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The Benefits and Detriments
of a Tax-exempt Organization's
Use of a For-profit Subsidiary

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THE BENEFITS AND DETRIMENTS OF A TAX-EXEMPT ORGANIZATION'S USE OF A FOR-PROFIT SUBSIDIARY

Often referred to as a taxable subsidiary, a for-profit subsidiary is a taxable business corporation, all or the majority of stock of which is owned by the sponsoring nonprofit organization. The law is clear that a tax-exempt organization may establish one or more for-profit subsidiaries and own

some or all of the stock. Moline Properties v. Commissioner, 319 U.S. 436, 438 (1943).

Principally, tax-exempt parent organizations establish for-profit subsidiaries to:

(1) conduct unrelated business activities that could threaten the tax exemption of the parent organization if they become "substantial" in nature;

(2) lessen Unrelated Business Income Tax (UBIT) burdens of the parent organization or maximize the use of tax deductions;

(3) protect the parent organization from any legal liabilities that may arise from the unrelated activities.

Example: An exempt organization was formed to provide museum management and support activities to nonprofit museums. However, the business was successful and the exempt organization planned to expand its operations to include for-profit entities such as auction houses and art galleries. Because the expanded activities could be viewed as noncharitable, the exempt organization formed a wholly-owned subsidiary to serve the for-profit entities. Thus, the exempt organization segregated the taxable activities so as not to jeopardize its tax-exempt status.

Through the use of a subsidiary, an exempt organization can indirectly be involved in a for-profit activity without jeopardizing the parent's exempt status. When unrelated activities are conducted by a for-profit subsidiary, the net income arising from these activities is taxed at federal and state corporate income tax rates. This is just as it would be if the activities had been conducted by the parent organization directly, but the parent's tax-exempt status is not threatened. Furthermore, because the income of the subsidiary is fully taxable, the parent will not be subject to UBIT on the subsidiary's income.

A for-profit subsidiary can transfer its after-tax profits to the parent as tax-free dividends (except from tax under the passive income exclusion discussed below).

Reasons for Use of a Subsidiary

There are a variety of reasons for using a subsidiary entity to conduct commercial venture activity.

Protects Parent's Tax-Exempt Status and Insulates the Parent from Liability

Use of a for-profit subsidiary protects the status of the exempt parent and insulates the parent and the parent’s assets from possible legal liability**.**

In Orange County Agricultural Society, Inc. v. Comm'r, 893 F.2d 529 (2nd Cir. 1990), the Court held that an operation of an unrelated business by an exempt organization will cause loss of exempt status if the business becomes too important a part of the activities of the organization.

Sources of Capital Are Expanded.

Frequently, investors and creditors will more readily invest or lend capital to for-profit entities rather than tax-exempt organizations.

Reasons why investors and creditors favor for-profit entities:

(1) in the event of insolvency of the exempt organization, an involuntary bankruptcy cannot be filed against it by creditors; and

(i) see 11 U.S.C. §303(a), which provides that :

> an involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not moneyed, business, or commercial corporation . . . .

(ii) the Senate judiciary specifically stated in a report that "eleemosynary institutions, such as churches, schools and charitable organizations and foundations, likewise are exempt from involuntary bankruptcy." S. Rep. No. 95-989, 95th Cong. (1983).

(2) a for-profit entity has the capacity to raise capital from the general public through a conventional stock issue.

For-Profit Subsidiaries Provide Flexibility in Operations.

The creation of a for-profit subsidiary is often based on essentially business reasons. Efficiency, managerial convenience and the need to reorganize are regularly cited in ruling requests as reasons for the creation of a for-profit subsidiary.

The independence of operations such as management, administration, and accounting, provide two key functions:

(1) the for-profit subsidiary will be viewed as a distinct entity from the tax-exempt parent, thereby preserving the parent's exempt status and limiting the liability of the parent; and

(2) the use of a for-profit subsidiary allows for growth within the subsidiary in its activities, whereas, if the tax-exempt parent directly engaged in the activity and the operations were successful, then its tax-exempt status could be adversely affected.

