Structuring Innovative Revenue Models for Nonprofits: For-Profits, Joint Ventures, and Social Enterprises

Tuesday, April 14, 2015, 12:30 p.m. – 2:00 p.m. ET
Venable LLP, Washington, DC

Moderator
Jeffrey S. Tenenbaum, Esq., Venable LLP

Speakers
Carrie Garber Siegrist, Esq., Associate, Venable LLP
Andrew Schulz, Esq., General Counsel, Arabella Advisors

Presentation

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June 4, 2015 – Top Trends and Traps in Nonprofit Executive Compensation

July 15, 2015 – Mental Health Issues in the Nonprofit Workplace: Questions Raised by the Germanwings Air Disaster *(details and registration available soon)*

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Agenda

- Federal Tax Exemption – A Quick Review
- For-Profit Structure Options
- Joint Ventures – Structuring Considerations
- Social Enterprise Legal Structures
- Questions

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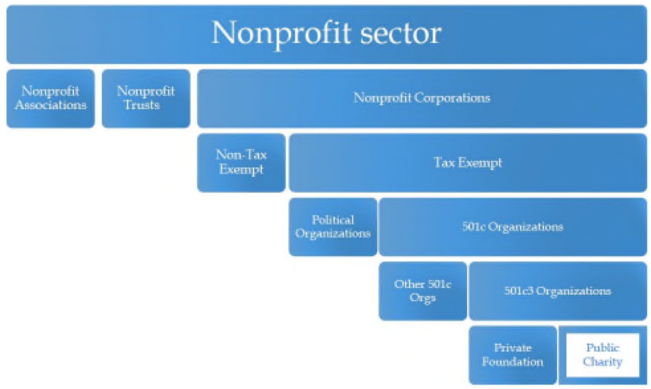
Scope of Presentation

- Public Charities



- For Another Time: Revenue Generating Activities
  – Commercial co-ventures, cause-related marketing, affinity/endorsement programs, etc.

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Federal Tax Exemption – A Quick Review

Exempt Organization Purposes

- Section 501(c)(3) tax-exempt organizations must be organized and operated ***exclusively*** for the exempt purposes described in the Code.
- §501(c)(3):
  "…religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals…"

Private Inurement/Private Benefit

- Earnings of an exempt organization may not inure to any private shareholder or individual:
  - Any person having a personal or private interest in the activities of the organization
  - Distinguish between private inurement and private benefit
- Examples:
  - Excessive compensation to insiders, greater-than-fair-market-value goods or services to members or insiders, excessive benefits to anyone
  - Paying personal expenses
  - Rent-free housing
  - Interest-free or no-obligation-to-repay loans

Commerciality – Not More Than an Insubstantial Amount

- Proper for an exempt organization to conduct a commercial trade or business if it is in furtherance of its exempt purposes and the primary purpose is not to engage in an unrelated trade or business
- Generally, the IRS will revoke or deny exempt status to otherwise qualifying organizations where their operation of a commercial trade or business is unrelated to the organization's purposes and it will require substantial attention from the organization

A Brief History

- Prior to 1950, exempt organizations owned and operated unrelated businesses on a tax-free basis
- *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (1951):
  - NYU Law School owned a subsidiary called the Mueller Macaroni Company
  - Paid no income taxes
  - Exempt organizations no longer allowed to conduct tax-free unrelated business activities; unfair competition

Unrelated Business Income Tax

- Unrelated business taxable income tax is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business:
  – Trade or business
  – Not substantially related
  – Regularly carried on

Income Excluded from UBTI

- Income that is specifically excluded from UBIT:
  – Interest income
  – Royalty income
  – Certain research income
  – Conference and trade show revenue
  – Qualified sponsorship income
  – Certain bingo games
  – Debt management plan services
  – Renting mailing list to another charitable organization

Trade or Business

- Not an unrelated trade or business if:
  - Volunteer labor
  - Convenience of members, students, patients, officers, or employees
  - Donated merchandise
  - Low-cost articles

Substantially Related

- Relevant factor here: Is the trade or business related to your exempt organization’s purposes?
  - Need to generate revenue is not enough
- Focus: Unfair competitive advantage to exempt organization?

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For-Profit Structure Options

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Subsidiaries

- Nonprofit organization may isolate profitable non-exempt-purpose activity into a for-profit subsidiary:
  - Preserves exempt status in cases where unrelated activities become excessive in comparison to exempt-purpose activities
- Relatively simply to establish assuming the activity is easily separated from the organization's other activities
- Nonprofit Affiliates? Permissible:
  - A nonprofit may separate some of its activities into one or more nonprofit, tax-exempt, controlled affiliates (for tax, liability protection, and/or other reasons).

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Legal Structures

- Traditional for-profit legal structures:
  - S and C Corporations
  - LLC/SMLLC (joint ventures)
  - Co-Op
- Social enterprise legal structures:
  - Benefit corporations, L3Cs, social purpose corporations, etc.

