

Legal Structures for Business Ventures: Finding the Right Legal Structure

By Brad Castel

For a nonprofit corporation, the tax ramifications of undertaking a business venture are an important consideration. But they are not the only factor that requires careful analysis. Matters such as liability and financing also have to be considered. And even though the corporation need not be required to form a subsidiary to conduct the business, it may find it desirable to do so.

Any business that is or will become a substantial activity of a 501(c)(3) nonprofit corporation must be related to the corporation's exempt (charitable or educational) purposes. That is, the business must be conducted as a means to achieve the charitable or educational purpose. "Substantial" is typically defined as exceeding approximately 15 percent of the corporation's time or gross revenues.

If not related to achieving charitable or educational purposes, the business must be conducted in a taxable (typically, for-profit) subsidiary. Otherwise, the corporation risks loss of its tax-exempt status. The fact that the revenue generated is used to support the corporation's other charitable or educational activities does not make the business related. Profits from related businesses are not taxed. Profits from unrelated businesses are taxed at normal corporate income tax rates.

Decisions concerning such issues of corporate structure need to be reviewed as new circumstances arise and as the corporation and its business develop. Initially, it may be appropriate to undertake a business within the corporation. But as the business grows, its management or capital needs, or the potential liability it represents, may necessitate transfer to a subsidiary.

A subsidiary corporation will be treated for tax, liability, and other purposes as a separate legal entity, despite the parent nonprofit corporation's control over the composition of the subsidiary's board of directors. However, certain precautions must be taken to ensure that the proper balance of separation and control is maintained.

That is why the nonprofit should consult a knowledgeable attorney during the planning phase for any new business. The attorney can conduct a board

training on organizational structure options in light of the specific business venture under consideration.

Too often, lacking this kind of information, nonprofit corporations self-impose constraints which the law does not impose. The legal structure issues discussed here should not be viewed as roadblocks, but rather as tools to assist the corporation in accomplishing its goals. If a corporation has developed a viable business opportunity, there are no legal structure impediments to its accomplishment.

Step One: Review Incorporation Documents

Before undertaking a business within the nonprofit corporation, review its articles of incorporation, bylaws, tax exemption application and determination letter, and other corporate documents such as its mission statement.

Articles of Incorporation

Determine whether the business activity is consistent with general or specific corporate purposes. For example, if a corporate purpose is to promote employment opportunities for the disadvantaged poor, minorities, unemployed, and underemployed in the community, then a business that will employ a significant number of such persons is consistent with that purpose. Thus, it is generally not necessary to state that business operation is a specific purpose. Also, most "purposes clauses" contain a general catch-all which permits the corporation to engage in any activities which further its charitable or educational purposes, and an insubstantial amount of activity which is not in furtherance of these purposes.

If the business activity is not authorized even generally, amend the articles and send a copy of the amendment to the Internal Revenue Service (IRS) and corresponding state tax agency with the corporation's next income tax filing (IRS Form 990 and corresponding state tax form). If not filing, send it within four-and-a-half months following the close of the corporation's fiscal year. Include a letter describing the new purpose and business activity and why the corporation considers them to be charitable or educational.

Bylaws, Mission Statement, Other Internal Documents

If the articles are amended, corresponding changes might be needed in these internal documents. In addition, they should be reviewed for any statements inconsistent with the operation of a business, or to add references to business activities where appropriate. For example, if a standing business

development committee has been formed, it may be necessary to add this to the bylaws.

Send a copy of the bylaw amendments to the IRS and state tax agency with the next income tax filing. The mission statement and other documents, such as a strategic plan, are internal to the corporation and need not be sent.

Tax Exemption Application and Determination Letter

Determine whether the business activity contradicts statements made in the application to the IRS/state tax agency or requirements imposed in the determination letter from the IRS/state tax agency. For example, the application might state that the corporation will never charge for its services. If the business activity is inconsistent with the application, notify the IRS/state tax agency of the new activity either by letter as part of the next income tax filing, or by ruling request.

A letter alerts the IRS to the business activity without seeking permission or obtaining approval. The letter should describe the business activity and why the corporation considers it to be charitable or educational. The IRS might disagree and require that the corporation cease the activity or transfer it to a subsidiary, but is unlikely to revoke the corporation's exemption as long as it gave notice of the activity. The corporation can also demonstrate its good-faith belief that the activity is charitable or educational by obtaining an opinion concerning the activity from its legal counsel.

