



Legal Structure Issues in the Development of Business Ventures

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This paper provides a general overview of its subject matter, and is not intended as legal advice. For legal assistance, the reader is advised to consult an attorney licensed to practice law in the reader's home state.

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HELPING PEOPLE AND COMMUNITIES BECOME, AND REMAIN, ECONOMICALLY SECURE

Background

A concern common to many nonprofit corporations is the desire to understand the tax, corporate, and other considerations in the legal structuring of their business ventures. Under what circumstances can and should a nonprofit, tax-exempt corporation carry out a business venture internally? When is it appropriate to form a for-profit or a nonprofit subsidiary? If a subsidiary is formed, what is the relationship between the parent corporation and the subsidiary? If private parties are involved in the venture, how should the relationship with the nonprofit, tax-exempt corporation be structured? This paper addresses these and similar questions.

Definitions

Certain terms will be used throughout this paper, such as “nonprofit” and “tax-exempt”. It may be helpful to begin with definitions for these terms.

Nonprofit Corporation

A nonprofit corporation has the attributes of a for-profit corporation (separate legal existence, limited liability for its members and directors, centralized management, perpetual life, etc.), but, although it can earn profits, it cannot distribute those profits to private persons. A nonprofit corporation is formed by filing articles of incorporation with a state agency, typically the secretary of state. Obtaining an income tax exemption is a separate process requiring application to the federal Internal Revenue Service (IRS) and the corresponding state tax agency, if required.

Tax-Exempt

There are many types of income tax exemption in Internal Revenue Code (IRC) Section 501(c). An organization with any of these exemptions does not pay income tax on earned and investment income, except net income from activities unrelated to its exempt purposes, or investment income from assets acquired with borrowed funds.

IRC Section 501(c)(3) Tax-Exempt

IRC Section 501(c)(3) tax-exempt (generally charitable and/or educational) organizations qualify for charitable tax-deductible contributions from individuals or others. Many grants from government, foundations, and corporations are limited to Section 501(c)(3) organizations. Section 501(c)(3) organizations can purchase property at less than fair market value in a transaction in which the seller receives a tax deduction for the difference between the value and the sales price (bargain sale).

Section 501(c)(3) organizations are also exempt from federal unemployment tax, are typically exempt from local business license tax, may be exempt from state property tax, and are rarely exempt from state sales and use tax. They are not exempt from FICA or state unemployment tax, although in some states they can opt out of the state unemployment system and self-insure alone or through a pool of Section 501(c)(3) organizations.

In exchange for these benefits, Section 501(c)(3) organizations must engage only in activities that are related to and further their exempt purposes, except for an insubstantial amount of unrelated activities. Their lobbying activity is limited, and they are prohibited from engaging in political activity on behalf of or

in opposition to any candidate for public office. On dissolution, after payment of debts, their assets must be distributed to another Section 501(c)(3) organization.

Section 501(c)(3) organizations hold their assets in public trust, and are typically regulated by the state attorney general's office. They cannot unduly benefit private parties, either by paying excessive salaries or making unreasonable payments, by purchasing property at more than fair market value, by paying dividends, or by otherwise allowing their earnings or assets to be used by private parties for private gain without reasonable compensation to the organization.

In furthering their exempt purposes, Section 501(c)(3) organizations can incidentally benefit private parties, and private parties can be the instrumentality through which the organization accomplishes its exempt purposes. For example, an organization can distribute its funds to private parties, provided that the organization retains control and discretion over the use of the funds, and receives and monitors reports on the use of the funds for tax-exempt purposes. Rev. Rul. 68-489, 1968-2 Cum. Bull. 210 (1968).

Charitable and Educational Purposes

To qualify for Section 501(c)(3) tax-exempt status as a charitable or educational organization, an organization must be operated for one or more of the following purposes:

Relief of the poor, distressed, or underprivileged (a "charitable class" of low-income, minority, elderly, disabled, other 501(c)(3) organizations, or similarly situated persons.)

The IRS does not apply a uniform definition of "poor", but often refers to definitions used by other federal agencies. Some non-needy individuals may benefit from activities whose primary purpose is to aid the needy, as long as this is incidental to accomplishing the charitable purpose.

Examples:

1. Helping the needy secure employment or self-employment, such as through vocational training or pre/post employment counseling and referral, financial and technical assistance to businesses owned either by the needy or by others who employ the needy, or by establishing a market for the products of their businesses. Rev. Rul. 76-37, 1976-1 Cum. Bull. 148 (1976); Rev. Rul. 66-257, 1966-2 Cum. Bull. 212 (1966); Rev. Rul. 74-587, 1974-2 Cum. Bull. 162 (1974); Rev. Rul. 68-167, 1968-1 Cum. Bull. 255 (1968).
2. Helping the needy secure other necessities of life, such as through the provision of housing, health care, food, transportation, child care, or legal services. Example: Rev. Rul. 78-428, 1978-2 Cum. Bull. 177 (1978).

