The Center for Association Leadership

Forming and Operating Subsidiaries and Related Entities: Maximizing the Benefits and Minimizing the Risks

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One of the most useful planning tools available to associations is the use of related entities to carry on activities. Whether it is to preserve tax exemption, generate revenue, limit legal liability, or for other legal, political or practical reasons, associations are increasingly establishing taxable subsidiaries and related foundations. Properly utilized, such affiliated entities can reap enormous benefits for the parent association. At the same, though, the legal terrain in which they operate is fraught with traps and pitfalls.

This article will discuss common reasons for establishing affiliated entities, describe guidelines for setting up and operating taxable subsidiaries and related foundations of associations, and provide practical tips for maximizing the returns and minimizing the risks in this complex legal terrain.

I. Reasons for Establishing Affiliated Entities

A. Exemption-Threatening Activities
It is not uncommon for an association to want to carry on an unrelated business activity that might threaten its tax exemption. If the gross revenue, net income, or staff time devoted to an unrelated business becomes "substantial" in relation to the tax-exempt function of an organization (thereby putting its tax-exempt status into jeopardy), the association can "spin off" the activity into a separate but related entity, commonly referred to as a taxable subsidiary. Such a taxable subsidiary will pay income tax on the net income from the activity, but can remit the after-tax profits to the parent (taxexempt organization) as dividends -- on a tax-free basis to the parent. This is a common practice in the trade and professional association community.

B. Providing Administrative and Marketing Services in Connection with Association Product/Service Endorsements
When associations endorse or lend their name to third-party products and services, the income they receive under such arrangements is only tax exempt to the extent it can be classified as a royalty (payment for the licensing of property such as an association's name and logo). However, if the income is in part a royalty and in part a payment for services (e.g., administrative or marketing services), then the IRS will treat all of the income as UBIT. Consequently, in order to ensure taxfree royalty treatment of their endorsement income, some associations do not conduct any services at all in connection with such endorsements, some "outsource" such services to unrelated third-parties, and others conduct such services through their taxable subsidiaries. In this latter option, the association enters into a contract with the vendor for the licensing of its name and logo, and the taxable subsidiary enters into a separate contract with the vendor for the provision of administrative and/or marketing services. The association's income is treated as tax-free royalty income; the taxable subsidiary pays tax on its income (the after-tax profits can then be transferred to the association in the form of tax-free dividends). Associations utilizing such a structure must be careful to ensure (i) that the income is divided between the association and the taxable subsidiary on a fair market basis; and (ii) that the arrangement is conducted on an arm's length basis (e.g., financial separation, employee time records, etc.).

C. Reducing Unrelated Business Taxable Income
In some cases, the IRS will only let a tax-exempt organization deduct the expenses of the unrelated part of an activity from the income of the unrelated part of an activity. For example, advertising income is considered unrelated business income ("UBI"). The IRS applies a complicated formula to determine what expenses of a not-for-profit's publication can be deducted against the advertising income to compute net taxable income from advertising. In many cases, the formula permits only advertising expenses (not other publication expenses) to be deducted from advertising income. This means that a publication as a whole could be losing money, but the tax-exempt organization could be paying substantial income tax on its advertising income, because the expenses which are directly related to the generation of the advertising income are nominal.

If the entire publishing activity is put in a separate taxable entity which is related to the tax-exempt organization, all expenses will be deductible from the total revenue generated by the publication to determine whether the publication is operating at a profit or loss. The very same revenue and expenses which can result in significant taxable income when an advertising activity is kept in a tax-exempt organization can result in little or no taxable income when the entire publishing activity is carried on in a taxable subsidiary.

D. Protection from Legal Liability
Sometimes new ventures can carry with them potential legal liability, especially if a product is being sold or other business activity is being undertaken. Common examples include legal claims for breach of contract (including debts), copyright or trademark infringement, defamation, and other tort (injury) claims. Carrying on the activity through a separate legal entity (e.g., taxable subsidiary) can protect the assets of the sponsoring tax-exempt entity from liability, even if the two entities

are related.