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Use of Separate Entities

- Benefits beyond simply minimizing tax liability:
  - Tort and contract liability
  - Isolate unrelated business income
  - Conduct for-profit or dissimilar nonprofit activities in a separate entity for a variety of reasons
- Must adequately capitalize the subsidiary

Separation of Operations

- Not just separation in corporate formation
- Entity separation requires:
  - Separate governing bodies (including distinct meetings and minutes)
  - Avoid commingling assets/separate bank accounts
  - Arm's length relationship between entities
- Other considerations:
  - Shared resources: employees, office space
  - Intellectual property (fair market value)
- Failure – Attribution of activities to parent (for tax, liability, and other purposes)

Considerations

- Administrative costs/state law compliance
- Prudent investment considerations
- Securities laws
- Exit strategy

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Joint Ventures – Structuring Considerations

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Joint Ventures

- An arrangement in which two or more entities (for example, an exempt entity and a for-profit entity) come together to jointly undertake an enterprise in which they will share the distribution of profits and losses from the enterprise:
  - Considered a partnership for federal tax purposes
- Why?
  - Raise capital
  - New Services
  - Allocate risk
  - Combine diverse areas of expertise

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Structures Available

- Joint venture may take a variety of legal structures:
  - General partnership
  - Limited partnership
  - LLC/SMLLC
  - Business corporation (including new social enterprise structures)
- Alternatively, the joint venture may exist as a contractual relationship:
  - Joint operating agreement
  - Service or management contract
  - Lease arrangements

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Key Considerations: Private Benefit

- Private benefit inherently conferred to participating partners:
  - Permits if not an impermissible amount and if the private benefit, both quantitatively and qualitatively, does not outweigh the public benefit of the activity
  - Any amount that is more than incidental may jeopardize exempt status
- Generally, if the exempt organization retains control over the venture's activities, then no jeopardy to the organization's exempt status:
  - Depends on the scope of the activities conducted

Exercising Control

- Key importance to IRS and courts:
  - Exempt organization must exercise majority control over the tax-exempt functions of the venture
- Evaluating joint venture for private benefit:
  - Furtherance of exempt purposes? On paper, in practice (responsibilities of exempt organization?)
  - Governance of the joint venture
  - Length of agreement
  - Distribution of earnings between parties

Considerations

- Explore other options where exempt organization is operating a profitable business:
  - Is the business furthering an exempt purpose?
    - Providing employment and training opportunities in restaurant
  - Does the organization's role need to be active?
- All transactions with exempt organizations should be:
  - Fair market value
  - Due diligence
  - Properly documented

Unrelated Business Income

- Related or unrelated activities?
  - If yes, no UBTI
  - If excluded under one or more of the UBI exclusions, no UBTI
  - If no, then is the activity substantial?
- Return on investment in joint venture: Will revenue be treated as unrelated business income?
  - Structure venture so that exempt mission is preserved
  - All about control

Social Enterprise Legal Structures

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The Social Enterprise Movement

- The idea: Using the power of business to solve societal and environmental problems:
  - Incorporating missions into corporate DNA
  - Social enterprises use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas
- Social entrepreneurs utilize for-profit and nonprofit legal structures:
  - We will outline the types of “hybrid” legal structures that are often described as “social enterprise” structures

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A Brief History

- Some argue that social enterprises actually arrived with the operation of organizations like the Hull House (1884) and Goodwill Industries (1895)
- Modern-day versions entered the scene in the 1970s and 1980s:
  - Recent explosion of popularity
- Social enterprise missions – anything:
  - Including workforce development, housing, community and economic development, education, and health

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Supporting Social Entrepreneurs

- ACCION
- Ashoka Innovators for the Public
- Echoing Green
- Grameen Foundation
- Mercy Corps
- Omidyar Network
- Schwab Foundation for Social Entrepreneurship
- Social Enterprise Alliance
- The Skoll Foundation

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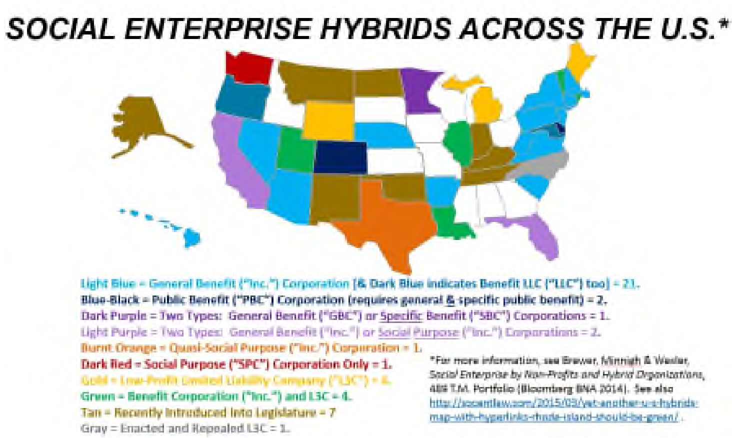
Geographic Scope of Structure Options



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Low-Profit Limited Liability Company (L3C)

