

But is it Legal?!

**The Do's and Don'ts of
Nonprofit Ventures**

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Overview

- Legal Issues
- Tax Issues
- Structure of Earned Income Activity
- Examples
 - Wholly Owned Taxable Subsidiary
 - Spin-Off of All Activities
 - Intellectual Property Commercialization

Legal Issues

- What is a “Nonprofit” Corporation?
 - Incorporated under a Nonprofit Corporation Act under state law
- What is a “Tax-Exempt” Corporation
 - A nonprofit corporation which also has received recognition from IRS as an organization described in Code Section 501(c)(3)

Limits on Nonprofit Corporations

- **Substantially all activities consistent with tax-exempt status**
- No private inurement
- No intermediate sanctions
- Insubstantial private benefit
- Assets to another charity on dissolution

Can Make “Profit”

- No limit on ability to make profit
- “Profit” must be retained in corporation or paid out for reasonable expenses
- No individual shareholder distributions
- If from unrelated activity
 - Taxable as “unrelated business taxable income”

Income

- Income Related to Exempt Purposes
 - No limit on amount of revenue
- Income from Unrelated Activities
 - Produces Unrelated Business Taxable Income (UBTI)
 - If less than 10-15%, ok
 - If more, consider moving activity outside of entity

Unrelated Business Taxable Income

- Test – Substantially related to exempt purposes
- How is activity related to reason for exemption?
 - How does sale of an item promote specific purpose of the organization?
 - How does performing a service promote the purposes of the organization?
- Use of funds not relevant
 - Look at activity itself

Unrelated Business Taxable Income

- Sales of Items
 - Primary purpose for the production and sale of each item
 - Does not matter if in competition with for-profit businesses
 - Ex. Off-site location enhance public understanding of museum collection
 - Related to specific purposes of organization

Unrelated Business Taxable Income

Performance of Services:

- Service activity itself must further organization's purposes
- Providing services to other nonprofits not necessarily related
 - at or below cost if unaffiliated nonprofit – could be charitable if donative intent
 - affiliated nonprofits may be ok

Exceptions to UBTI

- Passive Income Excepted
 - Dividends
 - Rents from real property, royalties, and interest from uncontrolled entities
 - “Control” = 50% ownership or control
 - Note, if “debt financed property”, UBTI is created in proportion to the amount
 - Any payment from S-Corp is UBTI
 - Activity of Partnership itself flows through to partners
 - If unrelated, partnership income UBTI
 - Single Member LLC – If no corporate election, activities considered those of its exempt entity single member

Exceptions to UBTI

- Capital Gains Excepted
 - As long as not held for sale in ordinary course
- Thrift shop
- Work performed substantially by volunteers
- One-time or intermittent activities
- Qualified sponsorship payments

Private Inurement

- Prohibits “Insider” From Siphoning Off Assets for Personal Use
- Insider
 - Directors, Officers, Key Employees

Private Inurement

- Loan
- Furnishing Goods, Services, Space
- Compensation
- Sale, Exchange, Lease of Property
- Any Transfer of Assets
- Percentage of Revenue Payments