E. Receiving Tax-Deductible Contributions, Private Foundation and Government Grants, and Nonprofit Postal Permits
Only section 501(c)(3) organizations are eligible to receive voluntary contributions on a tax-deductible basis (charitable contributions). Other tax-exempt organizations, such as 501(c)(6) organizations, can receive dues or other payments which will be deductible to the payor only if they serve a business purpose of the payor. It is common, however, for organizations other than 501(c)(3) organizations to want to solicit voluntary contributions which would not serve a business purpose of the donor.

In addition, it is also common for organizations other than 501(c)(3) organizations to want to receive grants from private foundations. However, the only classification of tax-exempt organizations to which private foundations may make grants are 501(c)(3) organizations. Furthermore, many federal and state government grant programs limit grant eligibility to 501(c)(3) organizations.

Finally, in general, only 501(c)(3) organizations can qualify for nonprofit postal permits, enabling utilization of preferred nonprofit postal rates.

As such, many associations establish related 501(c)(3) organizations (often called "related foundations") to accept taxdeductible charitable contributions and private foundation grants, as well as to obtain a nonprofit postal permit. The funds raised by a 501(c)(3) organization must be used for charitable, educational or scientific purposes, but, very often, the sponsoring entity is already carrying on significant charitable, educational or scientific activities which can be housed in the 501(c)(3) organization.

F. Lobbying

1. **Limits for 501(c)(3) Organizations**
   Section 501(c)(3) organizations can engage in lobbying only within narrow boundaries, governed by either the "substantial part" test or specific numerical limits (calculated as a percentage of total exempt-function expenditures) for organizations that make the "501(h) election." The penalties for stepping over the boundaries are quite severe -- loss of tax exemption for violation of the former, and significant financial penalties and potential eventual loss of tax exemption for violation of the latter.

   For this reason, many 501(c)(3) organizations set up related entities (often as 501(c)(4) organizations) which separately solicit donations for and conduct lobbying activities. The funds of a 501(c)(3) cannot flow to this separate entity, but the organizations can be affiliated. The other tax-exempt entity can solicit and use its own funds to lobby on issues which are of interest to the related 501(c)(3) organization.

2. **Lobbying Tax Law Considerations**
   Under the Omnibus Budget Reconciliation Act of 1993, a business tax deduction may not be claimed for dues paid to trade and professional associations to the extent of the association's expenditures for lobbying activities. The provisions, commonly referred to as the Lobbying Tax Law, also provide associations with an alternative of paying a flat 35 percent proxy tax on the association's lobbying expenses (in lieu of disallowing members' business tax deductions). The proxy tax is (generally) automatically assessed on any lobbying expenses not "passed through" to association members via the nondeductibility of their membership dues. The Lobbying Tax Law (i.e., the special provisions for tax-exempt entities) only applies to 501(c)(4) social welfare organizations, 501(c)(5) agricultural and horticultural organizations, and all 501(c)(6) organizations; all other classifications of tax-exempt organizations are not covered by the Law.

   While Department of Treasury regulations contain a broad "anti-avoidance" rule to prevent circumvention of the Lobbying Tax Law, certain restructuring is permissible. For example, if an association had one class of members which would benefit from a proposed multi-year lobbying campaign, but its other major class of members had no interest in, and would not benefit from, such lobbying, the association might establish an affiliated 501(c)(6) organization to fund and conduct the special lobbying campaign. Under this arrangement, a portion of the dues paid by the benefitting members could be allocated to the new affiliated entity (or a new special assessment imposed), thereby ensuring that such members alone would bear the increased tax burdens resulting from the increased lobbying activity. This would also have the benefit of ensuring that the non-benefitting members would not be funding the new lobbying activities.