- An L3C must be organized and operated as follows:
  - significantly furthers one or more charitable or educational [IRC § 501(c)(3)] exempt purposes;
  - would not have been formed but for its relationship to the accomplishment of such purposes;
  - no significant purpose can be the production of income or the appreciation of property.
- No purpose can be to accomplish one or more political or legislative purposes
- Created to facilitate program-related investments by private foundations

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Use of L3Cs

- Regulated as a for-profit, not a nonprofit
- For-profit subsidiaries of a charity (e.g., developing surplus real estate)
- Disregarded or exempt subsidiary of a charity
- Models that combine private, philanthropic and government capital (public-private partnerships)
- Program-related investments (but IRS says no advantage)

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Benefit Corporations

- New structure to require directors and officers to consider non-financial interests and to protect directors and officers if they sacrifice shareholder wealth in doing so:
  - Baked-in corporate purpose
  - Fiduciary duty redefinition
  - Annual reports

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Purpose of Benefit Corporations

- General “public benefit” is defined as:
  - A material positive impact on society and the environment,
  - taken as a whole,
  - as assessed against a third party standard

- May add a “specific public benefit” (but not in derogation of general benefit) specific to the entity's goals, including:
  - Improving health
  - Promoting economic opportunity
  - Carbon neutral operations
  - 100% local sourcing

B Corp – A Certification

- A "B Corp" is an entity that has received a certification from B Lab:
  - B Lab: "The Non-Profit Behind B Corps"
- A "B Corp" is not (always) a benefit corporation:
  - Multiple reasons to become a certified B Corp
  - Certification Process
- Examples:
  - Local: Arabella Advisors, Raffa, Busboys & Poets
  - National: King Arthur Flour, Patagonia, Greyston Bakery, Klean Kanteen, Ben and Jerry's, Dansko, The Honest Company

Benefit Corporations - Variation

- Earliest adopting states tended to follow the B Lab model Benefit Corporation Act
- 2013: Delaware and Colorado adopted a slightly different approach:
  - Specific benefit
  - Third-party standard
  - Annual benefit report

Social Purpose Corporations

- Social Purpose Corporations exist in:
  - California (Formerly called Flexible Purpose Corporation)
  - Washington
  - Florida
  - Minnesota (although called a “specific benefit corporation” or “SBC”)
- The social purpose can be broadly or narrowly defined, and/or could be a general benefit purpose

Using Social Enterprise Structures

- For profit subsidiaries of 501(c)(3) organizations:
  - Service based nonprofit that provides no-cost services to its nonprofit clients and under the benefit corporation provides at-cost services
- Social enterprises financed by mission-oriented investors/founders:
  - Product companies with founders who merge mission and business
- For-profit with nonprofit mission:
  - Service provider with a triple bottom line (people, planet, profit) serving companies and nonprofits that themselves have a social mission

Considerations

- Investor Confusion
- Additional corporate documentation required
- Conversion of a large entity
- Marketing strategy
- Management ability to consider all stakeholders
- Legal risks:
  - No case law
  - Unnecessary addition to corporate statutes?
- No IRS tax-exemption recognition for these structures

Questions

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Speaker Biographies

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INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

Financial Services

Consumer Financial Protection Bureau Task Force

GOVERNMENT EXPERIENCE

Legislative Aide, United States House of Representatives

BAR ADMISSIONS

District of Columbia

Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is a highly accomplished author, lecturer, and commentator on nonprofit legal matters. Based in the firm's Washington, DC office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting charities, foundations, trade and professional associations, think tanks, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media. He also has served as an expert witness in several court cases on nonprofit legal issues.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, and was an inaugural (2004) recipient of the *Washington Business Journal*'s Top Washington Lawyers Award. He was one of only seven "Leading Lawyers" in the Not-for-Profit category in the prestigious 2012 *Legal 500* rankings, one of only eight in the 2013 rankings, and one of only nine in the 2014 rankings. Mr. Tenenbaum was recognized in 2013 as a Top Rated Lawyer in Tax Law by *The American Lawyer* and *Corporate Counsel*. He was the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. Mr. Tenenbaum was listed in the 2012-15 editions of *The Best Lawyers in America* for Non-Profit/Charities Law, and was selected for inclusion in the 2014 edition of *Washington DC Super Lawyers* in the Nonprofit Organizations category. In 2011, he was named as one of Washington, DC's "Legal Elite" by *SmartCEO Magazine*. He was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. Mr. Tenenbaum started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill as a legislative assistant.