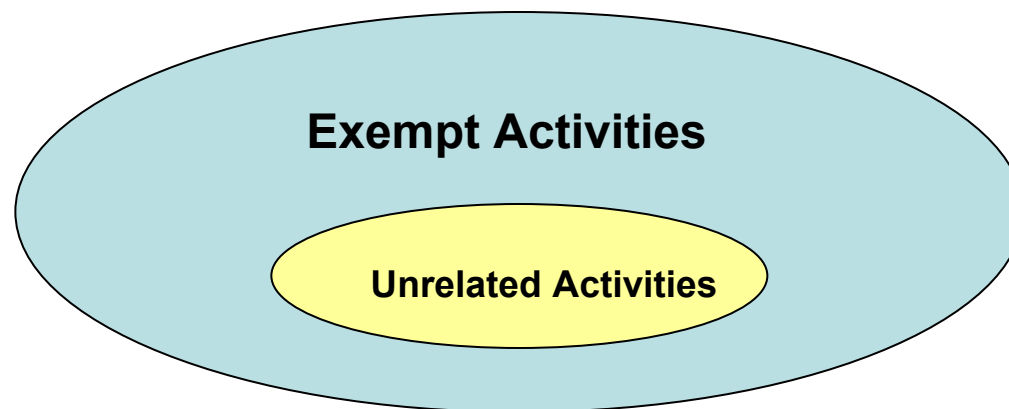
Structure of Earned Income Activity

- New or Expanded Activity **Inside**
- New or Expanded Activity **In New Entity**
- Joint Venture **Related** to Exempt Purposes
- Joint Venture **Unrelated** to Exempt Purposes

Structure

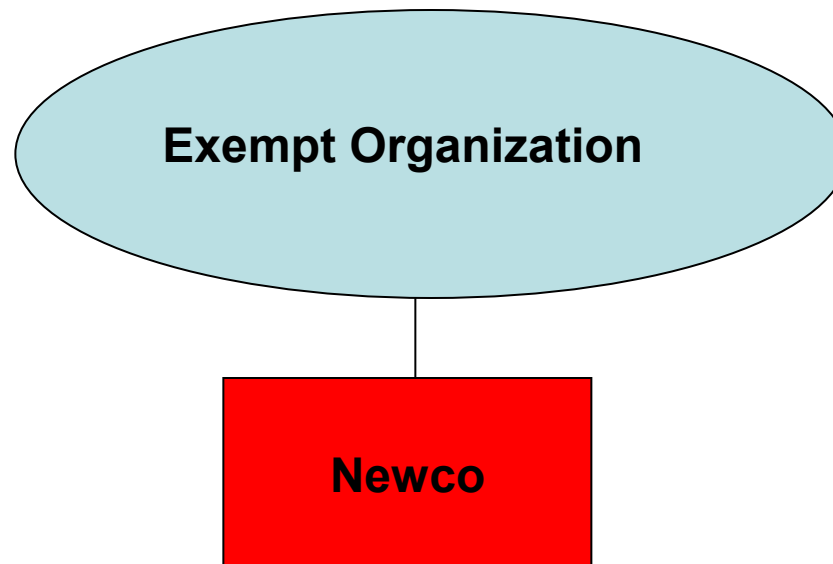
1. Within Exempt

- If related – no issues
- If unrelated - track unrelated revenue and activities



Structure

2. Outside of Exempt - Put Into Controlled Taxable Subsidiary
 - Avoids risk to exempt status
 - No tracking of “unrelated” activity necessary



Taxable Subsidiaries

- Why?
 - Maximize revenue without jeopardizing exempt status
 - Perception – “for-profit” activity
 - Reality – additional sources of financing
 - Operational efficiencies
 - Insulate charitable assets from claims
 - Segregation of operations
 - Possible joint venture vehicle

UBTI and Taxable Subsidiaries

- Income to parent – whether UBTI depends on legal form of subsidiary
 - C-Corp: dividends excepted from UBTI
 - S-Corp: any payment (even dividends) UBTI
 - Partnership or LLC: activity of partnership attributed to partners
 - If unrelated, partnership income UBTI
 - Single Member LLC: if no corporate election, considered same as exempt entity for tax

Taxable Subsidiaries

Operational Considerations

- **Respect corporate formalities**
 - Separate board and officers (can overlap)
 - Separate financials and accounts
- **Arms' length financial transactions**
 - Subsidiary must pay for services & facilities
- **Other considerations**
 - Mission
 - Governing structure - who runs it?
 - \$\$ - Capitalization

Taxable Subsidiaries

- Other Legal Considerations
 - UBTI & tax-exempt status of parent
 - State corporate law - choice of form
 - Tax-exempt bonds
 - Property tax
 - Employee benefits
 - Real estate
 - Intermediate sanctions

Related Organizations – 990 Reporting

- Required disclosures of compensation paid to and relationships between the exempt organization, its officers, directors, key employees and highly compensated (more than \$50,000) independent contractors and “related organizations”
 - Line 77b – disclose those “related to each other through family or business relationships”
 - Line 77c – disclose those who “receive compensation from any other organization, whether tax exempt or taxable that are ‘related’ to the organization.”