3. **Special Rule for 501(c)(4) Organizations**
   The Lobbying Disclosure Act of 1995 contained a provision, commonly referred to as the Simpson Amendment, which prevents section 501(c)(4) organizations that lobby Congress from receiving federal grants. However, the Conference Report which accompanied the law specifies that 501(c)(4) organizations may form affiliated organizations (even "sister" 501(c)(4) organizations) in which to carry on their lobbying activities with non-federal funds. Such a structure would allow one 501(c)(4) to receive federal grants, while the affiliated entity conducts the lobbying activities.

   Consequently, many 501(c)(4) organizations which, until this year, were both receiving federal grants and lobbying Congress, are establishing affiliated tax-exempt organizations to conduct their lobbying activities (with non-federal funds).

G. Use for Chapters or Regional Divisions
Many organizations cannot or do not want to control the finances and activities of regional divisions or chapters. If the divisions or chapters are established as

separate legal entities, the national organization can shield itself from tax and other liabilities. If the chapters or divisions of a national organization are all part of the same legal entity, then the national organization is responsible for reporting all income and expenses on its annual Form 990 and paying tax on any unrelated business taxable income ("UBTI"). In addition, lawsuits against a chapter would automatically jeopardize the assets of the national organization if they are part of the same legal structure.

If the chapters or divisions are established as separate legal entities, such chapters or divisions are responsible for their own IRS filings, for paying their own tax on any UBTI, and lawsuits against them would not automatically jeopardize the assets of the national organization.

H. Non-Legal or Tax Reasons
There are numerous non-legal or tax reasons for establishing affiliated entities. One such reason may arise when an association wishes to sponsor an activity that requires a degree of real (as well as perceived) independence from the association in order to be credible and effective. The use of a separate but related entity can permit the sponsoring organization to take a "step back" from the new activity, providing the association with the desired independence without relinquishing complete control.

For example, many associations establish affiliated entities to house certification or accreditation programs. They want the certification or accreditation program to appear, and to be, independent from the parent association, to give it greater credibility in the eyes of the public. In addition, as such programs are often fraught with potential legal liabilities, this structure can insulate the assets of the sponsoring organization from the legal risks posed by the certification or accreditation activities.

II. Taxable Subsidiaries

A. Establishment

1. To establish a taxable subsidiary:

   1. Articles of incorporation are filed with a state government.
   2. If the subsidiary's principal place of business will be located in a state different than the state of incorporation, then a certificate of qualification to transact business in the other state is obtained from that state's government.
   3. A federal tax identification number ("EIN") is obtained from the IRS.
   4. Bylaws are created and approved by the subsidiary's board of directors.
   5. A corporate record book and corporate seal are obtained.

Certain of these filings are subject to filing fees. The subsidiary must file annual reports with the state in which it is incorporated, as well as with any state(s) in which it has qualified to transact business. Furthermore, the subsidiary must file annual federal and state tax returns and pay annual federal and state taxes, like all other taxable corporate entities, to the extent that it generates taxable income.

2. The tax-exempt parent may capitalize the subsidiary through a transfer of cash and assets to the subsidiary in exchange for subsidiary stock which is issued. Ordinarily, the tax-exempt parent would own most or all of the stock that will be issued by the subsidiary, and can receive tax-free dividends on this stock from the subsidiary.

3. A separate bank account, separate financial books and records, separate business stationery, etc., must be established for the subsidiary, and strict financial and operational separation must be maintained (e.g., no commingling of assets, no subsidiary correspondence written on parent letterhead stationery).

4. The board of directors of the subsidiary should be appointed by the parent; the subsidiary's officers are then appointed by the subsidiary's board. The directors and officers of the subsidiary should be somewhat different from those of the parent. An initial meeting of the subsidiary's board of directors, separate from a meeting of the parent's board, must be held, and separate minutes must be recorded (although the subsidiary's board can meet on the same date and at the same place as the parent's board, with one meeting immediately following the other).

