Forming a Subsidiary of a Nonprofit, Charitable Tax-exempt Corporation

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What Is a Subsidiary?

A. It is a corporation owned or controlled in whole or in part by the Nonprofit (the "Parent").

B. A subsidiary may be nonprofit (usually also charitable tax-exempt) or for-profit.

C. Other terms that refer to a subsidiary include affiliate, support corporation, and title-holding corporation. These terms generally refer to a subsidiary that meets certain requirements, not to all subsidiaries.

D. A subsidiary with more than one owner is more complex than a wholly owned subsidiary. This Outline assumes a wholly owned subsidiary.

Why Create a Subsidiary?

A. A subsidiary can protect the Parent's tax-exempt status. The Parent's activities must further its charitable purposes, except for an insubstantial amount of unrelated activities. An activity that furthers the Parent's charitable purposes can be carried out either by the Parent or by a subsidiary. If an activity is substantial and unrelated to the Parent's charitable purposes, it can be carried out by a for-profit subsidiary without jeopardizing the Parent's tax-exempt status.

   Whether an activity furthers charitable purposes depends on how it is conducted, not on how its net earnings are spent. The following activities further charitable purposes.

   1. Housing (IRS Revenue Procedure 96-32)

      a. Relief of the poor and distressed safe harbor rule: at least 75% of the units in a project must be occupied by and affordable for families earning 80% or less of area median income. Of these, either at least 20% of the units must be occupied by and affordable for families earning 50% or less of area median income, or 40% of the units must be occupied by and affordable for families earning 60% or less of area median income. The remaining units can be at market rate. Affordable means no more than 30% of household income is spent on rent and utilities.

b. Relief of the poor and distressed facts and circumstances test.

c. Combating community deterioration in a blighted neighborhood.

d. Providing special housing for the elderly or disabled.

2. Commercial real estate

   a. Office space for the organization's own use.

   b. Space rented to other charitable organizations, if charge lowest feasible rent (IRS Revenue Ruling 69-572).

   c. Space rented to businesses owned by disadvantaged persons, especially in blighted areas, when the owners would have difficulty finding suitable space in the area (IRS Revenue Ruling 74-587).

   d. Space rented to businesses with lease provisions requiring job training and employment of disadvantaged area residents (IRS Revenue Ruling 76-419).

   e. Excess rent is used to make grants to other charitable organizations (IRS Revenue Ruling 64-182) or reduce the rent of other charitable tenants in the building (IRS Revenue Ruling 69-572).

3. Business development

   a. A business is an income-generating activity regularly carried on.

      The business must be done as a means to achieve a charitable purpose ("related business activity"), not for income generation ("unrelated business activity"). Look at the scale of the business and whether it is consistent with a charitable purpose, whether the fees charged are affordable or at low cost to disadvantaged persons, whether disadvantaged persons or charitable organizations are served, and whether the business operates in a typical commercial manner and competes with private business.

   b. Examples of related businesses include a job training program in which trainees manufacture an item sold at a profit (IRS Revenue Ruling 76-94), and investing in businesses in a distressed community that could not obtain conventional financing (IRS Revenue Ruling 74-587).

c. Examples of unrelated businesses include providing services to charitable organizations at cost (IRS Revenue Ruling 72-369), operating a low cost grocery or pharmacy in a distressed community even though needed (IRS Revenue Ruling 73¬127), and general business promotion in a distressed community (IRS Revenue Ruling 77-111).

B. A subsidiary can protect the Parent from the debts and liabilities of the activity, and vice versa. It can also protect the Parent's board of directors from personal liability (except for those directors also on the subsidiary's board of directors). To achieve liability protection, the Parent and subsidiary need to establish proper corporate separateness. Since a subsidiary involves indirect (not direct) control by the Parent over the activities, plus additional complexity and time to manage and operate, before forming a subsidiary for liability protection, determine the insurable and uninsurable risks and estimate the magnitude of the uninsurable risks. All business and housing activities involve risk, but not all risk justifies forming a subsidiary.

C. A subsidiary might attract grants, contributions, or equity and debt financing that the Parent cannot. A funding or financing source might require a subsidiary or, conversely, prohibit its funds from being used by a subsidiary. A subsidiary might be able to shield its activities from government grant rules.

D. A subsidiary can help the Parent overcome organizational capacity deficiencies. The subsidiary's board of directors and staff can have special expertise in its activities. The Parent's board of directors and staff might not have the time and ability to supervise and carry out a new activity.