Related Organizations – 990 Reporting

- A “related organization” is a tax exempt or taxable organization related to the reporting exempt:
 - Relationship 1: One organization owns or controls the other organization.
 - Relationship 2: The same persons own or control both organizations.
 - Relationship 3: The organizations are supporting and supported organizations under 509(a)(3).
 - Relationship 4: The organizations use a common paymaster.
 - Relationship 5: The other organization pays part of the compensation that the organization would otherwise be contractually obligated to pay.
 - Relationship 7: The organizations conduct joint programs or share facilities or employees.

[Note – currently the instructions also include a Relationship 6 and 8, but further IRS guidance has stated those can be disregarded]

Related Organizations – 990 Reporting

- **Exceptions:**
 - Bank. Related only because they are both controlled by a common trustee that is a bank or financial institution
 - Common Independent Contractor. If an independent contractor does not exercise substantial influence over either of the organizations. Does not apply to CEO, COO, CFO-type services
 - Volunteer. If Relationship 2 is met only because the same individuals control both the tax-exempt organization and a for-profit organization that is not owned or controlled directly by one or more tax-exempt organizations, and one of the Relationships described in 1 or 3-6 are met, no reporting of volunteers

Related Organizations – 990 Reporting

- If there is Relationship 1-5, the organization must provide:
 - name of the individual
 - the name and EIN of each related organization that provided compensation
 - a description of the relationship, and
 - the amount of compensation each related organization provided

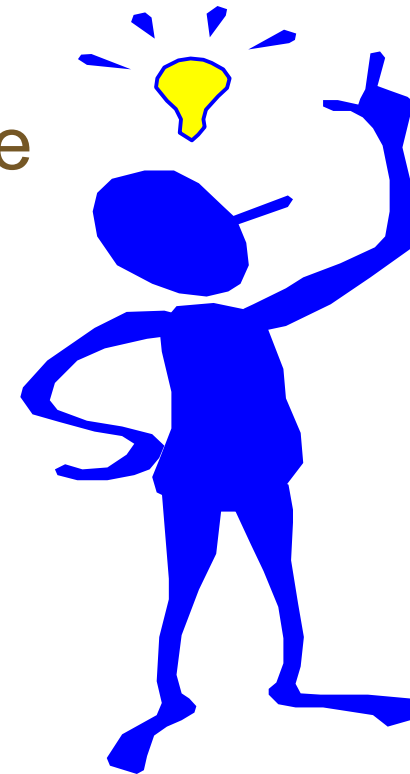
Related Organizations – 990 Reporting

- If the organizations are related only by Relationship 7 or if the volunteer exception applies:
 - organization must report all of the above other than the compensation paid by the related organization

Hypothetical #1 – Management Services, Inc.