A ruling request is necessary if the activity is inconsistent with the requirements in the determination letter; in other circumstances it is optional. For the payment of a fee, the ruling request seeks IRS agreement that the activity will not jeopardize the corporation's tax-exempt status. IRS approval, however, will be limited to the facts presented in the request. If the business changes, the approval might not cover the changed activities.

Step Two: Determine Whether the Business is Related or Unrelated

A business is related to the corporation's charitable or educational purposes if it is conducted as a means to accomplish those purposes and not primarily to provide additional funds. Consider the nature and size of the business and whether it is conducted on a scale consistent with charitable, rather than profit-making, purposes. Look at the fees charged and whether goods or services are provided at less-than-cost to the poor, while charging more to those who can afford to pay more. Who is served by the business--the poor, the elderly, other members of a charitable class, other charitable

corporations--or the general public? Ask whether the business operates in a typical commercial manner in competition with other private businesses.

The following cases and IRS rulings illustrate the application of these principles.

In *Aid to Artisans, Inc. v. Commissioner*, 71 Tax Court 202 (1978), the nonprofit corporation purchased and sold handicrafts from disadvantaged craftspeople. Sales were made to museums and other nonprofit shops and agencies. In determining that this business was related to the corporation's charitable purposes, the court emphasized that (1) the business alleviated economic deficiencies in communities of disadvantaged artisans, and (2) the crafts educated the public in the artistry, history, and cultural significance of handicrafts from these communities. A similar conclusion was reached in *Industrial Aid for the Blind v. Commissioner*, 73 TC. 96 (1979), in which the corporation purchased products manufactured by blind individuals and sold them to various purchasers.

In both these cases, the corporation's business was to find a market for items produced by disadvantaged persons, so that those persons could better support themselves. Another case, *Rev. Rul. 75-472, 1975-2 Cum. Bull. 208*, concerned a nonprofit that directly employed disadvantaged persons in its business for the same reason, and the IRS concluded that the business furthered charitable purposes.

That business involved the production and sale of furniture made by residents of the corporation's halfway house for alcoholics. The house was operated for people who needed a temporary home after receiving short-term intensive care for alcoholism. The work at the furniture shop was transitional employment, not occupational training. It was meant to help the residents develop regular work habits and a sense of self-discipline and independence at a time when they were not able to cope emotionally with the pressures of the outside world.

The workers were not expected to continue working in the furniture shop beyond the time when they attained a reasonable degree of self-respect and reliability, and thus became able to secure regular employment elsewhere. Residents usually stayed from six to nine months.

Similarly, in *Rev. Rul. 73-128, 1973-1 Cum. Bull. 222*, the IRS determined that a business conducted for the primary purpose of providing skills training to the disadvantaged was operated for charitable purposes. In that instance,

the corporation was formed to provide job training to unskilled persons who were unable to find employment or could not advance from poorly paid employment due to inadequate education.

The corporation manufactured and commercially sold toy products by training and employing residents of an economically depressed community who were unemployed or underemployed. A few skilled persons were hired as managers and trainers; some of the management and administrative staff were unskilled trainees. The corporation tried to place its trainees in permanent positions in the community as soon as they were adequately trained.

This particular ruling stands in contrast to *Rev. Rul. 73-127, 1973-1 Cum. Bull. 221*, in which the IRS denied tax-exempt status to a corporation that operated a cut-rate grocery store in which a small portion (about four percent) of the earnings was allocated to provide on-the-job training to the hard-core unemployed.

The store sold food to residents of a poverty area at prices substantially lower than those charged by competing grocery stores. The store was operated by an experienced staff. Trainees were selected from the area, and, on completion of the training, were expected to seek employment elsewhere in the retail food industry.

Although the training program was charitable, the sale of food was not. And although the store was located in a poverty community, it was open to the general public. The size of the food store operation was larger than reasonably necessary to carry out the training program. The food sales, although at low prices, still produced a profit. Food was not distributed free to those who could not afford to pay, or below cost to those who could not afford to pay more.