E. Other reasons for creating a subsidiary include enhanced community image, ability to offer incentive compensation, and the ease of transferring ownership of the activities to employees or other parties.

If the Parent Creates a Subsidiary, Choose Between a Nonprofit, Charitable Tax Exempt Subsidiary and a For-Profit Subsidiary.

A. Since the net earnings from related business activity are not subject to federal income tax, when an activity furthers charitable purposes a nonprofit subsidiary is preferable to a for-profit subsidiary.

B. For commercial real estate, a nonprofit subsidiary has a federal income tax advantage over a for-profit subsidiary. A nonprofit subsidiary pays no tax on passive rental income except to the extent that the rental activity is unrelated and debt financed. If 85% or more of the building is used for related activity, a nonprofit subsidiary pays no tax on the net rents from the unrelated activity.

C. Unlike a for-profit subsidiary, a nonprofit subsidiary might also be exempt from other taxes such as property or sales taxes.

D. For second and subsequent activities, can choose to utilize a subsidiary created for an earlier activity or to create a new subsidiary. Use the same analysis as described above. If more than one subsidiary is created, the subsidiaries need to be properly structured for tax and control reasons.

Subsidiary Formation Process.

A. For a nonprofit, charitable tax-exempt subsidiary, the Parent prepares the Articles of Incorporation and Bylaws. The Articles should provide that the Parent has the right to approve any amendments. The Bylaws should provide that the Parent has the right to appoint the board of directors and to remove directors without cause at any time, and the right to approve any amendments.

B. For a for-profit subsidiary, the Parent prepares the Articles of Incorporation and Bylaws. The Parent as shareholder should have the right to vote for the board of directors, the right to remove directors without cause at any time, and the right to approve any amendments. The Parent should make a reasonable contribution to the subsidiary's capital. Formation and capitalization of the subsidiary should comply with state and federal securities laws.

Intercorporate Relations and Maintaining Separate Legal Status.

A. The Parent and subsidiary should maintain separate books and records, bank accounts, meetings and minutes, stationery, and tax returns, and each of them should sign documents in their own corporate name.

B. The Parent should not manage the subsidiary's daily affairs. The Parent should establish annual goals for the subsidiary's performance, and should receive regular reports on the extent to which the goals are being achieved.

   The Parent can critique and comment on these reports, and make suggestions to enhance the subsidiary's performance.

C. The Parent maintains control of the subsidiary through the power to appoint and remove the board of directors and the power to approve any amendments to the Articles of Incorporation and Bylaws.

D. The board of directors of the Parent and subsidiary can overlap, but it is recommended that the subsidiary board include outside directors with the necessary time and expertise. Typically, the subsidiary board has fewer directors than does the Parent board. Having outside directors on the subsidiary board provides some liability protection for the non-overlapping Parent directors. It is easier to approve agreements between the Parent and subsidiary when there are non-overlapping directors, since overlapping directors may have to abstain. Agreements between the Parent and subsidiary must be fair and reasonable to both corporations.

E. Staff may perform services for both the Parent and subsidiary. The corporation that utilizes a majority of a staff person's time should be the employer, instead of having dual employment or independent contractor arrangements. A single employer arrangement is administratively easier, and avoids duplicate employment taxes and record keeping.

F. Net earnings from a for-profit subsidiary can be transferred to the Parent as an after-tax dividend. Net earnings from a nonprofit, charitable tax-exempt subsidiary can be transferred to the Parent as a contribution. Transactions between the Parent and subsidiary (for services, rental of space and equipment, the loan of funds, etc.) should be in writing and approved by both boards of directors. Note that if a subsidiary charges rental of space to the Parent, federal OMB Circular A-122 may limit to actual cost, not fair market rent, the allowable rent charge to the Parent's federal grants.

G. A Parent often provides management, administration, and accounting services to its subsidiary. A Parent can charge less-than-cost to a nonprofit, charitable tax-exempt subsidiary. A for-profit subsidiary should pay market rates, and can take a business expense tax deduction for its payment. A market rate charge helps the subsidiary establish an accurate cost of doing business. Staff of the Parent should keep time records, and the Parent should determine its hourly cost of providing services. The Parent treats the subsidiary's payment as either related or unrelated income, based on the principles described above. The Parent pays federal income tax only on net earnings from unrelated activity. If the Parent charges its cost of providing a service unrelated to its charitable purposes, then there are no net earnings and thus no federal income tax to pay. If the subsidiary needs funds, the Parent can make a further contribution to the subsidiary's capital or treat any unpaid amount as a debt that can be forgiven later if necessary or desired.