Promotion of social welfare by lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights, and combating community deterioration and juvenile delinquency.

These categories overlap with each other and sometimes with assistance to the poor, although the poor need not be the primary beneficiaries of this assistance. The entire community benefits when assistance is provided to minorities, women, immigrants, or other persons denied equal treatment because of race, gender, citizenship, or other protected status. Under this purpose, an organization can attack the physical, economic, and social causes of community deterioration, but not all improvement activity qualifies.

Examples:

1. Purchasing and renovating deteriorating residences and selling or renting to needy families at affordable rates. Rev. Proc. 96-32, 1996-1 Cum. Bull. 717 (1996).
2. Lending to businesses willing to locate in a blighted community but unable to obtain conventional financing because of the risks associated with the location. Rev. Rul. 74-587, 1974-2 Cum. Bull. 162 (1974).

Developing commercial or industrial space in the community and renting to businesses that agree to train and employ unemployed area residents. Rev. Rul. 76-419, 1976-2 Cum. Bull. 146 (1976).

Lessening the burdens of government.

It is not enough that an activity is sometimes done by government or is funded by government. This purpose requires an objective manifestation that government considers the activity to be its burden, and ordinarily supplies the community with this facility or service at government expense.

Examples:

1. Developing a community land use analysis and plan. Rev. Rul. 67-391, 1967-2 Cum. Bull. 190 (1967).
2. Providing or maintaining recreational facilities and public parks, and providing public parking. Rev. Rul. 78-85, 1978-1 Cum. Bull. 150; *Monterey Public Parking Corporation v. United States*, 481 F.2d 175 (9th Cir. 1973).
3. Providing recycling services. Rev. Rul. 72-560, 1972-2 Cum. Bull. 248 (1972).

Promotion of health.

Advancement of education, such as through instruction or training to improve or develop individual capabilities, or instruction on subjects useful to the individual and beneficial to the community.

Business Activity (as distinguished from fundraising or investment)

Although charitable and educational purposes are often pursued under grants at no/low charge to beneficiaries, certain earned revenue (business) activities can be carried out in a manner that furthers tax-exempt purposes. A business is defined as an income-generating activity that is regularly carried on. While an organization might regularly engage in fundraising, each fundraising activity is typically performed on an irregular basis (such as an annual dinner), and is thus not a business.

Specific provisions of the IRC also exclude certain activities that might appear to be businesses, but are carried out in a non-commercial manner. The sale of donated goods (thrift stores) and activities conducted primarily by volunteers are not treated as businesses, nor are sales for the convenience of employees (for example, vending machines) and bingo and certain other gaming activities.

Section 501(c)(3) organizations may also invest their funds for the sole purpose of generating income. Specific provisions of the IRC exclude from income tax the passive investment income of tax-exempt organizations, including interest (such as from bank accounts), dividends (such as from corporate stock

ownership), royalties (such as from the licensing of an organization's copyrighted works), capital gains from the sale of assets, and real estate rental income. IRC Section 512(b). However, investment income from assets acquired with borrowed funds is subject to income tax. IRC Sections 512(b)(4) and 514.

For example, a federal court held that the proceeds of timber cutting contracts to a Section 501(c)(3) organization were not taxable unrelated business income because the organization was not engaging in the timber business. The organization was merely an owner of timberland that it held for investment purposes. The organization negotiated a cutting contract with a private lumber company and received a basic minimum payment plus a percentage of the profits realized. *Louis W. and Maud Hill Family Foundation v. United States*, 347 F.Supp. 1225 (D.C. Minn. 1972).

In addition, the organization must comply with state laws on prudent investment by holders of assets in public trust. Prudent investment standards include appropriate diversification of investments and avoidance of speculation and undue risk to principal while seeking income. Assets used in the performance of an organization's charitable and educational programs are not subject to these investment standards. Thus, high-risk loans to start-up businesses may be made in furtherance of charitable purposes, even though such loans are not prudent investments.

Business Activities by Section 501(c)(3) Organizations

Overview

A nonprofit corporation, exempt from federal income tax under Internal Revenue Code (IRC) Section 501(c)(3), may engage in business venture activities either directly or through a controlled subsidiary corporation. A business that is or will become a substantial activity must be related to the corporation's exempt (charitable or educational) purposes, that is, the business must be conducted as a means to achieve a charitable or educational purpose. "Substantial" is typically defined as exceeding approximately 15% 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, if any, from related businesses are not taxed. Profits from unrelated businesses are taxed at normal corporate income tax rates.