The Idea: Provide Management Services to Unrelated Facilities

- Efficiencies of Scale
- Excess Capacity
- Maximize Revenue



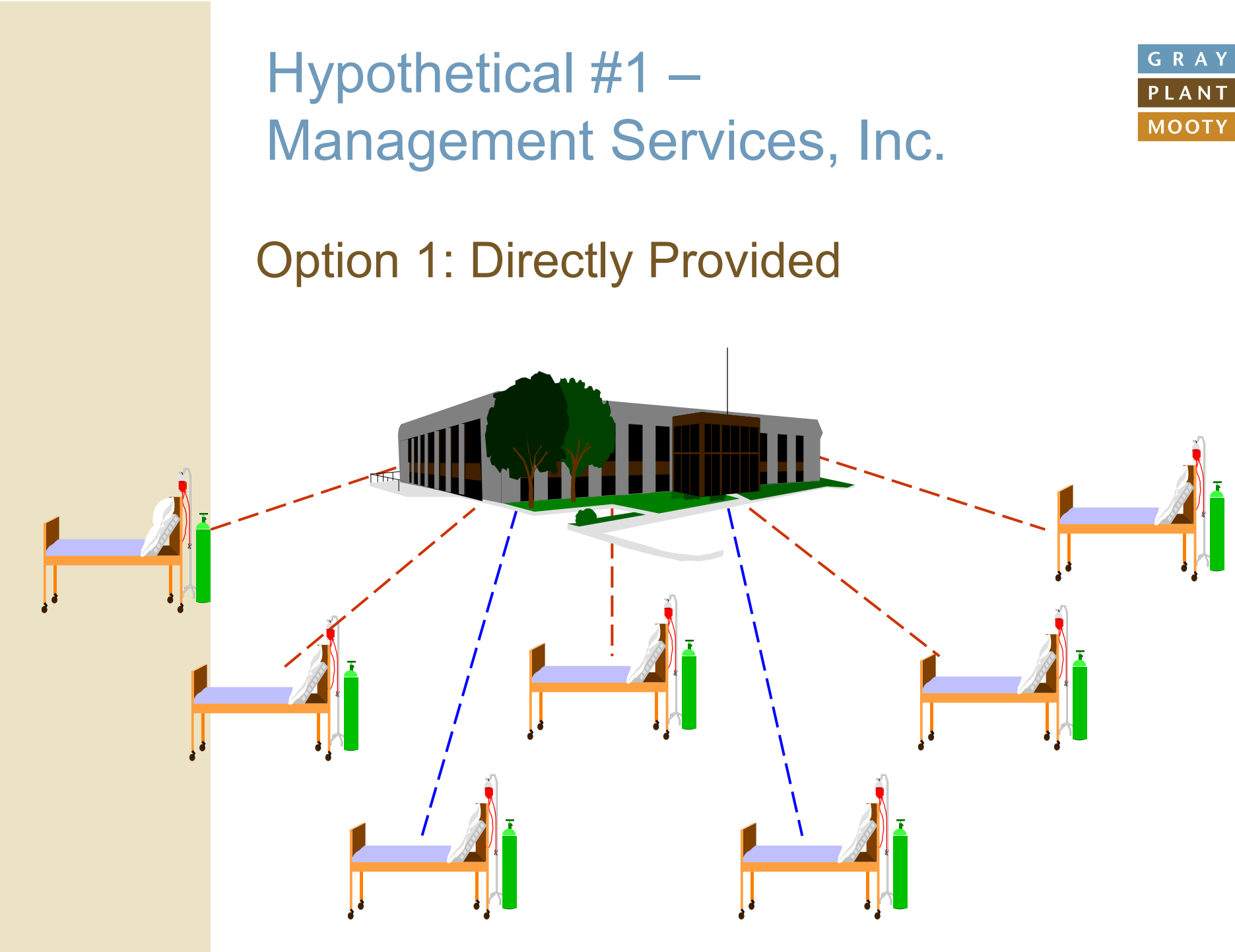
Hypothetical #1 – Management Services, Inc.

- Define business objective:
 - Maximize revenue
 - Liability shield
 - Operational efficiencies
 - Collaborative vehicle

Hypothetical #1 – Management Services, Inc.