REPRESENTATIVE CLIENTS

AARP
Air Conditioning Contractors of America
Airlines for America
American Academy of Physician Assistants
American Alliance of Museums
American Association for the Advancement of Science
American Bar Association
American Bureau of Shipping
American Cancer Society
American College of Radiology
American Friends of Yahad in Unum
American Institute of Architects
American Institute of Certified Public Accountants

EDUCATION

J.D., Catholic University of America, Columbus School of Law, 1996

B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS

American Society of Association Executives

New York Society of Association Executives

American Society for Microbiology
American Society of Anesthesiologists
American Society of Association Executives
America's Health Insurance Plans
Association for Healthcare Philanthropy
Association for Talent Development
Association of Clinical Research Professionals
Association of Corporate Counsel
Association of Fundraising Professionals
Association of Global Automakers
Association of Private Sector Colleges and Universities
Auto Care Association
Biotechnology Industry Organization
Brookings Institution
Carbon War Room
The College Board
CompTIA
Council on Foundations
CropLife America
Cruise Lines International Association
Design-Build Institute of America
Endocrine Society
Ethics Resource Center
Foundation for the Malcolm Baldrige National Quality Award
Gerontological Society of America
Global Impact
Goodwill Industries International
Graduate Management Admission Council
Habitat for Humanity International
Homeownership Preservation Foundation
Human Rights Campaign
Independent Insurance Agents and Brokers of America
Institute of International Education
International Association of Fire Chiefs
International Sleep Products Association
Jazz at Lincoln Center
LeadingAge
Lincoln Center for the Performing Arts
Lions Club International
March of Dimes
ment'or BKB Foundation
Money Management International
National Association for the Education of Young Children
National Association of Chain Drug Stores
National Association of College and University Attorneys
National Association of Manufacturers
National Association of Music Merchants
National Athletic Trainers' Association
National Board of Medical Examiners
National Coalition for Cancer Survivorship
National Council of Architectural Registration Boards
National Defense Industrial Association
National Fallen Firefighters Foundation
National Fish and Wildlife Foundation
National Propane Gas Association
National Quality Forum
National Retail Federation
National Student Clearinghouse
The Nature Conservancy
NeighborWorks America
Peterson Institute for International Economics
Professional Liability Underwriting Society
Project Management Institute
Public Health Accreditation Board
Public Relations Society of America
Recording Industry Association of America

Romance Writers of America
Telecommunications Industry Association
Trust for Architectural Easements
The Tyra Banks TZONE Foundation
U.S. Chamber of Commerce
United Nations High Commissioner for Refugees
United States Tennis Association
University of California
Volunteers of America
Water Environment Federation

HONORS

Recognized as "Leading Lawyer" in *Legal 500*, Not-For-Profit, 2012-14

Listed in *The Best Lawyers in America* for Non-Profit/Charities Law, Washington, DC (Woodward/White, Inc.), 2012-15

Selected for inclusion in *Washington DC Super Lawyers*, Nonprofit Organizations, 2014

Served as member of the selection panel for the inaugural *CEO Update* Association Leadership Awards, 2014

Recognized as a Top Rated Lawyer in Taxation Law in *The American Lawyer* and *Corporate Counsel*, 2013

Washington DC's Legal Elite, *SmartCEO Magazine*, 2011

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

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Listed in *Who's Who in American Law* and *Who's Who in America*, 2005-present editions

ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, now in its second edition, published by the American Society of Association Executives. He also is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. In addition, he is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. Mr. Tenenbaum is a frequent author on nonprofit legal topics, having written or co-written more than 700 articles.

SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer on nonprofit legal topics, having delivered over 700 speaking presentations. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *NBC News*, *The New York Times*, *The Wall Street Journal*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *ESPN.com*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine, The Chronicle of Philanthropy, The NonProfit Times* and other periodicals. He also has been interviewed on nonprofit legal topics on Fox 5 television's (Washington, DC) morning news program, Voice of America Business Radio, Nonprofit Spark Radio, and The Inner Loop Radio.

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Tax-Exempt Organizations

Political Law

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INDUSTRIES

Nonprofit Organizations and Associations

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J.D., *cum laude*, American University, Washington College of Law, 2010

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Carrie Garber Siegrist is an associate in Venable's Nonprofit Organizations and Political Law Practice Groups in Washington, DC. Ms. Siegrist counsels nonprofits, including public charities, private foundations, trade and professional associations, and other nonprofits, on a variety of tax, governance, political and lobbying, transactional, and general corporate matters.

Ms. Siegrist's practice includes a broad range of complex legal and compliance issues for nonprofits at any stage – from start-up to close – including corporate, tax and tax exemption, fundraising and charitable solicitation regulation compliance, and contractual matters. She has experience advising on applying for recognition of and maintaining tax exempt status, implementing corporate governance policies and procedures, structuring unrelated business activities, conducting international operations, and fundraising and promotions regulation compliance. Ms. Siegrist maintains an interest in the evolving area of social enterprise law and specifically regarding the new legal structures such as benefit corporations.

Prior to joining Venable, Ms. Siegrist was the Senior Program Officer with the Lex Mundi Pro Bono Foundation, where she utilized a network of lawyers to provide critical *pro bono* legal services to the world's leading nonprofits and social entrepreneurs. At the Foundation, she also managed the strategic operations of LawForChange.org. Ms. Siegrist also served as Counsel with the Public International Law and Policy Group, a public charity, where she managed the operations of U.S. Government-funded projects in Nepal, Kenya, Uganda, Tanzania and Bosnia.