Businesses related to charitable or educational purposes may, but need not, be conducted within the corporation, with no income tax on the net profits, if any. Businesses unrelated to these purposes but an insubstantial part of the corporation's overall activities may, but need not be conducted within the corporation; income tax must be paid on the net profits. The corporation jeopardizes its tax-exempt status if it conducts a substantial unrelated business. In order to carry out such a business, it should form a subsidiary.

The IRS and the courts have not defined "substantial." A common rule of thumb is that no more than 15 percent of the corporation's time and gross

revenues should be devoted to or be derived from the business. However, given the uncertainty of where the line will be drawn, and the risk of losing exempt status, most nonprofits decide to form a subsidiary for any unrelated business, no matter the size, at the time when it is certain that the business will become a regular ongoing activity.

Sometimes, a business that is related at its inception will change over time. A business intended as a job training site may decide to retain its trainees and make them permanent employees instead of bringing in a new round of trainees. Thus, it is important to regularly review the nature of the business and its relationship to charitable or educational purposes.

A common misconception is that related businesses are "good" and unrelated businesses are "bad." A corporation should not distort its business--add a particular component such as job training, for example--just to make it related. There is nothing wrong with starting an unrelated business, making profits, and paying income tax.

Step Three: Decide Whether to Form a Subsidiary

A nonprofit corporation should carefully consider both the advantages and the disadvantages of forming a subsidiary. For even if running a particular business might not jeopardize the corporation's tax-exempt status, there may be other reasons to form a subsidiary. Not all of them will apply to every situation, and not all should be given equal weight.

Liability

A subsidiary protects corporate assets from the debts of the business, such as payments owed to suppliers or lenders, or from lawsuits brought by customers or former employees. Similarly, the business is protected from the debts of the parent nonprofit corporation.

Liability protection can be lost if the corporation guarantees to pay certain debts of the subsidiary--by co-signing a loan, for example. The corporation would be liable up to the amount of its guarantee. Protection can also be lost if the corporation undercapitalized a for-profit subsidiary (provided it with insufficient capital to meet its ordinary business needs). Liability protection could also be lost if the corporation caused the subsidiary to transfer to the corporation so much money that the subsidiary was unable to meet its obligations.

The most common reason for loss of liability protection, however, is a failure to observe the corporate formalities required of two separate corporations. If a claimant can prove that the parent nonprofit corporation and its subsidiary are not two separate entities, the parent may be liable for claims brought against the subsidiary.

To maintain its separate legal status, the subsidiary must have its own board of directors with separate meetings and minutes; separate books, records, and financial accounts; and must use separate stationery. The subsidiary can contract with the parent corporation for staff, space, and other needs, and the parent corporation can lend money to the subsidiary, without loss of liability protection, as long as the transactions are reasonable and fair to both corporations at the time they are entered into.

Board overlap is possible. Generally, subsidiary board members should be chosen for their expertise, time availability, and sensitivity to the goals of the parent corporation and the subsidiary's business. But it is a good idea to have some subsidiary directors who are not also parent corporation directors, especially to approve contracts between the corporations.

The minutes of the two boards of directors should reflect that the subsidiary corporation board is the one that makes decisions concerning the day-to-day operations of the subsidiary and its business. The parent corporation can request reports and explanations as to the activities of the subsidiary and any deviance from its business plan, conditions imposed in a loan or other agreement between the corporations, or in meeting the goals established by the parent corporation for the business. The parent corporation can recommend that certain actions be taken or not be taken. However, it should not substitute itself for the subsidiary board and directly take those actions itself.

The parent corporation must be content with its indirect control over the subsidiary through its power to select the board, remove board members and fill vacancies, approve the bylaws and any amendments, and approve any action that would adversely affect its rights. It can also have its auditor perform the subsidiary's audit, and its attorney serve the subsidiary in a similar capacity.

Since all businesses involve some risk, it would be reasonable to conclude that a nonprofit corporation should always form a subsidiary to operate a business venture. However, the cost of a subsidiary, in terms of both money and time, can be significant. Instead of simply plowing ahead and forming a

subsidiary, the corporation should evaluate the risks associated with the business, determining which are insurable and which are not. It should then estimate the magnitude of the uninsured risk, and weigh that along with other relevant factors.