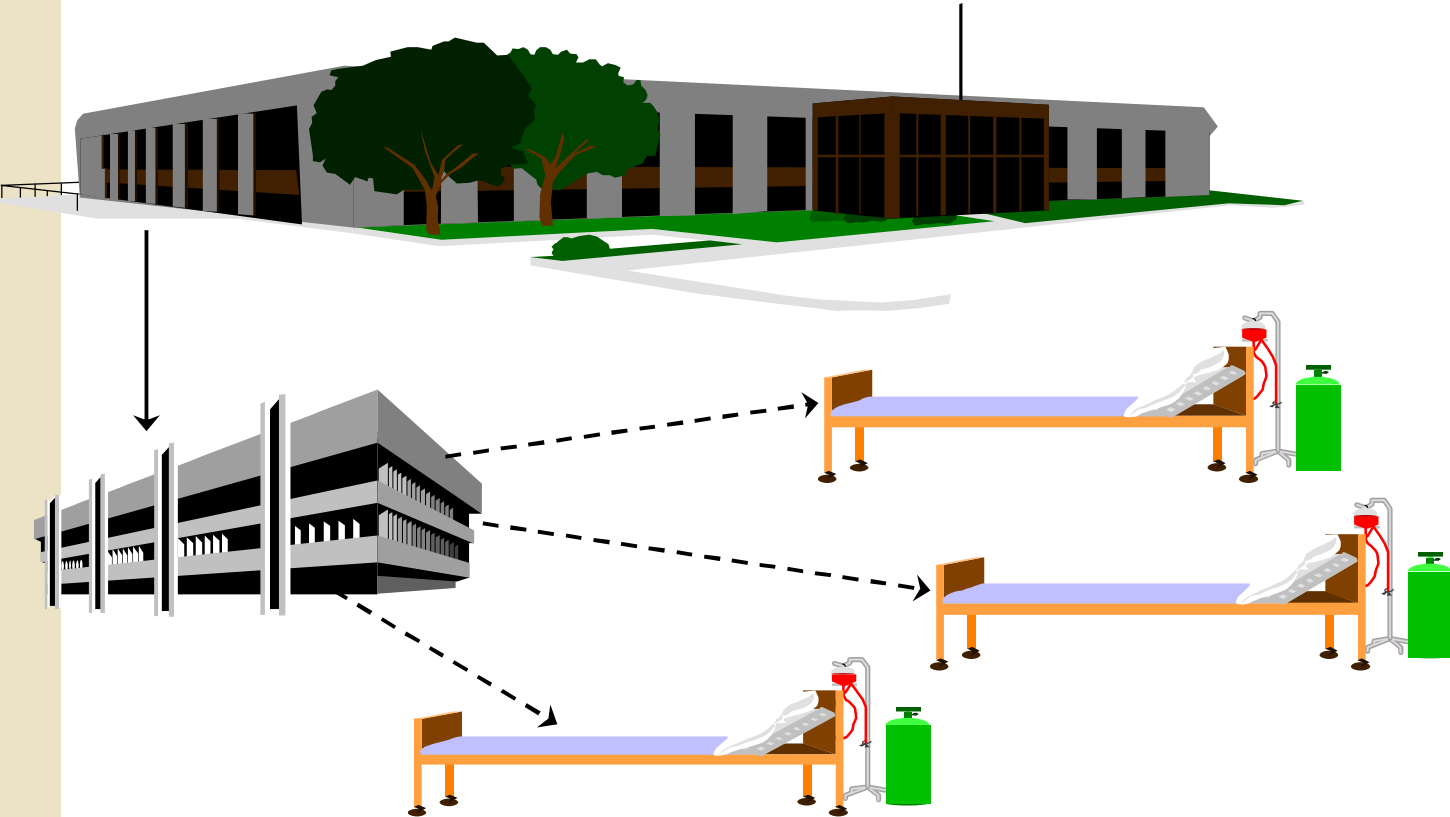
Option 1: Directly Provided



Hypothetical #1 – Management Services, Inc.



Option 2: Through Subsidiary



Hypothetical #1 – Management Services, Inc.

Option 2: Subsidiary

- Corporate Form
 - C Corp.
 - Parent owns 100% stock
- Governance
 - Parent appoints 100% board
 - Overlapping board with business community reps
 - Different corporate officers
 - Separate board meetings

Hypothetical #1 – Management Services, Inc.

Option 2: Subsidiary

- Capitalization
 - UBTI \$
 - Charitable assets
 - Loan
 - Guaranty
 - Third Party Financing
- Employees
 - All management service employees move to subsidiary
 - Employee benefit plan issues

Hypothetical #1 – Management Services, Inc.