Previously, Ms. Siegrist co-founded a non-profit organization, Cambodia's Children Education Fund, which provided educational opportunities for impoverished and orphaned Cambodian students. Ms. Siegrist also taught fifth grade with Teach for America in New York City.

LEGAL TEACHING

Ms. Siegrist adjunct teaches the course Leading and Counseling Nonprofit Organizations at the American University Washington College of Law.

ACTIVITIES

Ms. Siegrist is an active member of the nonprofit community who has co-founded a nonprofit organization, served on nonprofit boards and provided significant *pro bono* contributions to a variety of nonprofit organizations and their leaders regarding their legal compliance and obligations.

United Nations Committee Against Torture Project

M.S.Ed., Bank Street College of Education, 2007

B.A., Bates College, 2005

MEMBERSHIPS

American Bar Association Taxation Section, Exempt Organizations Committee

American Bar Association Business Law Section, Nonprofit Organizations Committee

SPEAKING ENGAGEMENTS

Ms. Siegrist is a frequent lecturer on tax-exempt organizations, corporate governance, and social enterprise legal topics, including legal structures and qualifying for recognition of and maintaining tax-exempt status.

- April 26, 2015, "Scholarships: Unique Challenges and Issues" at the Council on Foundations' 2015 Annual Meeting
- April 15, 2015, Structuring Innovative Revenue Models for Nonprofits: For-Profits, Joint Ventures, and Social Enterprises

ANDREW SCHULZ
General Counsel

As general counsel, Andrew Schulz manages Arabella's legal affairs, provides legal advice to the firm's leadership and staff, and ensures that the foundations and independent nonprofits Arabella helps to manage, such as the New Venture Fund, are in compliance with the law. He has expertise in a broad cross-section of tax, legislative, and regulatory issues, including tax-exempt organizations, charitable giving, fiscal sponsorship, lobbying, political activity, and international grant making.

Prior to joining Arabella, Andrew was executive vice president at Foundation Source where he provided executive leadership and implemented the chief executive officer's vision of building a community of grant makers, philanthropists, advisors, and others who serve private foundations. He was Foundation Source's voice within policy, legislative and regulatory circles and cultivated relationships with attorneys to expand Foundation Source's presence within the legal community.

Previously, Andrew was vice president of legal and government relations for the Council on Foundations, where he headed its public policy department, providing oversight of the council's legislative initiatives. He also served as in-house counsel, educating council members on legal issues that affected their operations, administering the council's governance functions, serving as the lead staff member on matters of ethics and best practices, and ensuring organizational compliance with state, local, and federal laws. Andrew is nationally recognized as an authority on private foundations and has been a frequent speaker at conferences related to philanthropy, including for the University of Texas School of Law, the NYU Center for Philanthropy and Fundraising, the Heckerling Institute on Estate Planning, Philanthropy Roundtable, the Council of Michigan Foundations, the Southeastern Council on Foundations, Philanthropy Southwest, and many others.

He is a graduate of the College of Wooster and has a JD from the George Washington University Law School. He is a member of the Maryland and District of Columbia bars.

Additional Information

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April 8, 2015

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Venable's Nonprofit Organizations Practice is pleased to share below these articles, presentations, and recorded webinars by our attorneys. These quarterly digests are a collection of our most interesting and useful materials to help your organization as you tackle the always-challenging array of legal issues facing nonprofits. In case you missed it, please **click here** for the Collection of Venable's Nonprofit Legal Articles, Presentations, and Recordings from the Fourth Quarter of 2014.

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Boycotts and Association Meetings: Managing Your Organization's Risk (Article)

Federal Grant and Contract News for Nonprofits - March 2015 (Article)

What Hillary Clinton's Use of BYOD Teaches Us about the Protection of Nonprofits' Trade Secrets (Article)

How to Avoid Hiring Mistakes: Oops! Too Late; Now What? (Article)

Top Ten Legal Checklist: Keys to Strengthening Your Nonprofit Organization (Presentation) (Recorded Webinar)

U.S. Supreme Court Issues Long-Awaited Association Ruling on Industries' and Professions' Ability to Challenge Their Federal Regulators' Actions (Article)

***Association TRENDS* 2015 Legal Review** (Article)

DC Nonprofits Subject to New Notice Requirement and Bigger Penalties under New Wage Theft Prevention Act (Article)

Federal Grant and Contract News for Nonprofits - February 2015 (Article)

U.S. Supreme Court Decision in *North Carolina Dental Board* Narrows Scope of State-Action Antitrust Immunity for State Boards (Article)

A Primer on Detecting, Preventing, and Investigating Nonprofit Fraud, Embezzlement, and Charitable Diversion (Article)

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A Primer on Detecting, Preventing, and Investigating Nonprofit Fraud, Embezzlement, and Charitable Diversion