In Private Letter Ruling. 9305026 (Nov. 2, 1992), the for-profit subsidiary had separate and independent management from the tax-exempt parent. The majority of the directors of the subsidiary consisted of individuals unrelated to the exempt parent. The exempt parent was not involved in the day-to-day management of the subsidiary. Lastly, all transactions between the parent and the subsidiary were conducted at arm's length.

Under these circumstances, the Internal Revenue Service’s Letter Rulings Department held that the parent corporation which owns 100 percent of the subsidiary will not jeopardize its tax-exempt status. Thus the subsidiary's income and activities will not be attributed to the parent and the dividends paid by the subsidiary to the parent will not jeopardize its exempt status and are not taxable to the

parent under I.R.C. §512(b).

For-profit subsidiaries also add flexibility in compensating employees because a for-profit subsidiary is not limited in paying compensation of employees in the same manner as a tax- exempt organization.

How to Set the For-Profit Subsidiary Up as a Separate Legal Entity

In order to utilize a for-profit subsidiary, the tax-exempt parent must take care to structure the subsidiary arrangement so that the subsidiary is viewed as a separate legal entity from the parent.

If the subsidiary is not viewed as a separate legal entity, the activities of the subsidiary could be attributed to the exempt organization, which would be in jeopardy of losing its tax-exempt status.

In General Counsel Memorandum 39,598 (Jan. 23,1987), the Service noted that:

> the parent [must] not be so involved in, or in control of, the day-to-day operations of the subsidiary that the relationship between parent and subsidiary assumes the characteristics of the relationship of principal and agent, i.e., that the parent not be so in control of the subsidiary that it is merely an instrumentality of the parent.

In Britt v. United States, 431 F.2d 227 (5th Cir. 1970), the Service formulated a two-part test to determine if the parent and the subsidiary activities were sufficiently segregated. The test required that the for-profit subsidiary serve a bona fide business function and not be a mere instrumentality of the tax-exempt organization.

Bona Fide Function.

> Where a corporation is organized with a bona fide intention that it will have a some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That function need not be an inherently commercial, for-profit activity.

In Gens. Couns. Mem. 39,598 (Jan. 17 1987), the Service noted:

> [t]he first aspect is the requirement that the subsidiary be organized for some bona fide purpose of its own and not a mere sham or instrumentality of the parent. We do not believe that this requirement that the subsidiary have a bona fide purpose should be considered to require that the subsidiary have an inherently commercial or for-profit activity. The term "business," as used in the context of this text, is not synonymous with "trade or business" in the sense of requiring a profit motive. Instead, we believe the term "business" was simply carried over from *Moline* and *Britt*, . . . which involved for-profit corporations, and in- which the determination as to the existence of a business purpose of activity was an appropriate test for requiring substance over form given the factual circumstances of the particular case.

Hence, a parent corporation and its subsidiary are separate taxable entities so long as the subsidiary engages in or carries on independent business activities. When a corporation is organized with a bona fide intention that it will have some real and substantial business function separate and apart from the parent, its existence generally may not be challenged for tax purposes.

The chief counsel's office of the I.R.S.'s Exempt Organizations division noted in the above memo that it is very difficult to make an attribution of activities of a subsidiary to the parent organization. It is necessary to have "clear and convincing evidence" that the for-profit entity should not be respected for the Service to look beyond the existence of the for-profit entity and attribute the activities of the subsidiary to the parent organization. The IRS looks for evidence of fraud, sham transactions and lack of a valid business purpose.

Not a Mere Instrumentality of the Tax-Exempt Parent.

The for-profit subsidiary must not, in reality, be a mere arm, agent, instrumentality or integral part of the tax-exempt parent. When the subsidiary is an arm, agent or integral part of the parent, the Service will attribute the activities of the subsidiary to the parent and the parent risks losing its tax-exempt status. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 488 F.2d 1098, 1106 (5th Cir. 1973)..