The income tax ramifications of undertaking a certain business within the corporation are but one factor to be analyzed. Even though the corporation need not form a subsidiary to conduct the business, it may find it desirable to do so. A number of factors, such as liability and financing, often must be considered. No subsidiary should be formed unless a clear, well thought-out reason exists.

Decisions concerning corporate structure need to be reviewed as new circumstances arise and as the corporation and its business develop. Although it may be appropriate to initially undertake a business within the corporation, 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 are maintained.

These issues are discussed below in greater detail, but still in general terms. The advice of an attorney should be sought during the planning for a new business. The attorney can conduct board training on organizational structure options in light of the specific business.

Too often, due to lack of this kind of information, nonprofit corporations self-impose constraints which the law does not impose. Understand that the legal structure issues discussed here are not roadblocks. They should be seen 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 the 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 have a general catch-all that permits the corporation to engage in any activities that further its charitable or educational purposes, and an insubstantial amount of activities that are 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), or, if not filing, within 4 1/2 months after 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. Also, review them 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, and is optional in other circumstances. For the payment of a fee, the ruling request seeks IRS agreement that the activity will not jeopardize the corporation's tax-exempt status. However, IRS approval 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

How to determine

A business is related to the corporation's charitable or educational purposes if 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. Look at who is served by the business -- the poor, other charitable corporations, the elderly, or other members of a charitable class -- or the general public. Ask whether the business operates in a typical commercial manner in competition with other private businesses.

Examples

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

The IRS ruled that it is charitable to lend or invest funds in businesses unable to obtain funds from conventional commercial sources because of the risk involved. The organization gave preference to businesses that offered the greatest potential community benefit, such as businesses that provided training and employment opportunities for unemployed or underemployed area residents. When appropriate, the organization provided technical assistance and counseling to the business. The organization disposed of its interest as soon as the success of the business was reasonably assured. The IRS stated that the businesses were merely the instruments by which charitable purposes are accomplished. Rev. Rul. 74-587, 1974-2 Cum. Bull. 162 (1974).

The IRS ruled that it is charitable to encourage businesses to locate in an economically depressed area in order to provide employment opportunities for the area's low-income residents. The organization purchased blighted land and converted it to an industrial park. Tenants were required by their leases to hire a significant number of unemployed area residents and to train them in needed skills. Businesses that required low-skill workers were favored over those with high-skill job requirements. Rev. Rul. 76-419, 1976-2 Cum. Bull. 146 (1976).

The Tax Court held that it is charitable to operate an experimental model farm to conduct research projects designed to demonstrate that marginal land should be held as conservation land, and ecologically sound techniques can restore land to productive use. The organization kept the public informed of the results of its research. To encourage conservation, the organization had to demonstrate the economic viability of techniques that conserve and protect the environment. Thus, the organization grew produce and timber on its land, and sold them in the usual markets, with the proceeds used to cover operating costs and to make the results available to the public. The organization worked with government agencies and academic institutions in planning its research. The organization did not plant traditional cash crops. Instead, it planted and harvested promising new strains. The organization limited its activities to those that preserved the ecology and maintained local wildlife. *Dumaine Farms v. Commissioner of Internal Revenue*, 73 T.C. 650 (1980).

Similarly, the IRS ruled that an organization formed for the purpose of preserving the natural environment by acquiring ecologically significant undeveloped land, and either maintaining the land or transferring it to a government conservation agency, is engaged in charitable activity, Rev. Rul. 76-204, 1976-1 Cum. Bull. 152 (1976), but an organization that restricts its farmland to ecologically suitable uses, but is not operated for the purpose of preserving ecologically significant land, is not engaged in charitable activity. Rev. Rul. 78-384, 1978-2 Cum. Bull. 174 (1978).

The IRS ruled that it is charitable to sell collected solid waste such as newspapers to commercial companies for recycling. The organization was formed to educate the public concerning environmental deterioration due to solid waste pollution, and the advantages of recycling. It sponsored workshops, conferences, and exhibits. The IRS determined that the recycling of waste materials was an essential element of the organization's efforts to combat environmental deterioration, and that the sales were merely incidental to the accomplishment of the organization's exempt purposes. Rev. Rul. 72-560, 1972-2 Cum. Bull. 248 (1972).

In *Aid to Artisans, Inc. v. Commissioner*, 71 T. C. 202 (1978), the 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 Tax Court emphasized (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 T.C. 96 (1979), in which the corporation purchased products manufactured by blind individuals and sold them to various purchasers.