Increasing Scrutiny of Nonprofit Fraud, Embezzlement, and Charitable Diversion

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Media Coverage and Recent Examples
On October 26, 2013, *The Washington Post* reported that from 2008 through 2012, more than 1,000 nonprofit organizations disclosed hundreds of millions of dollars in losses attributed to theft, fraud, embezzlement, and other unauthorized uses of organizational funds and assets. According to a study cited by the *Post*, nonprofits and religious organizations suffer one-sixth of all major embezzlements—second only to the financial services industry. While the numbers are shocking, the underlying reasons for nonprofit susceptibility to fraud and embezzlement are easy to understand. Many nonprofits begin as under-resourced organizations with a focus on mission rather than strong administrative practices. As organizations established for public benefit, nonprofits assume the people who work for them, especially senior management, are trustworthy. Often these factors result in less stringent financial controls than implemented by their for-profit counterparts.

Of course, nonprofit employees are not immune to the vulnerabilities of economic distress, including financial difficulties, overspending, and even gambling. Further, high-level employees and their close associates have significant access to organizational funds and financial records, causing them to believe they can successfully commit the fraud and embezzlement and conceal their conduct from outside scrutiny. Employees may rationalize their unlawful conduct as just compensation for lower salaries or unfair treatment, or as legitimate financial arrangements whereby the employee is simply "borrowing" money from the organization.

Recent examples of nonprofits that have fallen victim to these crimes include:

- In 2012, the Global Fund to Fight Aids, Tuberculosis, and Malaria reported to the federal government a misuse of funds or unsubstantiated spending of $43 million.
- In 2011, the Vassar Brothers Medical Center in Poughkeepsie, New York, reported a loss of $8.6 million through the theft" of certain medical devices.
- From 1999 to 2007, the American Legacy Foundation, a nonprofit dedicated to educating the public about the dangers of smoking, suffered an estimated $3.4 million loss as a result of alleged embezzlement by a former employee.

In light of the disturbing numbers reported by the *Washington Post*, Congress and numerous state attorneys general have pledged to launch investigations, and reportedly, some have. This will likely lead to even greater scrutiny by government regulators. External audits are necessary to ensure that effective financial controls and fraud prevention measures are being followed, but a standard audit is not the method by which nonprofit organizations should expect to detect fraud. The Association of Certified Fraud Examiners ("ACFE") reports that less than 4% of frauds are discovered through an audit of external financial statements by an independent accounting firm.

Nonprofits may no longer elect to handle instances of fraud or embezzlement quietly to avoid unwanted attention and embarrassment. As of 2008, a larger nonprofit must publicly disclose any embezzlement or theft exceeding $250,000, 5% of the organization's gross receipts, or 5% of its total assets.[1] A tax-exempt organization whose gross receipts are greater than or equal to $200,000—or whose assets are greater than or equal to $500,000—is subject to additional public disclosure requirements on its IRS Form 990 concerning the embezzlement or theft.

The Regulators

Oversight of nonprofit activities falls under the jurisdiction of the attorneys general of the various states. State attorneys general normally require all registered charities to annually report whether they have experienced theft, embezzlement, diversion, or misuse of the organization's charitable property or funds in any amount in the past year. Where appropriate, state prosecutors could elect to bring charges for embezzlement or theft.[2]
As discussed below, the IRS and state tax authorities have co-extensive jurisdiction over nonprofit organizations that have been granted recognition of tax-exempt status under federal and state law, respectively, and can levy penalties or excise taxes, or revoke tax-exempt status altogether, if a significant diversion of assets is involved.

A nonprofit that receives federal funding faces additional scrutiny by that federal agency's Office of Inspector General ("OIG"). In addition to performing traditional audits, the OIG—and in some cases, the FBI—works hand-in-hand with federal prosecutors across the country to investigate fraud and embezzlement. Federal prosecutors may elect to bring charges under, among other applicable federal statutes, 18 U.S.C. § 641, which makes it a crime to

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[1] The *Washington Post* scrutinized a database of IRS Form 990 information returns. Since 2008, Form 990 information returns have required filers to report "any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft." A "charitable asset diversion" is defined as "any unauthorized conversion or use of the organization's assets other than for the nonprofit's authorized purposes." 501(c)(3) organizations that file a Form 990 information return are required to report the gross value of all diversions discovered during the nonprofit's tax year if exceeding a threshold more than the lesser of (i) 5% of the organization's gross receipts for its tax year; (ii) 5% of the organization's total assets as of the end of its tax year; or (iii) $250,000.

In addition, asset diversions (in any amount) by a charity's insider—including, but not limited to, a charity's founders, members of its governing body, officers, senior employees, persons with financial oversight responsibilities, or anyone in a position to exert significant influence on the charity—must also be reported. Called "excess benefit transactions," these sorts of charitable asset diversions occur whenever such insiders (or, as referred to by the IRS, "disqualified persons") receive some kind of economic benefit from the nonprofit organization that exceeds the value of the benefit they provide to the organization. The Internal Revenue Code Regulations state in Section 53.4968.4(c) that "in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services." Thus, embezzlement by a disqualified person is an automatic excess benefit transaction, and as such, it must be reported.

