED BUSINESS TAXABLE INCOME ISSUES 8

A. GENERAL RULES 8

B. EXCEPTIONS/MODIFICATIONS 11

C. UNRELATED BUSINESS TAXABLE INCOME AND SECTION 512(b)(13) 11

D. COMMENSURATE-IN-SCOPE TEST 12

IV. REASONS TO CREATE A MORE COMPLEX STRUCTURE 13

A. PROTECT EXEMPT STATUS 13

1. Primary Purpose 13

2. Exploiting For-Profit Benefits 13

3. Substantial Lobbying/Political Intervention 13

4. Non-Charitable Exempt Organization Creating Exempt Affiliate 14

B. REDUCE UBI 14

C. ASSET PROTECTION 15

D. OTHER RATIONALES 15

1. International Operations 15

2. Distinct Activities/Management Focus 15

3. Efficiencies 15

V. COMMONLY USED ENTITIES AND THEIR KEY ATTRIBUTES 16

A. NONPROFIT CORPORATION 16

B. FOR-PROFIT CORPORATION 16

C. LIMITED LIABILITY COMPANIES 17

VI. CONSIDERATIONS FOR CHOICE OF ENTITY 20

A. PRIMARY PURPOSE OF NEW ENTITY 20

1. Exempt 21

a. Nonprofit Corporation 21

b. Limited Liability Company 22

2. Non-Exempt 23

a. For-Profit Corporation 23
b. Limited Liability Company 24
B. STATE TAXES 24
C. CONTROL AND MANAGEMENT/OWNER LIABILITY 25
D. CAPITALIZATION (FUNDRAISING) 29
E. TRANSFER PRICING ISSUES 29
F. DISSOLUTION/LIQUIDATION ISSUES 30
VII. MANAGING THE RELATIONSHIP 31
A. BUSINESS PURPOSES 31
B. CORPORATE FORMALITIES 32
C. SHARED DIRECTORS AND OFFICERS 32
D. SHARED EMPLOYEES 32
E. SHARED PROPERTY 33
F. OTHER INTER-COMPANY TRANSACTIONS 34
VIII. CONCLUSION 34

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]

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[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.

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