Option 2: Subsidiary

- Facilities
 - Lease from parent
 - Okay if no bonds outstanding
 - property tax exemption
 - Rent UBI to parent
 - FMV
 - Lease from 3rd party
 - No revenue to parent
 - Equipment purchased from parent
 - FMV
 - Not UBTI

Hypothetical #1 – Management Services, Inc.



Option 2: Subsidiary

- Revenue
 - Dividends to parent tax-free
 - Rent = UBTI because controlled sub
 - Interest on loan = UBTI because controlled sub
 - Parent pays subsidiary for management services to related entitled--can be at cost

Hypothetical #1 – Management Services, Inc.

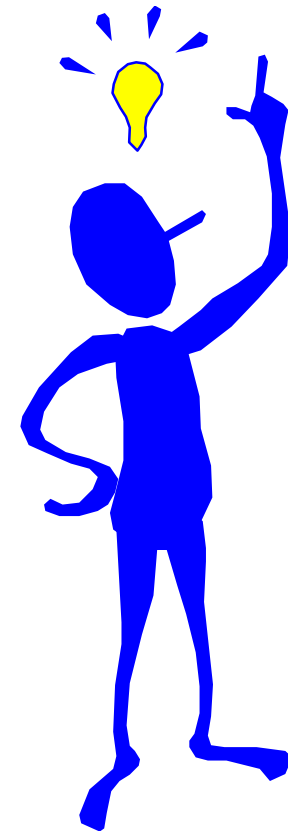


Did We Accomplish Business Objective?

- Maximize efficiencies
 - subsidiary provides all management services
- Maximize revenue
- Liability Protection
 - Separate governance
- Operational Separateness
 - No joint employees
 - 3rd party lease

Hypothetical #2 – Job Training, Inc.

- Tax-exempt organization provides job training for low income individuals in an urban area in need of redevelopment
- Idea is to expand the scope of the business to maximize revenue
- May include hiring contract workers
 - Not necessarily meeting low-income and training criteria

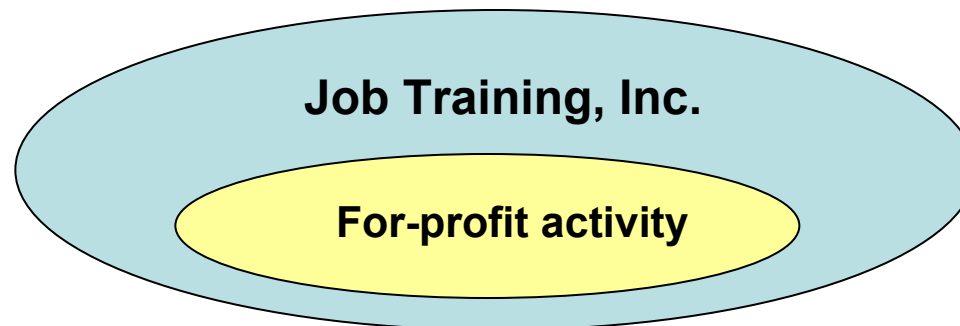


Hypothetical #2 – Job Training, Inc.

- Is Expanded Activity Related?
 - Vocational training is a charitable and educational activity, but:
 - Can be done through own business
 - Must be on scale no greater than necessary for accomplishment of exempt purposes
 - Scale in excess of need would be unrelated
 - Targeted at underserved people in need of training
 - Goods sold in substantially the same shape as produced by trainees
 - Temporary training, not permanent employment