[2] California Penal Code Section 503, for example, defines embezzlement as "the fraudulent appropriation of property by a person to whom it has been entrusted." Under New York Penal Code Section 155, embezzlement occurs when a person, having been entrusted to hold property on behalf of the rightful owner, causes the conversion of such property.

steal money from the United States or any department or agency thereof, and 18 U.S.C. § 1341, which makes it a crime to devise a scheme to defraud another of property or money with the use of interstate wire communications.

The Role of the Board of Directors
Directors are charged with conducting and overseeing the management of a nonprofit organization. While day-to-day operations are often delegated to staff, directors maintain the ultimate authority and responsibility for the organization's activities. State law and judicial decisions impose fiduciary duties of care and loyalty on nonprofit directors. A director who observes these duties is generally insulated from personal liability. However, a board must carry out actions in good faith, employing the degree of diligence, care, and skill that an ordinary prudent person would exercise under similar circumstances.

Detecting the Warning Signs at Your Nonprofit Organization

According to the ACFE, if you know what to look out for, most employees who commit fraud or embezzlement exhibit tell-tale signs that are easily identifiable. If you notice a combination of the following warning signs, you may be able to detect and prevent fraud within your organization:

- A review of financial statements and account records demonstrates an unusual and unexplainable drop in the organization's profits;
- Check requests for reimbursement of expenses do not contain original receipts;
- Financial records are disorganized, and documents such as vendor contracts are missing;
- An employee who refuses to take vacation, continually works overtime, or wants to take work home with them;
- An employee who exhibits signs of or discusses financial hardship or personal issues;
- Excessive or lavish personal spending by an employee that does not seem reasonable based on salary;
- Inventory or petty cash is unexpectedly missing;
- An employee who has an unusually close relationship with vendors; and
- Vendors who do not appear to have legitimate websites or contact information.

Recommended Preventative Measures

Nonprofits are not defenseless against charitable asset diversion. In fact, there are several proactive steps a nonprofit and its board can, and should, take to prevent and detect fraud and embezzlement. Below are common internal controls that can be modified for nonprofit organizations of various complexities and sizes and applied to volunteers and/or employees.

Require Double Signatures/Authorizations and Back-Up Documentation
Multiple layers of approval increase the difficulty for embezzlers to steal from a nonprofit. For expenditures over a predetermined amount, require two signatories on every check and two different signatories on every authorization or payment. If a nonprofit's professional staff is too small to effectively implement a double signatory/authorization policy, consider having a volunteer officer or director be the second signatory. All check and cash disbursement requests should be accompanied by an invoice or other document showing the payment or disbursement is appropriate. Never allow checks to be pre-signed. It is preferable for an administrative assistant to be responsible for bringing the checks to the two signatories for signing, so that a buffer is always maintained between signatories. Require prior written approval from two individuals for credit card expenditures estimated to exceed a certain amount (*e.g.*, $20), and require back-up documentation demonstrating expenditures are bona fide. The person using the credit card should not be the same person who authorizes its use.

Segregate Financial Duties
No single person should be responsible for receiving, depositing, recording, and reconciling the receipt of funds. Task different employees with the responsibility of preparing payment records, authorizing payments, disbursing funds, reconciling bank statements, and reviewing credit card statements. If there is not enough professional staff to effectively segregate duties, use a volunteer officer or director to reconcile the bank statements and review credit card statements. Similarly, all contracts should be approved by a manager who is uninvolved and personally disinterested in the transaction, and large contracts should be the product of competitive and transparent bidding.

Conduct Fixed Asset Inventories
At least annually, an organization should perform a fixed asset inventory to ensure that no equipment or other goods are missing.

Implement Automated Controls
Use electronic notifications to alert more than one senior member of an organization of bank account activity, balance thresholds, positive pay exceptions, and wire notifications.

Perform Background Checks
Background checks on new employees and volunteer leaders are crucial in unearthing undisclosed criminal records, prior instances of fraud, and/or heavy debt loads that may render the person more vulnerable to succumbing to fraud. The ACFE reports that 6% of embezzlers were previously convicted of a fraud-related offense.

Establish Audits and Board-Level Oversight
The above control measures are effective only if someone is monitoring the organization. Regular external audits are necessary to ensure effectiveness. Establish an audit committee on the board of directors, composed of at least one person familiar with finance and accounting to serve as the primary monitor of the anti-fraud measures. In lieu of an audit committee, smaller nonprofits should consider including a CPA or other financially knowledgeable person on the board of directors to serve a similar function.

Encourage Whistleblowers
Nonprofits must encourage volunteers and employees to report suspected wrongdoing to management and/or a designated board member. A means of anonymous reporting is essential—if employees believe reporting could jeopardize their jobs, they may be reluctant to report theft or mismanagement. The board must ensure such reports are taken seriously, that the reporting employee is protected, and that outside legal counsel is brought in, if appropriate. An active board will inspire confidence among employees and ensure employees follow proper internal controls and protocols, including reporting troubling activities among the organization's personnel.

