THE FOR-PROFIT SUBSIDIARY AS A STRATEGY FOR THE NONPROFIT

Leadership in nonprofit organizations are challenged to find alternate strategies to generate revenue to support their mission, which have traditionally included fundraising and grants. The sources of income are shrinking for these categories making it ever more critical for leadership to think outside the traditional forms of third-party financial support. For tax-exempt nonprofits, another prominent challenge exists when generating revenue: "Unrelated Business Income." Unrelated Business Income translates, at a minimum, to the payment of corporate tax on such income ("UBIT"), and in some cases, could lead to the revocation of an organization's tax-exempt status.

How does this work? If the amount of revenue generated is considered unrelated to the mission of the organization and is disproportionate to the level of income raised within its business purpose, the organization is subject to UBIT and could jeopardize its tax-exempt status.

What is UBIT? This is a tax imposed on income derived from a regularly carried on trade or businesses that is unrelated to the performance of the organization's tax-exempt (e.g., charitable) purpose. UBIT was instituted by Congress in an effort to level the playing field between nonprofit and for profit entities when the tax-exempt organization is engaging in business activities that might compete with for profit businesses.

Unfortunately, making a determination as to when the revenue generating activity is unrelated to the purpose of the organization is not a bright line test in that it is not always clear under federal tax law when an activity might be considered unrelated to the organization's tax-exempt purpose. If a nonprofit has a successful business that may be deemed unrelated to its mission and purpose, it will need to develop and implement a strategy that allows the organization to pursue a broader range of profit-making activities.

What type of strategy? Insulating the organization from UBIT requires the development of a platform and organizational structure that is separate from the nonprofit's traditional business activities. This might involve creating a for-profit entity that is partially owned by the organization and operated as a separate business from the exempt organization. This model creates an opportunity for the nonprofit to attract outside investors, and if the venture derives a profit, there are avenues for the nonprofit to benefit from the for-profit activity without jeopardizing its tax-exempt status or becoming subject to UBIT. A for-profit subsidiary also presents an opportunity for employees to share in the profit of the business, providing a broader range of employment options.

The revenue generated by the activities of a for-profit subsidiary and its business operation would be included on the tax-exempt organization's Form 990; however, the disclosure is more limited than that which is required by the nonprofit activity. Additionally, this structure creates a clear line of separation between the exempt and non-exempt activities which aids in avoiding confusion relating to the mission of the tax-exempt organization which is important for those making contributions.

It should be noted that the creation of a for-profit enterprise will involve additional costs, governance and infrastructure challenges, a different board and restrictions on the financial arrangement between the for-profit and nonprofit. The business operations and governance structure of each entity must be separate; i.e., the relationship between the for-profit and nonprofit must be at arm's length governing body will be separate and each board must conduct separate meetings with all transactions between the organizations at arm's length and at market value as it relates to financial transactions. To the extent practicable, it is important to avoid complete overlap in directors and officers so as to further insulate the nonprofit. The nonprofit leadership must be cognizant of the possibility that a failure to segregate operations of the for-profit entity from the nonprofit parent may cause a regulator or court to disregard the structure.

For federal income tax purposes, a corporation is recognized as a separate taxpaying entity. The corporation will realize net income or loss, pay taxes, and distribute profits to shareholders. The profit is taxed to the corporation when earned and is taxed, with certain exceptions, to the shareholders when distributed as dividends, resulting in a double tax. For a tax-exempt nonprofit parent, the dividends it receives may not be taxable, because they qualify as passive income; however, the income of the subsidiary will be taxed at the subsidiary level.

Certain payments typically are deductible to the subsidiary as a business expense, such as the cost of borrowing money, renting space, or licensing intellectual property. However, in the case of a corporate subsidiary where the parent owns more than fifty (50%) percent of the stock (or, if the subsidiary is a limited liability company ("LLC"), more than fifty (50%) percent of the profit or capital interests), the interest, rents, and royalties paid by the subsidiary to the parent will be subject to UBIT. LLCs are typically "pass-through" entities.

Multiple-member LLCs are treated like partnerships and are not subject to income tax at the entity level (although an LLC can elect to be taxed separately from its members, in which case it would be taxable as a corporation). Instead, the LLC allocates to each member its share of the LLC's income and expense, and each member pays its own tax on this net income (regardless of whether the LLC actually makes any distribution to its members). The Internal Revenue Service will attribute activities carried on by an LLC to its tax-exempt members when evaluating whether the nonprofit members are operated exclusively for exempt purposes.

It is possible for an LLC to have only one member, in which case it is generally disregarded for federal income tax purposes. Its income and expenses are reflected on the tax return of its sole member, and the IRS will regard the nonexempt activities carried on by the LLC to be the activities of its sole member. The LLC structure may work well when the nonprofit's goal in setting up the subsidiary is to limit liability or to attract additional investors, and the LLC's activities are still substantially related to the parent's charitable mission.

A tax-exempt parent may not wish to hold a membership interest in an LLC where the subsidiary will conduct an unrelated business activity. In that situation, the member may be required to file a Form 990-T and pay unrelated business income tax on its share of net income from the LLC. The revenue-generating activities also potentially could jeopardize the charity's tax exemption. A nonprofit organization therefore may opt for a taxable corporation to house activities that are unrelated to its mission in order to avoid this attribution.

A subsidiary will be subject to registration and reporting requirements in its state of formation (e.g., with the secretary of state). If the entity establishes certain minimum contacts with another state through its operations, the entity also will be subject to the jurisdiction of that state. Some states impose taxes or annual fees on LLCs, notwithstanding the fact that a single-member LLC is disregarded for federal income tax purposes or that a multiple-member LLC has only tax-exempt organizations as its members. A lack of uniformity across states means that an LLC subsidiary could owe taxes or fees in one or more states while operating in other states free of any entity-level payment.

The nonprofit parent must capitalize its subsidiary. A contribution in return for an equity interest is an investment. The parent must determine whether the investment is either (1) a prudent investment that will not violate any state fiduciary requirements or prudent investor laws, or (2) a "program-related" investment that is being made primarily to further a charitable purpose rather than an investment purpose. If a subsidiary is formed to house business activities that are unrelated to the parent's tax-exempt purpose, only the first option may be available. The nonprofit therefore should be aware of any prudent investment standards that govern how the organization may invest its funds.

In conclusion, the use of a for-profit subsidiary can be an effective strategy for a variety of reasons which range from shielding the nonprofit organization from liability or UBIT, to attracting outside investment and scaling a business beyond what might be possible if conducted inside the nonprofit parent. When a revenue-generating activity or a significant asset is involved, the directors of a nonprofit organization and legal counsel should consider whether a subsidiary is the most efficient structure.

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