General Relationship

Ownership of the stock and the power to appoint an entire board of directors does not necessarily indicate sufficient control to make the for-profit subsidiary a mere arm of the tax-exempt parent. Factors such as involvement in the day-to-day management of the subsidiary and arm's length transactions between the two are critical. However, the Service does permit the parent to establish long-range plans and policies for the subsidiary without jeopardizing that parent's exempt status.

In determining whether the for-profit subsidiary operates independent of the tax-exempt parent, the Service analyzes the amount of control the parent has over the subsidiary such as the commonality of officers, directors, trustees, and key employees, as well as the power to appoint such.

In examining any control element, the Service looks at

> [c]ontrol through ownership of stock, or power to appoint the board of directors, of the subsidiary will not cause the attribution of the subsidiary's activities to the parent. We do not believe that the GCM should be read to suggest, by negative inference, that when the board of directors of a wholly-owned subsidiary is made up entirely of board members, officers, or employees of the parent there must be attribution of the activities of the subsidiary to the parent. Gen. Couns. Mem. 39,866 (Dec. 30, 1991).

The extent to which the tax-exempt parent is involved in the day to day management of a for-profit subsidiary is the critical factor which must be considered, along with the bona fide and substantial purpose of the subsidiary, in determining whether the subsidiary is so completely an arm, agent, or integral part of the parent that its corporate identity should be disregarded. As discussed above, the doctrine of corporate identity is well

established, and the courts, in considering whether to disregard corporate identity, have articulated a very demanding evidentiary standard requiring clear and convincing evidence of the subsidiary's lack of independent status.

Hence, the activities of the subsidiary should not ordinarily be attributed to its parent organization, unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the tax-exempt parent.

In General Counsel Memorandum 39,598 (Jan. 23,1987), the Service, in deciding that a for-profit subsidiary of a tax-exempt organization did not qualify for tax-exempt status, noted that if the private benefits caused the denial of tax-exempt status to the subsidiary could be attributed to the exempt partner, then the exempt partner may also jeopardize its exempt status. The rationale is that the subsidiary could be acting as the "mere instrumentality" of the parent, without any independent business purpose.

Common Directors

Ideally, the board of directors of the for-profit subsidiary should consist, as much as possible, of persons who are not directors or officers of the parent. If the directors, or most importantly, the chief executive officer or the chief operating officer, are the same for both entities, then their involvement may be used as an indicator that the tax-exempt parent organization is overly involved in the day-to-day operations of the subsidiary. The Service also looks for persons with the same duties in both organizations. Some overlap is clearly permissible, such as giving the current chairmen of the board and the president of the parent seats on the subsidiary's board. There is no hard and fast standard. This is a case by case analysis.

Under certain circumstances, it is permissible to have substantial overlap between the tax- exempt parent and for-profit subsidiary directors. Even if most or all of the subsidiary's directors were directors or officers of the parent, the parent's tax exempt status 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.

Shared Officers and Employees

A more substantial problem would arise if officers of the tax-exempt parent were also officers of the for-profit subsidiary. In that scenario, it is more likely that the subsidiary's activities would be attributed to the parent because the overlap between officers tend 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, in Letter Ruling 8352091 (Sept. 30, 1983), the Service noted that 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 parent and the subsidiary is permitted. In addition, as a practical matter, there is a tradeoff between having common directors and common officers; the less the overlap of one category, the greater, the overlap may be in another.

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 Service 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 contract employees must be at arm's length. It is critical for shared employees to keep detailed, contemporaneous time records of the work for each corporation to substantiate the allocation of costs.

Shared Facilities and Services

The tax-exempt parent and for-profit subsidiary may share office space, equipment, supplies, and facilities if reimbursement is calculated on an arm's length basis. For example, the parent may sublease office space to the subsidiary at cost. In addition , 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.

If the subsidiary's activities grow to the stage where the subsidiary requires the significant use of one or more parent employees, it is generally recommended that those 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.