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

The 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 outside pressures of the everyday 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 (1973), the IRS determined that a business conducted for the primary purpose of providing skills training to the disadvantaged was operated for charitable purposes. In the ruling, the corporation was formed to provide job training to non-skilled 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 under-employed. 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 ruling stands in contrast to Rev. Rul. 73-127, 1973-1 Cum. Bull. 221 (1973), in which the IRS denied tax-exempt status to a corporation that operated a cut-price 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. 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 at below cost to those who could not afford to pay more. Although the store was located in a poverty community, it was open to the general public.

Similarly, a federal court held that a store employing and training the elderly was not operated for charitable purposes. The organization, controlled by one family, sold items repaired by its elderly employees. Training was only for the employees and was restricted to the needs of the business. The elderly did not receive a discount on purchases and items were rarely given to the needy. The operation of the store was not distinguishable from that of typical family-operated businesses. *Senior Citizens Stores, Inc. v. United States*, 602 F.2d 711 (5th Cir. 1979).

Also, a federal court held that a pharmacy providing services to the general public and discounts to the elderly and disabled, but no free or below-cost services to the needy, was operated primarily for commercial purposes in competition with other pharmacies. *Federation Pharmacy Services v. United States*, 80-2 USTC ¶ 9553 (8th Cir. 1980).

The Tax Court held that it is not charitable to provide consulting services at cost to nonprofit organizations. The organization's activities were found to be commercial, not charitable, and in competition with commercial enterprises. *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978). The IRS issued a similar ruling, finding that the provision of managerial and consulting services at cost to tax-exempt organizations lacked the donative element necessary to be considered charitable. Rev. Rul. 72-369, 1972-2 Cum. Bull. 245 (1972).

The IRS ruled that it is not charitable to engage in promotional activities that seek to increase business patronage in a deteriorated area, or to develop a shopping center to reverse the economic decline of a community by reviving business patronage, unless assistance is limited to businesses owned by disadvantaged persons and experiencing difficulty because of this location, or businesses that agree to provide employment opportunities to unemployed and under-employed persons in the area. Rev. Rul. 77-111, 1977-1 Cum. Bull. 144 (1977).

Consequences

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. It should form a subsidiary to carry out such a business.

The IRS and the courts have not defined "substantial." A common rule of thumb is that no more than 15% 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 loss of exempt status, most corporations 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 will be related at its inception, but 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 business and the decision that it is related to charitable or educational purposes.

A common misperception is that related businesses are "good" and unrelated businesses are "bad." The corporation should not distort its business with job training to make it related. There is nothing wrong with starting an unrelated business, making profits, and paying income tax.

Comparison to commercial real estate development

Certain commercial real estate activities can further charitable purposes. A Section 501(c)(3) organization can develop office space for its own use or for rental to other Section 501(c)(3) organizations, as long as it charges them the lowest rent necessary to cover the costs of ownership. Rev. Rul. 69-572, 1969-2 Cum. Bull. 119 (1969). A Section 501(c)(3) organization can also rent space to businesses owned by disadvantaged persons, especially in economically depressed areas, when these businesses would have difficulty finding other suitable space in the area. Rev. Rul. 74-587, 1974-2 Cum. Bull. 162 (1974). Numerous Section 501(c)(3) organizations have developed business incubators in which low-cost space rental to start-up businesses is combined with technical assistance and shared overhead, with the expectation that after a few years the business will be sufficiently stable to seek other space.

A Section 501(c)(3) organization can rent space to private businesses with lease provisions requiring job training and employment of disadvantaged area residents. The business must have sufficient job opportunities appropriate to the skill level of community residents so that the lease provisions are meaningful. Rev. Rul. 76-419, 1976-2 Cum. Bull. 146 (1976). Finally, the organization can use commercial rental income to make grants to other Section 501(c)(3) organizations or to reduce the rent of other Section 501(c)(3) organization tenants. Rev. Rul. 64-182, 1964-1 Cum. Bull. 186 (1964); Rev. Rul. 69-572, 1969-2 Cum. Bull. 119 (1969).

An organization can engage in an insubstantial amount of non-charitable commercial real estate activity, and will pay tax on the net rental income only if and to the extent that its acquisition of the property was financed with borrowed funds. Furthermore, if 85% or more of the commercial property is used for charitable purposes, the net rental income from the non-charitable use is not taxed even though financed with borrowed funds.

Step Three: Review Other Factors Regarding Formation of Subsidiary, and Determine Whether Advisable

Although the business might not jeopardize the corporation's tax-exempt status, there may be other reasons to form a subsidiary. The major reasons are discussed below. Not all of them might apply in a particular situation, and some that apply should not be given equal weight. The corporation should carefully weigh the advantages and disadvantages of forming a subsidiary before making its decision.

