

**PUTTING THINGS TOGETHER:  
SUBSIDIARIES, COMPLEX ORGANIZATIONAL STRUCTURES,  
JOINT VENTURES, AND JOINT FUNDING VEHICLES**

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## TABLE OF CONTENTS

<b>I.</b>	<b>INTRODUCTION .....</b>	<b>2</b>
<b>II.</b>	<b>TAX EXEMPTION PRINCIPLES.....</b>	<b>2</b>
A.	ORGANIZATIONAL TEST.....	2
B.	OPERATIONAL TEST .....	2
C.	NO PRIVATE INUREMENT .....	4
D.	NOT AN ACTION ORGANIZATION / NOT AGAINST PUBLIC POLICY .....	4
E.	COMMERCIALITY CONCERNS.....	4
F.	UNRELATED BUSINESS TAXABLE INCOME AND SECTION 512(b)(13).....	7
<b>III.</b>	<b>CHOICE OF ENTITY OPTIONS/ATTRIBUTES .....</b>	<b>8</b>
A.	TAXABLE CORPORATIONS .....	8
1.	<i>Nonprofit corporation</i> .....	8
2.	<i>For-profit corporation</i> .....	9
B.	LIMITED LIABILITY COMPANIES.....	10
C.	JOINT VENTURE AND FUNDING VEHICLES .....	12
1.	<i>Partnerships</i> .....	12
2.	<i>Joint Operating Agreements</i> .....	14
3.	<i>Affiliations and Other Contractual Arrangements</i> .....	15
<b>IV.</b>	<b>CONSIDERATIONS FOR CHOICE OF ENTITY .....</b>	<b>15</b>
A.	IMPACT ON EXEMPT STATUS .....	16
1.	<i>Corporations</i> .....	16
2.	<i>Partnerships</i> .....	16
3.	<i>Limited liability company</i> .....	18
B.	STATE TAXES .....	19
C.	CONTROL AND MANAGEMENT/OWNER LIABILITY .....	19
D.	CAPITALIZATION (FUNDRAISING).....	24
E.	TRANSFER PRICING ISSUES.....	25
F.	DISSOLUTION/LIQUIDATION ISSUES.....	25

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**I. INTRODUCTION**

Whether scaling to increase greater impact, engaging in joint ventures or collaborative efforts with others, or needing to address unrelated business income or risk-to-exemption, charities often find themselves looking to structure their operations through subsidiaries, affiliates, and other joint venture vehicles. Choosing to “put things together” in one of these manners involves consideration of factors ranging from choice of form, tax status of the vehicle, and ultimately the impact on the exempt organization and its tax status. The discussion below reviews the major legal issues to be analyzed and the structural options to be considered when “building out” various organizational structures.

**II. 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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

**B. OPERATIONAL TEST**

For purposes of the operational test, an organization must show that it is (or will be) operated exclusively for exempt purposes.<sup>5</sup> In this context, the word “exclusively” means “primarily.”<sup>6</sup> Said differently, an organization will be regarded as operated exclusively for one or

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<sup>1</sup> Portions of this paper originally appeared as part of “Commercial Activities and Subsidiaries: Issues and Choices in Planning,” Darren B. Moore, *Taxation of Exempts*, Volume 28, Issue 4, Copyright 2016 Thomson Reuters/Tax & Accounting, and is reprinted here with permission.

<sup>2</sup> See Reg. 1.501(c)(3)-1(a).

<sup>3</sup> See Reg. 1.501(c)(3)-1(b)(4).

<sup>4</sup> See Reg. 1.501(c)(3)-1(b)(4).

<sup>5</sup> See Section 501(c)(3).

<sup>6</sup> See Reg. 1.501(c)(3)-1(c)(1).

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)).<sup>7</sup> An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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...."<sup>11</sup>

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.<sup>12</sup> 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.<sup>13</sup> This primary purpose test, as it relates to the conduct of a trade or business, is further influenced by the commerciality doctrine discussed below.

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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> Any private interest must be incidental to the public interest both quantitatively and qualitatively.<sup>17</sup> 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."<sup>18</sup> 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.<sup>19</sup> 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

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<sup>7</sup> See *id.*

<sup>8</sup> See *id.*

<sup>9</sup> See *id.*; *Better Business Bureau*, 326 U.S. 279 283 34 AFTR 5 (1945).

<sup>10</sup> *B.S.W. Group, Inc.*, 70 TC 352 356-357 (1978).

<sup>11</sup> *Id.*

<sup>12</sup> See Reg. 1.501(c)(3)-1(e)(1).

<sup>13</sup> See Reg. 1.501(c)(3)-1(c)(1).

<sup>14</sup> See Reg. 1.501(c)(3)-1(d)(ii).

<sup>15</sup> See GCM 37789, 12/18/78.

<sup>16</sup> See GCM 38459, 7/31/80.

<sup>17</sup> See GCM 37789, 12/18/78.

<sup>18</sup> See *id.* (referencing Rev. Rul. 70-186, 1970-1 CB 128); see also Ltr. Rul. 9615030.

<sup>19</sup> See Rev. Rul. 72-559, 1972-2 CB 247; Rev. Rul. 73-313, 1973-2 CB 174.

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