5. The subsidiary can have its own employees (as long as withholding and other employer obligations are met) or the parent's staff can work on subsidiary matters (with their services essentially "leased" to the subsidiary). In the latter scenario, which is generally recommended (at least initially), the subsidiary must reimburse the parent — at the parent's cost — for the staff time (including salary and benefits) that the parent provides.

6. The subsidiary can be housed in the parent's existing offices, provided that the subsidiary reimburses the parent — at the parent's cost — for its allocable share of rent, office equipment and supplies, utilities, etc.

7. The parent and the subsidiary should enter into an arm's length written agreement covering all aspects of the shared facilities, equipment, supplies, services and employees.

8. If necessary, the parent's articles of incorporation and/or bylaws should be amended to permit business endeavors or the establishment of a taxable subsidiary by the parent.

9. A business plan, including attention to the details of financial and legal separation between the parent and the subsidiary, should be drafted and approved by the parent's board of directors.

10. The name of the subsidiary may incorporate the parent's name, but this is not a legal requirement. If the parent's name is incorporated into the subsidiary, the terms of such a trademark license should be part of the written agreement discussed above. Although it is not required, the subsidiary may pay the parent -- on a regular basis and at fair market value -a royalty for the right to use the parent's name (and logo, if desired).

At this point, the subsidiary will be a separate, taxable corporate entity, distinct from the parent. It can own property, sue or be sued, be taxed, etc. Obligations incurred by the subsidiary will not become the responsibility of the shareholders (i.e., the parent) in the event of a default on those obligations by the subsidiary unless 1) the obligations are guaranteed by the parent, or 2) a court "pierces the corporate veil" between the parent and the subsidiary, finding that they are not separate and distinct entities, but that the subsidiary is a "mere instrumentality" of the parent. The latter will generally not occur if the entities maintain the strict financial, management and operational separation discussed above.

B. Operation

A tax-exempt organization may form, own and receive dividends from a taxable subsidiary that operates a commercial business(es), so long as the taxable subsidiary operates separately and apart from the tax-exempt organization and the taxexempt organization continues to engage in its tax-exempt activities. The separate existence of the subsidiary will not be disregarded for tax purposes where it is organized with the bona fide intention of performing some real and substantial business function. The separate corporate form of the subsidiary will be ignored only where the parent corporation controls the affairs of the subsidiary so pervasively that the subsidiary becomes a "mere instrumentality" of the parent. A subsidiary will be deemed the alter ego of its parent only where "the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent."

IRS rulings in this area also indicate that no one factor determines whether a subsidiary will be respected as a separate entity. Instead, the IRS will consider several different factors and reach a conclusion based on their significance takentogether. These include whether a valid business purpose exists for forming the taxable subsidiary; whether the parent is involved in the day-to-day management of the subsidiary's affairs; the extent to which the two entities share directors, officers and/or employees; and the extent to which the two entities share facilities and services. Each of these factors is discussed below.

1. **Business Purpose:** A tax-exempt organization can easily establish a legitimate business purpose for forming a taxable subsidiary. A tax-exempt organization's incorporation of a taxable subsidiary has been regarded by the IRS as valid whenever the purpose was to: isolate unrelated business activities in order to safeguard the parent's tax-exempt status; limit liability; generate funds to support the parent's tax-exempt activities; or facilitate the management of, and separate accounting for, activities unrelated to the parent's tax-exempt purposes.

2. **General Relationship:** Most IRS rulings indicate that, in order for the taxable subsidiary to be treated as a separate entity, the tax-exempt parent organization must not be involved in the day-to-day management of the subsidiary. However, the IRS does permit the parent to establish long-range plans and policies for the subsidiary without jeopardizing the parent's tax-exempt status. In addition, as noted below, the parent may provide substantial support to the subsidiary through the sharing of employees and facilities. However, the distinct separate corporate identity of the subsidiary should be made clear to third parties through, for example, the use of separate business stationery and by the subsidiary entering into contracts in its own name (not that of the parent), and signed by one of its own officers, as an officer of the subsidiary.