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, such as by co-signing a loan. 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, that is, did not provide it with sufficient capital to meet its ordinary business needs. Instead of providing too little funds, if the corporation caused the subsidiary to transfer to the corporation so much funds that the subsidiary was unable to meet its obligations, liability protection again might be lost.

The most common cause of loss of liability protection, however, is due to 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 the 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. It is

advisable 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 made the 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 taken. However, it should not substitute itself for the subsidiary board and directly take those actions.

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 the corporation should always form a subsidiary to operate a business venture. However, the cost of a subsidiary, both in money and time, can be significant. Instead, 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 cannot guarantee that the business 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 that the ordinarily prudent person would consider. Directors can rely on the reports of experts, but are not excused from making an independent inquiry when reasonable and appropriate.

Perhaps not all of 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 business. 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 lacking among the nonprofit corporation staff. If an outsider must be hired to manage the business, it might be more attractive to offer a position as the President of a new subsidiary rather than that of a division or program manager in a larger nonprofit corporation.

To be competitive, the business might have to pay more for its staff than would be permitted by the pay scales of the parent nonprofit corporation. A subsidiary can also develop incentive compensation plans,

such as profit-sharing and bonuses, more easily than can the parent charitable corporation. It might be easier to create the subsidiary than to upset the existing corporate culture. Also, staff of a subsidiary will be devoted to 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 might be 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, so that extra employment taxes and bookkeeping expenses are not incurred. Staff should be employed by the corporation that 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 nonprofit corporation, or business revenues might be used to subsidize non-business overhead.

Some funding/financing sources are only available to for-profit corporations, such as the Small Business Administration, 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.

A parent nonprofit corporation that acquires a building might be able to charge its grants a greater amount of the operating costs if a subsidiary owns the building. A nonprofit corporation that owns a building typically can charge its grants an amount equal to its actual cost of ownership: depreciation, maintenance, taxes, insurance, and interest. This may be less than the market rate rent for the equivalent space. A nonprofit corporation that leases a building from its subsidiary might be able to charge its grants the market rent under the lease. However, federal allowable cost rules in Office of Management and Budget (OMB) Circular A-122 do not allow a market rent charge to federal grants when a grantee leases

space from a controlled subsidiary. Instead, federal grants may be charged only the actual cost of ownership as though the parent nonprofit corporation owns the building. Many states have chosen to apply federal rules to state grants, although states may adopt their own rules for their grants and even for some federal block grants that are passed through the state.

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 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 promote 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. There are two types of IRC Section 501(c)(3) corporation, the public charity and the private foundation. Public charity status is preferable. Private foundations are, in practice, ineligible for some grants, are subject to greater administrative requirements, are taxed on net investment income, and are subject to stringent self-dealing, business holding, and other rules.

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 1/3 of total support, but permits as low as 10% in 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%) of its support from related business income, it is classified as an IRC Section 509(a)(2) corporation. This test requires at least 1/3 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 1% 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 1/3 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 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 (see also the discussion of IRC Section 501(c)(4) below). 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 that 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 pays tax on net income. It also pays tax on unrelated passive income, as described above; a tax-exempt subsidiary might not be taxed on this income.

Certain other factors described above, such as image and funding source requirements, might also have a bearing on the choice between a nonprofit and a for-profit subsidiary.

For the nonprofit corporation's second and subsequent businesses, it has 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 whether gains and losses can and should be offset, simplicity of structure, and the importance to the parent nonprofit corporation of direct rather than indirect control over a subsidiary's activities.

Conclusion

Whether a nonprofit corporation would benefit from forming a subsidiary to carry out a business venture depends on many factors. There are advantages and disadvantages, and the analysis can change over time. An in-house venture saves the cost of a new corporation, and the nonprofit corporation retains complete control. A subsidiary can protect the parent corporation from legal liability, might benefit the business through more focused effort, and might attract new revenue. Before reaching a decision, a nonprofit corporation should obtain expert legal and financial advice.

The Mechanics of Creating a Subsidiary, and Parent-subsubsidiary Relationships

Forming a Wholly Owned For-Profit Subsidiary

As sole owner, the parent Section 501(c)(3) organization has complete control over the subsidiary's activities, but must follow certain formalities to ensure that the subsidiary is treated as a separate legal entity. The subsidiary has its own board of directors and officers, although the same individuals may serve in that capacity for both organizations. The subsidiary should have its own bank accounts and books of record, and must separately observe all corporate filing and other requirements. The subsidiary should have its own stationery, and should enter into transactions in its own name.

As the owner, the Section 501(c)(3) organization, acting through its board of directors, elects the subsidiary's directors. These directors choose the president and other officers who manage the subsidiary's affairs. The Section 501(c)(3) organization controls the subsidiary through the power to elect and remove directors as provided in the subsidiary's bylaws. The bylaws should also provide that the organization fills vacancies on the subsidiary's board and must approve bylaw amendments.

