Is it Time to Form a For Profit Subsidiary

Nonprofits engaging in social enterprise or other active business pursuits often worry that a growing stream of unrelated business income could threaten their tax-exempt status. This concern is related to the prohibition against tax-exempt organizations engaging in more than an "insubstantial" amount of activity unrelated to their tax-exempt purpose. Unfortunately the term "insubstantial" is undefined. Based on court cases, it appears that gross unrelated business income receipts of 5 % or less is always safe while over 20% is probably too much.

When unrelated business endeavors take off, the success of the business can threaten a 501(c)(3) organization's tax-exempt status. To protect their tax-exempt status, many tax-exempt organizations with successful unrelated business ventures move their unrelated business activities into a taxable for profit subsidiary.

A taxable subsidiary is essentially a separate for profit entity that the charity owns and controls. As the owner, the tax-exempt parent is entitled to distributions from the for profit subsidiary. If the subsidiary is not properly structured, the distributions of business income to the tax-exempt parent will retain their character as unrelated business income. However, if the taxable subsidiary is properly structured and operated, the distributions will be treated as exempt passive income to the tax-exempt parent.

To ensure that the distributions from the taxable subsidiary are treated as exempt passive income, the IRS has developed a two-part test to determine whether a subsidiary should be treated as a separate taxable entity whose commercial activities will not be attributed to the parent corporation for tax purposes.

1. <u>Bona Fide Purpose</u>. The requirement is that the subsidiary must be organized for some bona fide purpose of its own and not be a mere sham or instrumentality of the parent." This does not mean that the subsidiary has to have a profit motive; however, it must have a business purpose or activity.

2. <u>Instrumentality of Parent</u>. The second part of the test is the requirement that the tax-exempt parent not be so involved in, or in control of, the subsidiary's day to day activities that the relationship between the parent and the subsidiary takes on the form of a principal-agent relationship or that the subsidiary becomes merely an instrumentality of the parent. This does not mean that the parent cannot control the subsidiary through ownership of stock or appointment of the board of directors.

In addition, the taxable subsidiary should be formed as a C-corporation or as an LLC that elects to be taxed as a C-corporation. Pass-through entities such as partnership, LLCs taxed as partnerships, or S-corporation will not block distributions from being treated as unrelated business income to the tax-exempt parent.

Also, while interest, rents, royalties and annuities are normally excluded from unrelated business income, a special tax rule provides that such income is to be taxed as unrelated business income if that income is received from a controlled subsidiary. Dividends are not subject to this rule. Therefore, the distributions from the taxable subsidiary to the tax-exempt parent should be made in the form of dividends.

Finally, as is the case with all related entities, to ensure the tax-exempt parent does not treat any subsidiaries it may create as instruments or alter egos of the tax-exempt parent, the tax-exempt parent should do the following:

1. The tax-exempt parent and its 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.

2. The tax-exempt parent should maintain control of its subsidiaries through its power to appoint and remove the board of directors and the power to approve any amendments to the Articles of Incorporation and Bylaws.

3. The tax-exempt parent should not directly manage the subsidiary’s daily affairs.

4. The board of directors of the tax-exempt parent and the subsidiary can overlap, but it is recommended that the subsidiary board include outside directors as well.

5. Net earnings from a for profit subsidiary can be transferred to the tax-exempt parent as an after-tax dividend. Transactions between the tax-exempt parent and the subsidiary (for services, rental of space and equipment, loans, etc.) should be in writing and approved by both boards of directors.

When forming a for profit subsidiary of a tax-exempt parent, the tax-exempt parent, as the sole or majority shareholder or member, should have the right to vote for the board of directors, the right to remove directors or managers without cause at any time, and the right to approve any amendments. The nonprofit should make a reasonable contribution to the subsidiary’s capital. If investors are sought, capitalization of the subsidiary should comply with state and federal securities laws.