3. **Common Directors:** Ideally, the board of directors of the taxable subsidiary should consist, as much as possible, of persons who are not directors or officers of the parent, even though the parent would elect all of the board because of its (generally) 100 percent voting stock ownership. The fact that all, a majority, or even a substantial minority of a subsidiary's board are not directors, officers or employees of its parent is often cited as a positive factor in IRS rulings holding that the subsidiary's activities are not attributable to the parent. Thus, for example, the parent could elect representatives of parent member companies that do not currently sit on the parent's board to fill some of the seats of the subsidiary's board. Further, some overlap is clearly permissible, such as giving the current Chairman of the Board and President of the parent seats on the subsidiary's board.

Indeed, under certain circumstances, it is permissible to have substantial overlap between parent and subsidiary directors. Even if most or all of the subsidiary's directors were directors or officers of the parent, the parent's tax exemption would not be jeopardized so long as other factors indicated that the parent was not involved in the day-to-day management of the subsidiary and dealt with the subsidiary at arm's length.

In any event, the parent's board should limit its discussion of the subsidiary to policy (as opposed to management) issues, and the parent's and the subsidiary's boards should hold separate meetings and record separate minutes (although the meetings can be held on the same date and at the same place, with one immediately following the other).

4. **Shared Officers and Employees:** A more substantial problem would arise if officers of the parent were also officers of the subsidiary. In that scenario, it is more likely that the subsidiary's activities would be attributed to the parent because the overlap between officers tends to show that the parent is managing the subsidiary on a daily basis (since officers, as opposed to directors, are generally more involved in the day-to-day management of a corporation). However, where a majority of the subsidiary's board consists of "outside" directors (i.e., directors other than officers of the subsidiary), overlap of officers between the parent and the subsidiary has been permitted. In addition, as a practical matter, there is a tradeoff between having common directors and common officers; the less the overlap in one category, the more the overlap may be in the other.

Because business expenses deductions -- including deductions for salaries -- are more valuable to a taxable entity than to a tax-exempt organization, there is an incentive for more of the compensation of not-for-profit executives to be "paid by" the taxable entity and less by the tax-exempt group. But as such compensation shifting is subject to reallocation by the IRS to accurately reflect the income of the organizations involved and to prevent evasion of tax, if there is overlap between paid officers, for example, care should be taken to ensure that compensation received by the parent's officers for services to the parent is paid solely by the parent, and vice-versa.

In addition, compensation from related organizations must be reported on the Form 990 when the total compensation paid by related organizations to the executive exceeds $10,000. A related organization is any entity that owns or controls, or is owned or controlled (directly or indirectly), by the filing organization, or that supports or is supported by the filing organization. A 50 percent test is used for ownership or control. In determining "control," the rules look at commonality of officers, directors, trustees, and key employees, as well as the power to appoint such.

In contrast to overlapping officers and directors, sharing of employees between the parent and the subsidiary is less of a problem. In a number of situations, the IRS has ruled favorably where the subsidiary contracted with the parent to "lease" all or some of the parent's employees to the subsidiary for particular services. Charges for any such contract employees must be at arm's length, for example, based on reimbursement of the allocable share of their actual salaries and benefits. This type of reimbursement arrangement generally results in lower payroll taxes than having each employee employed part-time by two separate employers.

It is critical for shared employees to keep detailed, contemporaneous time records of their work for each corporation to substantiate the allocation of costs. If possible, shared employees should be paid at the identical rate when working for the parent or the subsidiary. This would negate any perception that one entity was subsidizing the other, thus demonstrating the absence of an arm's length relationship. Parent and subsidiary employees may participate in the same health and benefits plans if the costs borne by each corporation are proportionate to the respective time worked for each corporation.

5. **Shared Facilities and Services:** The parent and subsidiary may share office space, equipment, supplies and facilities so long as reimbursement is calculated

on an arm's length basis. For example, the parent may sublease office space to the subsidiary at its cost (i.e., pass-through of a pro-rata share of the parent's actual lease payments). A requirement in the sublease agreement that the subsidiary insure its portion of the premises against risk of loss or damage would be a positive factor in demonstrating an arm's length relationship.