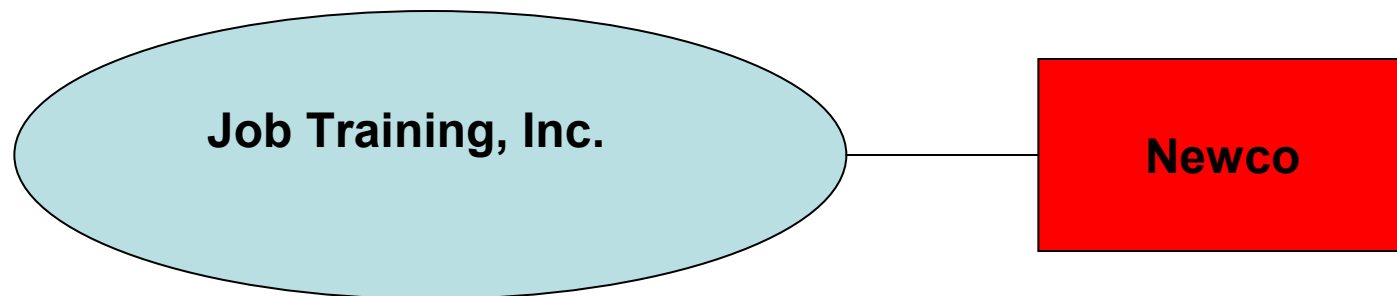
Hypothetical #2 – Job Training, Inc.

- Expansion of Activity likely makes that activity unrelated
- Option 1: Keep it within the current corporation
 - Careful tracking and accounting to track expanded activity as unrelated, but core as related
 - May be challenging to administer



Hypothetical #2 – Job Training, Inc.

- Option 2: Spin additional work into taxable subsidiary
 - Need to respect corporate formalities and not treat all as one entity
 - Best if can operationally divide the work, use of different machines, etc.
 - If not, challenging to administer

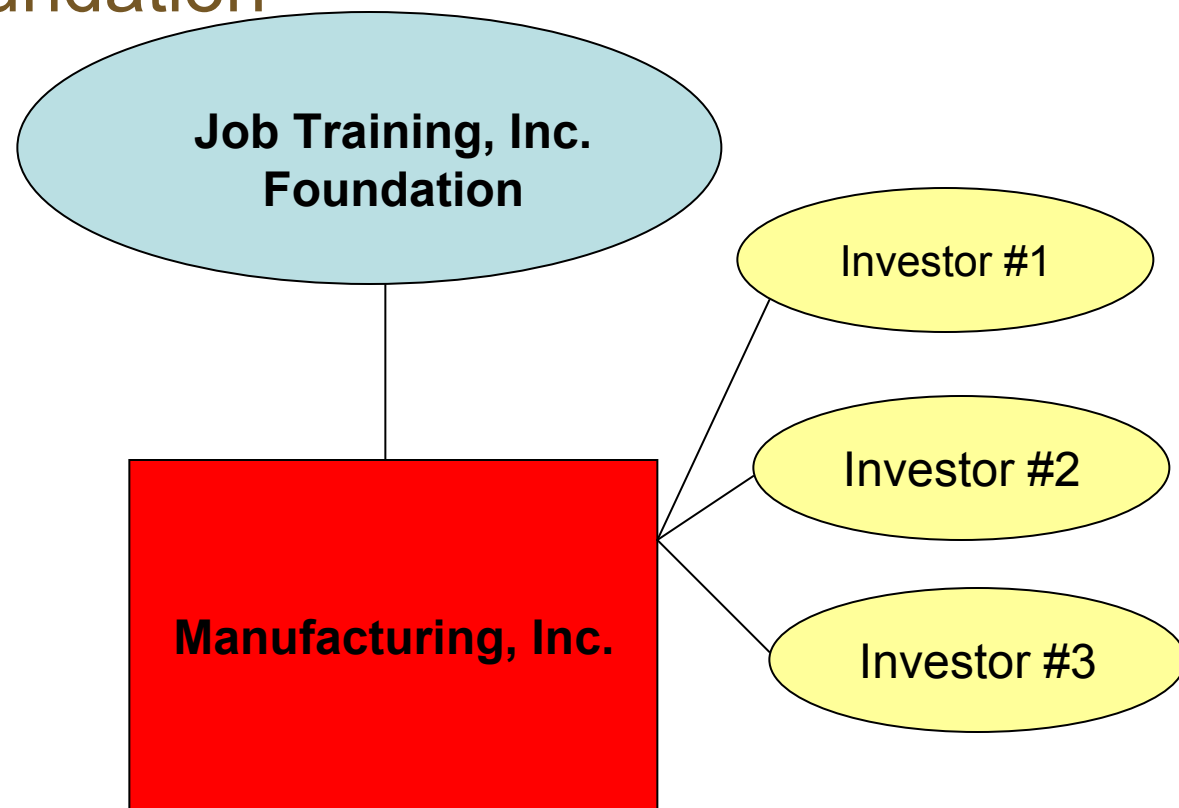


Hypothetical #2 – Job Training, Inc.