Board Capacity

Board members can never guarantee that a particular business venture will be successful. If it fails, generally they are not liable for the debts of the business or the loss of invested assets. However, to be protected, they must exercise reasonable care in managing the affairs of the business. Business decisions should be based on information which an ordinarily prudent person would consider. Directors can rely on the reports of experts, but they are not excused from making independent inquiries when reasonable and appropriate.

It may be that not all the nonprofit corporation's board members are comfortable with the time commitment and responsibility involved in managing a business. Perhaps they do not have the business expertise necessary to provide guidance to the venture.

To deal with those issues, the corporation could form a committee to oversee the business, add new members to its board, or request the resignation of certain board members. Alternatively, the corporation could form a subsidiary with its own specialized board chosen by the parent corporation.

Unlike the board of a nonprofit corporation with multiple projects, the subsidiary board could have more focused meetings and make more timely business decisions. It could attract knowledgeable people in the business community who would not have the time or inclination to serve on the parent corporation board.

Staff Capacity

The business might require a manager with specialized business skills and an entrepreneurial attitude that members of current staff lack. If an outsider must be hired to manage the business, it might be more attractive to offer a position as president of a new subsidiary rather than a position as program manager in a larger nonprofit corporation.

Rather than upset the existing corporate culture, it might be preferable to create a subsidiary. One reason is that to be competitive, the business venture might have to pay its staff more than the pay scale of the parent nonprofit would dictate. A subsidiary could develop incentive compensation

plans, such as profit-sharing and bonuses, more easily than can the parent charitable corporation can. Also, staff of a subsidiary will be more focused on making it succeed. Business staff in the nonprofit corporation might have to devote a portion of their time to non-business venture matters.

On the other hand, subsidiary staff might be hired sooner than needed; as an internal division, many business start-up activities can be effectively performed by existing nonprofit corporation staff. Also, separate subsidiary staff might feel alienated from the parent nonprofit corporation, and resent its control.

If a subsidiary is formed, usually some staff of the parent nonprofit corporation will devote a portion of their time to the subsidiary. It is better for staff to be employed by one corporation, rather than two, to avoid incurring extra employment taxes and bookkeeping expenses. Staff should be employed by the corporation which uses the greater percentage of their time. The other corporation should pay the full cost of purchasing the remaining time from the employing corporation.

Funding and Financing

A subsidiary corporation might be able to attract funds not available to the parent nonprofit corporation. Some funders prefer to fund a subsidiary devoted to a single business purpose. Accounting for the expenditure of their funds is easier, and it is clearer that their funds are being devoted to the business. Operating within a parent nonprofit corporation, a business venture's overhead costs may be buried within the overall costs of the corporation, or business revenues might be used to subsidize non-business overhead.

Some funding/financing sources, such as the Small Business Administration, are available only to for-profit corporations, while others are available to nonprofit corporations with specified and limited purposes. A subsidiary can meet these requirements.

Some funding/financing sources have limited experience with nonprofit corporations, and others have limited experience with for-profit corporations. For example, banks may not believe that a nonprofit corporation can operate a sound business venture. They understand and appreciate the for-profit corporation form.

Although a for-profit subsidiary often cannot directly receive foundation grants and some government grants, the parent nonprofit corporation

generally can receive the funds and then either loan them to or invest them in the subsidiary.

A for-profit subsidiary can also attract private investors, who contribute capital to the business in exchange for a portion of the ownership. Alternatively, the nonprofit parent corporation or a nonprofit subsidiary could form a joint venture (partnership) with investors. When it comes time to sell the business, it may be easier to sell a subsidiary than a portion of the nonprofit corporation.

Cost

In the short run, a subsidiary will incur incorporation expenses such as legal fees, government filing fees, and, if a for-profit subsidiary, securities law compliance fees. In the long run, the major added cost is the time necessary to maintain proper corporate separation, such as separate tax returns.

Community Image

A business operated within the nonprofit corporation might generate confusion of identity and purpose within its low-income community, and resentment of "unfair competition" within the business community. A subsidiary, particularly a for-profit subsidiary, might avoid these problems. On the other hand, community residents might not have the same positive feelings toward a for-profit subsidiary as they do towards the parent nonprofit corporation, which they know to be operating for the good of the community.