The desire to close the gap between ownership and day-to-day control may lead the Section 501(c)(3) organization to elect its own board of directors to the subsidiary's board and to select the organization's managers to manage the subsidiary. This may not be the best approach. Directors and managers knowledgeable of the subsidiary's business enhance its ability to succeed. In selecting directors, organization's should choose individuals from within and outside the organization whose presence will further the subsidiary's success.

The organization can exercise considerable indirect control over the subsidiary's activities. As the owner, the organization can require regular reports that compare the results of the subsidiary's activities to previously agreed-upon goals and outcomes. For example, at the start of the year, the organization and subsidiary might agree on targets for profitability at the end of each quarter. If the first quarter target were not met, the subsidiary would develop a corrective plan for the organization's review, and the organization could suggest alternative actions. Final decisions would be made by the subsidiary's board, subject to the power of the organization to remove directors who made inappropriate decisions.

The subsidiary formally exists upon the filing of articles of incorporation with the appropriate state agency, typically the secretary of state. The articles generally contain only a few provisions; more complex articles include provisions involving shareholder rights and multiple classes of shares that are not needed when there is only one shareholder. Once the subsidiary is incorporated, the incorporator or initial directors

named in the articles call an organizational meeting to adopt bylaws, elect officers, and transact other business, similar to the process used by the Section 501(c)(3) organization when it incorporated.

The subsidiary must be capitalized with cash or other property with which to begin operations. Some states have a minimum capitalization requirement. Payment of the minimum capital does not excuse the Section 501(c)(3) organization from responsibility for liabilities incurred by the subsidiary if it was not adequately capitalized for the business operations in which it engages. In capitalizing a subsidiary, the organization uses unrestricted funds or approved grant funds, and receives stock (shares) in this non-taxable exchange. The transaction should be documented with an agreement for the purchase and sale of stock executed by each corporation.

Federal and state securities laws regulate the issuance of shares. These laws require registration of shares unless an exemption is available. Several federal exemptions are potentially available, including the intrastate exemption. In most states, an exemption from state securities registration is also available.

It is best to form the subsidiary before, rather than after, the Section 501(c)(3) organization purchases property intended for subsidiary ownership. The subsequent transfer of the property to the subsidiary may trigger acceleration clauses in loan financing or may result in the imposition of transfer taxes.

Furthermore, the subsidiary has a carryover basis for depreciation purposes in property transferred to it by the organization. Property has no basis to the extent acquired by the Section 501(c)(3) organization with grant funds. If instead the organization transfers the cash from its grants so that the subsidiary purchases the property, the subsidiary can take depreciation based on the purchase price. The organization might need grantor approval to transfer grant funds to the subsidiary.

Profits earned by a subsidiary may be transferred to the Section 501(c)(3) organization as dividends on the subsidiary's stock. The board of directors of the subsidiary may declare a dividend as long as the subsidiary's ability to pay its debts is not thereby impaired. Since subsidiary profits are subject to federal income tax, dividends are paid with after-tax dollars. The Section 501(c)(3) organization does not pay tax on dividends received. The subsidiary cannot make tax-deductible contributions to the Section 501(c)(3) organization because the organization controls the subsidiary.

Dividends are not the only way in which a subsidiary can provide financial support to the organization. A subsidiary can contract with the organization and make payments for management, bookkeeping, or other services, rent of space, and interest on loans. The organization may have unrelated taxable income from such payments, but will pay tax only on the amount by which the payments exceed the organization's cost of providing the services, facilities, or loans.

A subsidiary should pay "market" rates, and these payments are business expenses that reduce the subsidiary's taxable income. Both boards of directors should approve a written agreement for the transaction(s), and organization staff should maintain records of time spent on behalf of the subsidiary. If the subsidiary does not have the funds to make the payment, or needs the funds to maintain or expand operations, the organization can forgive payment of this subsidiary debt, or can return the funds by making a further contribution to the subsidiary's capital.

Forming a Controlled Nonprofit Subsidiary

The parent Section 501(c)(3) organization has complete control over the subsidiary's activities, but must follow certain formalities to ensure that the subsidiary is treated as a separate legal entity. The subsidiary

has its own board of directors and officers, although the same individuals may serve in that capacity for both organizations. The subsidiary should have its own bank accounts and books of record, and must separately observe all corporate filing and other requirements. The subsidiary should have its own stationery, and should enter into transactions in its own name.