The parent may also share equipment, telephones and supplies with the subsidiary, so long as the costs are allocated fairly and accurately, based on actual usage. Additionally, the parent may provide administrative, data processing, or other nonmanagement services to the subsidiary so long as the fees charged for such services are based on their fair market value.

The parent and the subsidiary should enter into an arm's length written agreement covering all aspects of the shared facilities, equipment, supplies, services and employees. The agreement should, of course, be followed in practice. It is critical that strict financial separation be maintained (i.e., separate financial books and records, separate bank accounts, separate tax returns, and avoidance of any commingling of assets).

If, in the future, the subsidiary's activities grow to the stage where the subsidiary would require significant use of one or more parent employees, it is generally recommended that one or more individuals be made employees of the subsidiary, not the parent. This would help to minimize any risk of jeopardizing the parent's tax-exempt status.

C. Taxation of Payments from Subsidiary to Parent

The discussion above concerned the organizational and operational rules that a parent and its subsidiary must follow to protect the parent's tax-exempt status. The discussion below now turns to the question of whether funds or assets received by the parent from the subsidiary would be characterized as unrelated business income which would be subject to tax, even though the parent would retain its tax exemption for its other activities.

As stated above, a tax-exempt organization may engage in incidental business activities unrelated to the purposes for which it was granted tax exemption; however, the net income derived from such activities may be subject to tax. The net unrelated income is taxable if the activities constitute a trade or business that are conducted on a regular basis and are not substantially related to the performance (i.e., do not contribute importantly to the accomplishment) of the organization's taxexempt purposes. Finally, regardless of whether an activity is substantially related to tax-exempt purposes, certain types of "passive" income are generally excluded from UBI, including dividends, interest, annuities, royalties, and certain rents.

However, the otherwise-applicable passive income exclusion is unavailable when interest, annuities, royalties, and certain rents are received by a tax-exempt organization from a "controlled" subsidiary. As amended by the Taxpayer Relief Act of 1997, IRC section 512(b)(13) provides that although such interest, annuities, royalties, and certain rents are generally excluded from UBI, that exclusion will not apply and such payments from the subsidiary to the parent tax-exempt organization will be taxable as UBI: 1) when the tax-exempt parent owns more than 50 percent, directly or indirectly, of the voting power or value of the subsidiary's stock; and 2) to the extent that the payments reduce the net unrelated income, or increase the net loss, of the subsidiary. This special rule does not apply to dividend distributions from the subsidiary to the tax-exempt parent.

Applying these rules to the common example of a 501(c)(6) trade or professional association which establishes a taxable subsidiary, it is useful to identify the various forms of potential payments from the subsidiary to the parent. As noted above, with regard to dividends paid by the subsidiary to the parent, because section 512(b)(13) does not apply to dividend distributions, and because dividends are excluded from UBI as passive income, dividends paid by the subsidiary can be received tax-free by the parent.

With regard to payments by the subsidiary to the parent for administrative services and the "leasing" of employees, such payments would not qualify as excludable passive income, nor would they qualify as payments for services that are substantially related to the performance of the parent's taxexempt purposes. As such, such payments would be UBI to the parent. However, all such income received by the parent could be offset through the allocation of corresponding costs (deductions reflecting the parent's actual expenditures), resulting in no UBIT liability for the parent.

With regard to payments by the subsidiary to the parent for rent for shared office space and equipment, while rents for such property are often excludable from UBI as passive income, because of the application of section 512(b)(13), if the parent maintained more than 50 percent "control" of the subsidiary, such rents would be UBI to the parent. However, as explained above (with regard to payments for services and staff), the rents from the subsidiary for shared office space and equipment can be "netted" against the actual cost of that office space and equipment to the parent, resulting in no