Capitalization

If the for-profit subsidiary meets the requirements discussed above for establishing itself as a separate entity, the tax-exempt parent's contribution of cash or assets to the subsidiary should not jeopardize the parent's tax-exempt status. A single transfer of cash or assets by the parent to the subsidiary in exchange for subsidiary stock is the ideal method of capitalization. Further irregular and infrequent investments of cash or assets in the subsidiary are also acceptable.

However if regular transfers are made to the subsidiary, the separateness of the two entities might come into question. Consequently, to the maximum extent possible after its initial capitalization, the subsidiary should be funded from its own cash flaw.

Dividends

As long as the for-profit subsidiary qualifies as a separate entity, the tax-exempt parent's receipt of dividends from the subsidiary generally will not jeopardize the parent's tax- exempt status. In LTR 8805059 (Nov. 13, 1987), a trade association anticipated that dividends received from its subsidiary would exceed 50 percent of the association's income in several years. The Service stated that the associations's tax-exempt status would not be jeopardized by the receipt of the dividend income "[s]o long as the sources and the amount of your traditional membership support do not change and you continue to maintain a meaningful amount of support from your membership and from activities related to your [tax-]exempt purpose."

Tax Implications

UBIT Implications of the Use of a For-Profit Subsidiary

In general, if the tax-exempt parent and for-profit subsidiary maintain separate corporate identities, the subsidiary's income will be taxable to it at normal corporate tax rates, and distributions from the subsidiary to the parent in the form of dividends, interest, etc. will not result in UBIT to the parent.

Recently in Letter Ruling 9705028 (Jan. 31, 1997), the Service ruled that a tax-exempt scientific research organization's creation of a for-profit subsidiary will not adversely affect the organization's exempt status, but the royalties and rental payments from the subsidiary will be unrelated business taxable income.

Exceptions for Controlled For-Profit Subsidiaries

Certain types of so-called "passive" income are generally excluded from unrelated business income of the tax-exempt organization subject to UBIT. Traditionally, "passive" income has included dividends, interest, annuities, royalties, and certain rents. This passive income exclusion does not apply when the tax-exempt parent has more than 80 percent "control" of the for-profit subsidiary, and to the extent that the subsidiary's income would be taxable unrelated business income if earned by the parent.

This obscure and complex provision is in §512(b)(13), which provides special rules for "controlled" subsidiaries. "Control" under is defined as at least 80 percent of the total combined voting power of all classes of stock entitled to vote *and* at least 80 percent of the total number of shares of all other classes of stock of the for-profit subsidiary. This provision creates a problem because it is possible to structure the control of taxable entities by working around this special 80 percent rule and thwart the intent of Congress.

If a parent corporation receives rent, interest, annuities, or royalties from a "controlled" subsidiary engaged in any unrelated trade or business, a portion of the income received by the parent is subject to UBIT, taxable at graduated corporate income tax rates. LTR 19994048 (July, 20, 1999).

This rule applies whether or not the activity conducted by the controlled subsidiary to derive those items represents a trade or business or is regularly carried on. Thus, amounts received by a controlling tax-exempt organization from the rental of its property to a controlled for-profit subsidiary may be included as unrelated business income of the controlling exempt organization, even though the rental of such property is not an activity regularly carried on by the controlling exempt organization.

The amount of interest, annuities, royalties, or rents included by the controlling tax-exempt parent organization is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling parent as taxable income from the controlled for-profit subsidiary as the "excess taxable income" of the controlled subsidiary bears the greater of the following:

(1) the taxable income of the controlled subsidiary, or

(2) the excess taxable income of the controlled subsidiary.

The excess taxable income is the excess of the controlled subsidiary's taxable income over the amount of such taxable income which,

if derived directly by the controlling organization, would be subject to UBIT.