The Section 501(c)(3) organization prepares the subsidiary's articles of incorporation and bylaws, which may provide that the organization is the only member or that the subsidiary has no members, with all of the directors appointed by the Section 501(c)(3) organization. As sole member or sole appointing body, the organization selects and removes directors, and must approve bylaw amendments and fundamental changes such as dissolution. As with a for-profit subsidiary, it is not always best for the organization to elect its own board of directors to the subsidiary's board and to select the organization's managers to manage the subsidiary. Directors should be chosen for their time availability, commitment, and expertise in the subsidiary's activities.

As with a for-profit subsidiary, the organization's control over the subsidiary's activities is indirect. Final decisions would be made by the subsidiary's board, subject to the power of the organization to remove directors who made inappropriate decisions.

The subsidiary formally exists upon the filing of articles of incorporation with the appropriate state agency, typically the secretary of state. Once the subsidiary is incorporated, the incorporator or initial directors named in the articles call an organizational meeting to adopt bylaws, elect officers, and transact other business, similar to the process used by the Section 501(c)(3) organization when it incorporated. The subsidiary can then apply for tax-exempt status, and can qualify for public charity status as a "support corporation" under Section 509(a)(3) as described above. It is best to form the subsidiary before property intended for subsidiary ownership is purchased, for the loan acceleration and transfer tax reasons described above regarding for-profit subsidiaries.

A subsidiary can contract with the organization and make payments for management, bookkeeping, or other services, rent of space, and interest on loans. For liability protection purposes, it is advisable to document these transactions with a written agreement and to establish that payments were made at no more than market rate. If the subsidiary cannot pay or needs the funds for its operations, the organization can forgive payment. After all payments are made, net earnings of the subsidiary can be transferred to the organization or other Section 501(c)(3) organizations as a charitable contribution.

Forming a Limited Liability Company

A limited liability company (LLC) provides liability protection for its owners, similar to a corporation, while avoiding corporate income tax due to the pass-through of taxes to its owners. The IRS has recently provided guidance on whether an LLC qualifies for Section 501(c)(3) tax-exempt status. The IRS will recognize the Section 501(c)(3) status of an LLC if it satisfies 12 conditions designed to ensure that it is organized and operated exclusively for exempt purposes and to preclude inurement of net earnings to private shareholders or individuals. The IRS treats an exempt LLC as an association (corporation), not a partnership, having long held that a partnership cannot qualify under Section 501(c)(3).

However, some states, including California and New York, and the District of Columbia appear to require that an LLC be formed for a business purpose. In these states, it is questionable whether an LLC may be formed as a Section 501(c)(3) charitable organization. For the time being, however, absent state case law

to the contrary, the IRS is willing to recognize exemption based on the LLC's representation that its charitable status is permitted under state law. An LLC that meets each of the 12 conditions would also qualify for Section 501(c)(4) tax-exempt status if it otherwise meets the requirements for that section.

As an alternative to separate tax-exempt status, an LLC owned by one Section 501(c)(3) organization can be treated as a tax-exempt, disregarded part of the owner. The exempt owner of a disregarded LLC treats the operations and finances of the LLC as its own for tax and information reporting purposes. New IRS Form 990, Part IX, solicits information from the exempt owner relating specifically to disregarded entities. LLC activities that are unrelated to the owner's exempt purposes may cause the owner to lose tax-exempt status and/or pay unrelated business income tax.

The 12 conditions necessary to qualify an LLC as a separate Section 501(c)(3) tax-exempt entity are:

1. The organizational documents (articles of organization and operating agreement) must include a specific statement limiting the LLC's activities to one or more exempt purposes, such as "The organization is organized exclusively for exempt purposes under Section 501(c)(3) of the Internal Revenue Code, and may not carry on activities not permitted to be carried on by an organization described in Section 501(c)(3)."
2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.
3. The organizational language must require that the LLC's members be Section 501(c)(3) organizations or governmental units or instrumentalities (hereafter called "permitted members").
4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a permitted member.
5. The organizational language must state that the LLC, interests in the LLC, or its assets may only be availed of or transferred to any person, other than a permitted member, in exchange for fair market value. However, grants for exempt purposes to individuals or non-charitable organizations are permitted.
6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to its charitable purposes will continue to be devoted to charitable purposes.
7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with Section 501(c)(3).
8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.
9. The organizational language must require that the LLC not distribute any assets to members who cease to be permitted members, unless the distribution is not made due to membership, such as payment on a loan.
10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be a permitted member, such as forfeiture of the member's interest, or forced sale to a permitted member within a reasonable time such as 90 days after ceasing to be a permitted member.
11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.
12. The LLC must represent, in a separate written statement, that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

Partnering with Other Parties

Partnerships can be effective ways to leverage existing resources. The other party may have development and management skills and experience, as well as pre-development and seed capital funds to bring a project to the point in which it can secure permanent funding and financing. The other party may also have a track record and credibility with funding and financing sources, suppliers, customers, and others.