Lobbying and Other Restricted Activities

A charitable corporation is limited by federal tax law in the amount of lobbying it can undertake. A non-charitable subsidiary would not be subject to those limitations, although other limitations might apply. On the other hand, the amount of permissible lobbying by a charitable corporation increases as its revenues and activities increase. By engaging in the business without a subsidiary, the corporation thus increases the amount of its permissible lobbying.

Taxation

If the nonprofit corporation's business is unrelated to its charitable purposes, the first \$1,000 in profits is not taxed. In a for-profit subsidiary, the entire profit would be taxed. Passive unrelated income (capital gains, interest, dividends, royalties, and real property rents) received by the nonprofit corporation might not be taxed; in a for-profit subsidiary they would be.

Under some circumstances, business activities could jeopardize a nonprofit corporation's public charity status.

Public charities must receive a certain percentage of their income from "public" sources. There are two numerical tests. IRC Section 509(a)(1) requires public support at least equal to one-third of total support, but permits as low as ten percent under certain circumstances. Related business income is not counted as either public or total support, and unrelated business income is counted as non-public support. However, if the corporation receives most (approaching 90 percent) of its support from related business income, it is classified as an IRC Section 509(a)(2) corporation. This test requires at least one-third public support, and does not permit a lesser percentage. Related business income is included as public support, but only up to the larger of \$5,000 or one percent of total support from any one source. Unrelated business income is counted as non-public support.

Thus, a small nonprofit corporation with a substantial amount of related business income might not qualify for Section 509(a)(1) status, and might not meet the one-third public support test of Section 509(a)(2).

A subsidiary avoids this problem. Its income is not counted when determining whether the parent nonprofit corporation meets the public charity requirements. If its business activities are charitable, the subsidiary could qualify as a public charity under IRC Section 509(a)(3), a non-numerical test which requires that the subsidiary be organized for the benefit of, to perform the functions of, or to carry out the purposes of the parent nonprofit corporation.

Step Four: If You Decide to Form a Subsidiary Choose Its Legal Form

When the primary activity of the subsidiary is unrelated to charitable or educational purposes, it must be a for-profit corporation or nonprofit, taxable corporation. The nonprofit, taxable corporation is relatively rare, used only when a for-profit corporation would present a negative image or is prohibited by a funding source.

When the primary activity of the subsidiary is related to charitable or educational purposes, it can be a nonprofit, IRC Section 501(c)(3) tax-exempt corporation. However, if lobbying is intended as a substantial part of its activities, an IRC Section 501(c)(4) tax-exempt corporation should be considered.

A Section 501(c)(4) social welfare corporation can engage in substantial lobbying and can engage in certain business activities which would be unrelated if carried out by a Section 501 (c)(3) corporation. For example, a Section 501(c)(4) corporation can assist individuals who are not low-income, minority, or otherwise disadvantaged as long as the activity serves the common good and general welfare of the community, such as the making of loans to private businesses to induce them to locate in a depressed community. A Section 501(c)(4) corporation is not directly eligible for tax-deductible contributions and government or foundation grants, which must go through the parent nonprofit charitable corporation.

The primary advantage of a nonprofit, tax-exempt subsidiary over a for-profit or nonprofit, taxable corporation is its exemption from income tax and possibly from property, sales, or other taxes, licenses, and fees. The tax-exempt corporation does not pay tax on net income from businesses related to its exempt purposes. On the other hand, a for-profit or nonprofit, taxable corporation does pay tax on net income. It also pays tax on unrelated passive income; a tax-exempt subsidiary might not be taxed on this. For the nonprofit corporation's second and subsequent businesses, there are additional considerations as to legal structure. If the first business is unrelated and conducted within the nonprofit corporation, one advantage of conducting a second unrelated business within the same corporation is the ability to offset for tax purposes the profits from one business with the losses from the other. Of course, the other factors described above, such as liability, capacity, and funding source requirements, must also be considered.

If a subsidiary was formed for the first business, the second business could be carried out in the parent nonprofit corporation, in the same subsidiary, or in a new subsidiary. A new subsidiary can be controlled either by the parent nonprofit corporation or by the first subsidiary. In addition to the factors described above, some of the additional considerations are offsetting gains and losses, simplicity of structure, and the importance to the parent nonprofit corporation of direct rather than indirect control.

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