Example 2: A, an exempt museum described in §501(c)(3), owns all the stock of M, a nonexempt subsidiary. During 1992, M leases office space for tour programs and gift shop from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from tour programs, and $350,000 from the operation of the gift shop which is a business unrelated to A's exempt purpose. A's deductions for 1992 with respect to the leased property are $4,000 for the office space and $16,000 for the gift shop. Under these circumstances, $56,000 of the rent paid by M will be included by A as the net income in determining its UBIT, computed as follows:

M's taxable income (disregarding rent to A) $500,000

Less taxable from tour programs -150,000

Excess taxable income =350,000

Ratio ($350,000/$500,000) 7/10

Total rent paid to A 100,000

Total reductions ($4,000 + $16,000) 20,000

Rental income treated as gross income from

unrelated business (7/10 of $100,000) 70,000

Less deductions directly connected with

income (7/10 of $20,000) -14,000

Net rental income included by A in computing its UBIT =56,000

For discussion of this example see Reg. §1.512(b)-1(1)(3)(iii).

These rules are intended to prevent tax avoidance in situations in which a tax- exempt parent corporation could characterize payments by a for-profit subsidiary to itself as rent, interest royalties, or annuities. Those payments are generally deductible by the subsidiaries and not taxable to the exempt parent. However, with controlled for-profit subsidiaries, §512(b)(3) makes such payments taxable.

Example: A parent organization, exempt pursuant to 501(c)(4), received substantially all of its income

from parimutuel horse racing activity. The parent made its facilities available for a substantial number of civic and community activities. The parent formed a wholly-owned, taxable subsidiary. The subsidiary will engage in the for-profit keno lottery. Under this arrangement, the subsidiary will lease space from the parent organization. Accordingly, the taxable income of the subsidiary will not constitute UBIT to the parent. However, a portion of the rents derived by parent from the subsidiary will be included in the UBIT of the parent consistent with §512(b)(13).

This example is based on the factual situation presented in Private Letter Ruling 9245031 (Nov. 6, 1992.

As with all non-controlled for-profit subsidiaries, dividends paid by a controlled for- profit subsidiary to its tax-exempt parent are not deductible by the subsidiary; thus, the dividend payments to the parent organization would not be subject to UBIT.

Federal Income Taxation

Capitalization

The contribution of cash or assets to, and the issuance of stock by, a for-profit subsidiary are not taxable to the subsidiary.

For-Profit Subsidiary Operations

A for-profit subsidiary of a tax-exempt organization is taxed on its income as a regular for- profit corporation. It is taxed at regular federal and state corporate income tax rates, with the same deductions and exclusions available to all other taxable corporations.

One practice used to reduce the taxable income of a taxable subsidiary is to "drop" into the for-profit subsidiary a tax-exempt activity of the parent that generates losses. This generally permits the taxable subsidiary to deduct the losses generated by the unprofitable activity from the income generated by its profitable activities, reducing the subsidiary's tax liability. Additionally, the subsidiary may be able to use the cash method of accounting and reduce its taxable income by managing the timing of its income and deductions.

State Income Tax Treatment

As a general rule, a for-profit subsidiary is subject to state corporate income tax in the state or states in which it conducts business. Net income for state corporate income tax purposes is generally computed in the same manner as it is for federal corporate income tax purposes.

Conclusion

Whether the benefits of establishing a taxable subsidiary will outweigh the burdens will differ in each case. In general, if a tax-exempt organization is not prepared to do the detailed record keeping, cost allocation, and other administrative functions necessary to maintain the requisite financial, management and operational separation, then it should not establish a subsidiary. It is no doubt burdensome to keep separate minutes at meetings, to maintain separate financial records, and to allocate expenses. But there are significant potential benefits and opportunities to be derived from the creative use of subsidiaries.

Some organizations will have no choice. For, example, if a tax-exempt organization is carrying on a substantial unrelated business, and relies on the income from that business as a principal source of revenue, it will have no choice but to "spin off" the business into a taxable subsidiary in order for it to maintain both its income and its tax exemption.

Ultimately the question to be asked is whether the tax, legal, or practical benefits of establishing the taxable subsidiaries will serve such a useful purpose for the sponsoring tax-exempt organization that the cost and the trouble will be worthwhile. As one practitioner has cautioned "Look before you leap."

This paper was prepared from information from the following sources:

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