Of course, there are disadvantages too. The organization may lose some control of its project and may have to compromise on some of its social goals. The project may become more complex and may also become associated with the other party.

For the other party, of course, similar advantages and disadvantages exist. The organization may have greater access to special funding and financing. The organization may also have a closer relationship to the community and thus have greater ability to perform certain tasks. The organization may bring community support for the project, and can help with the politics of the public approval process. In some projects, the other party can take advantage of tax benefits that the organization cannot use.

On the other hand, the internal processes of the organization may slow down the project's development. Some social goals of the organization may reduce the project's economic rate of return. Control of the project must be shared, and the project may become more complex.

Potential partners include other nonprofit organizations, for-profit businesses and individuals, and government agencies. When selecting a partner, verify that they have the experience and financial capability to complete the project. Request a list of previous projects and the other party's level of involvement, appropriate financial statements and tax returns for the past three years, references for relevant staff that will work on the project, and organizational references from lenders or funders. Discuss and agree on the project concept and on the project's social and financial goals. Assess the other party's reputation in the community and their ability to attract financial and other support.

In documenting the relationship with the other party, consider the inclusion of these elements in the agreement:

- Project definition, including social goals.
- Beginning date and ending date.
- The amount of each party's contribution of pre-development funds, debt, and equity, and payment of operating deficits. Specify which party is responsible for securing outside funds, and how the parties will value non-cash assets (property).
- Responsibilities and control rights, including how decisions will be made, the decisions that can be made by one party and those that must be approved by the other parties, the tasks to be performed by each party, the consequences if one party fails to perform, and how internal management, accounting, and reporting will be handled.
- The sharing of economic benefits, including taxable profits and losses, cash distributions, and proceeds from the sale or refinancing of property.
- The extent of one party's liability for the actions of the other party, including indemnification of each party by the other for their own improper acts, and the insurance required of each party and of the project.

- Restrictions on transfer of property and partnership interest, including a party's right of first refusal, option to purchase, and approval of substitute parties if the other party desires to sell.
- The grounds for and methods of termination of the agreement and dissolution of the relationship, whether for cause or without cause prior to the ending date, and what each party receives on dissolution.

There are many possible relationships with other parties. For example, one party, as owner, may contract for services with, or rent space to, the other party, with payment based on revenues or profits. One party may passively invest in the project, relying on the management expertise of the other party. In these relationships, a project's economic rewards can be shared without the sharing of control or liability.

The relationship may be as simple as one party paying a fee to the other party for the performance of certain services. The fee may vary based on performance. For example, if the party meets certain employment and training goals, the fee might be higher than if the goals are not met. The organization might lend money or lease assets to the other party, and charge a lower rate if certain performance goals are met.

A common relationship with another party is that of co-owner in which control, risk, and profits are shared. The organization can be majority, minority, or co-equal owner with the other party. This relationship is often called a "joint venture." The joint venture can be structured as a partnership, corporation, or limited liability company (LLC). Because a corporation is subject to income tax on net profits before making a distribution to its owners, most joint ventures are structured as a partnership or an LLC in which net profits are passed through to the owners for payment of income tax.

When a Section 501(c)(3) organization enters into a partnership or an LLC with a private party, it risks loss of its tax-exempt status unless the joint venture furthers its exempt purpose and allows it to act exclusively in furtherance of such purpose. The Section 501(c)(3) organization must have sufficient control of the joint venture to ensure that it can only act in furtherance of exempt purposes. If tax-exemption might be lost due to participation in a joint venture, a Section 501(c)(3) organization can form a for-profit subsidiary to enter into the joint venture. If tax-exemption would not be lost, a Section 501(c)(3) organization might prefer to form a nonprofit subsidiary to enter into the joint venture for liability, management, or other reasons as described above.

A Section 501(c)(3) organization may become a shareholder in a corporation without risking loss of tax-exempt status, because the activities of the corporation are not attributed to its shareholders. However, in this or in any joint venture involving a Section 501(c)(3) organization, the organization must ensure that private parties are not unduly benefited. The economic return to the parties should be consistent with their relative investment in and services to the joint venture.

Conclusion

Corporate and tax law does not restrict the business venture activities of nonprofit corporations. However, these activities must be properly structured to protect tax-exempt status and to protect corporate assets from undue risk. This paper describes general guidelines for choosing the appropriate structure, with their advantages and disadvantages. General questions concerning the information presented in this paper

should be directed to the author. Questions concerning the application of the principles discussed in the paper to specific business venture activities should be directed to local legal counsel.