- Option 3: Put all work into taxable subsidiary
 - Retain current tax-exempt entity as a foundation that can raise money and provide educational or other programs that are supportive of the new entity
 - Perhaps don't wholly control the subsidiary to allow third-parties access to ownership to facilitate capitalization
 - If run at generally break-even, income tax ramifications might not be too bad
 - Note, lose property tax exemption and sales tax exemption
 - Lose any funding by grants

Hypothetical #2 – Job Training, Inc.

- Put all manufacturing into taxable subsidiary
- Retain current exempt organization as a foundation



Hypothetical #2 – Job Training, Inc.

- Define business objective:
 - Maximize revenue
 - Growth of business
 - Liability shield for exempt
 - Retain current employees/trainees
 - Ensure ongoing viability of business
 - Enhance social impact of the business

Hypothetical #2 – Job Training, Inc.

- Corporate Structure
 - LLC
 - Likely not a viable option because of extent of unrelated business in venture, likely entire income coming to exempt would be UBTI
 - C-corporation
 - Exempt organization holds shares on same terms as other investors
 - Could put strings on investment and transfer of assets to ensure goals are met

Hypothetical #2 – Job Training, Inc.

- Capitalization
 - Value assets and good will transferred by Job Training, Inc. into Manufacturing, Inc.
 - Other investors ownership based on capital they invest
 - Governance and ownership must be in sync
 - Profits and losses distributed based on ownership

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 - FMV
 - Not UBTI
 - Can be part of value of parent's capitalization in exchange for stock

Hypothetical #2 – Job Training, Inc.

- Advantages:
 - Can more easily attract financing for growth
- Disadvantages:
 - How to ensure original social mission is retained?
- Balance:
 - Must carefully select investors with an eye on mission
 - Can put strings on leases or other contractual relationship with Job Training, Inc.
 - Require Manufacturing, Inc. to keep X% of jobs for true trainees, or for low-income individuals, etc.

Hypothetical #3 – Midwest Medical Association

- Midwest Medical Association (“MMA”) operates as a tax-exempt trade association for physicians in the upper Midwest
- It has established protocols and quality benchmarks for care provided by member physicians
- How can they realize \$\$ on those protocols and benchmarks?



Hypothetical #3 – Midwest Medical Association

- The protocols and benchmarks are “intellectual property” of MMC
 - The IP is likely in the copyright of the materials
- Copyright
 - Protects literary works, visual arts, music, dramatic works
 - Protects the expression, not the underlying ideas
 - Rights vest upon the creation of the work (no legal registration is required)

Hypothetical #3 – Midwest Medical Association



- Compare a “trademark” which would be the MMA name and logo – and perhaps tag line
 - Signifies the source of certain goods or services
 - Rights created by use of the mark – no registration is required

Hypothetical #3 – Midwest Medical Association

- Commercializing the IP:
 - License the protocols and benchmarks to other associations
 - License them to physicians who are not members
 - License the right to use its mark on third party's good or services

Hypothetical #3 – Midwest Medical Association

- Passive royalty revenue is not UBTI
 - But no services can be provided by MMA in connection with the license
 - If services are provided, turns entire payment into UBTI
- Relatedness argument:
 - Dissemination of the protocols and benchmarks are related to MMA's exempt purposes of enhancing the profession and improving the quality of physician services
 - Likely challenging argument

Hypothetical #3 – Midwest Medical Association



- Use of logo
 - Try and make it passive royalty
 - No services can be provided
 - Not likely to be considered related activity

Questions?

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