Construct a Strong Compliance Program
An effective compliance program must be more than a mere "paper program." It must be tailored to a specific organization, include a written code of ethics, be effectively implemented through periodic training, have real consequences for violations, have an effective reporting mechanism, and be periodically audited to ensure its effectiveness. A nonprofit's commitment to ethical behavior should be clearly and concisely communicated to the board, management, and employees, and commitment to the code should be affirmed by all employees on a periodic and ongoing basis.

Communicate with Donors
Regular conversations with donors can also serve as an early warning system against embezzlement. Donors are often privy to issues with donations that may not be obvious to management, such as checks being cashed without record from the organization, or donor contributions that are not properly acknowledged. In the case of an organization that receives federal or state grant funds, the board should review all correspondence between the nonprofit and the funding agencies to ensure that the board is kept apprised of any of grant agency concerns.

Perform Self-Audits
Outside expertise—such as CPAs experienced in conducting fraud audits (different from the standard annual financial statement audit) and attorneys experienced in evaluating and enhancing internal controls as well as training staff on best practices—can be a critical tool in identifying fraud and embezzlement that may be occurring and/or in shoring up weak controls or other process deficiencies that make an organization more susceptible to theft.

Acquire Insurance Coverage
Various types of insurance help ensure stolen property or money can be replaced or repaid. Fidelity insurance protects a nonprofit from theft by "covered individuals" of property owned by it. Generally "covered individuals" include the insured's employees, but not necessarily all of its volunteers. A separate endorsement may be required to protect against that risk. Depositor's forgery insurance covers theft of blank checks, credit cards, and instances of altered checks. Some insurance policies cover the cost of hiring outside counsel to conduct an internal investigation of alleged fraud or embezzlement. A good insurance broker – familiar with the nonprofit sector – can help a nonprofit navigate the choices and make informed decisions about coverage.

Steps for Investigating Allegations of Fraud and Embezzlement

Fraud and embezzlement can severely undermine a nonprofit's mission through damage to an organization's public reputation, loss of donor funds, revocation of tax-exempt status, and even closure of the organization. Thus, it is crucial that every nonprofit create a comprehensive plan of action to handle cases of suspected fraud or embezzlement before there is ever a need for it.

This plan must include the following:

Address Preliminary Considerations
If a nonprofit board suspects embezzlement or other charitable asset diversion, the board must investigate quickly and carefully. A thoughtful investigation is the first step the board should take to discharge its fiduciary responsibility to protect the nonprofit's charitable assets and help insulate its members from any claim of personal liability for the loss. To satisfy these duties, directors should (i) exercise independent and informed judgment; (ii) judge what is in the nonprofit's best interest, irrespective of other entities with which the director is affiliated or sympathetic, or to which the director owes his board appointment; and (iii) have adequate information and assure the adequacy and clarity of information.

For the sake of confidentiality, the board may initially choose a small sub-committee or an individual to conduct the inquiry. Depending on the sensitive nature of the investigation, the board may elect to retain the services of an attorney or auditor experienced in handling such investigations. The duty of care permits a director to rely on information, opinions, reports or statements, including financial statements, prepared or presented by others whom the director believes are reliable and competent in the matters presented. If the embezzlement scheme has been sophisticated or longstanding, the nonprofit may require a forensic accountant or certified fraud examiner to determine the amount stolen.

Evaluate the Need to Retain Outside Counsel
In determining whether outside counsel is necessary, at the outset of the investigation, the board should evaluate the following considerations to ensure the matter is handled fairly, impartially, and consistent with personnel policies:

- Whether anyone on the board has sufficient investigative skill and experience to lead the inquiry;

- The likelihood that employees with first-hand knowledge of the alleged fraud or embezzlement will be honest and forthright with board members;

- The relative scale of the suspected misconduct, and the management level of the person(s) implicated;

- The board members' relationships and personal history with the subject and whistleblower (the investigator should never be the subject's supervisor);

- Whether the nonprofit's insurance policy will cover the costs of the internal investigation;[3]

[3] If a nonprofit's insurance policy provides coverage, prompt notice to the insurer may be needed. It is possible that the insurer will provide advice about preparing for, or elect to participate in, the investigation. The insurance company may require the organization to file a police report in connection with an insurance claim.

- Whether it may be important to rely on the attorney-client privilege to protect from subsequent disclosure to private third parties or the government in the event of a future investigation or litigation; and

- If insurance coverage is not available, the availability of other nonprofit resources to pay for outside investigative expertise.

Anticipate Employment Law Ramifications

Employment-related investigations must be prompt, thorough, and fair to those being investigated. An employee accused of misconduct should always be confronted with the allegations and given a fair opportunity to present his or her side of the story. If a preliminary investigation establishes credible evidence of embezzlement involving a current employee, a nonprofit should consult with employment counsel. While the facts may seem to constitute grounds for immediate termination, the most prudent employer response will depend on the offense, state of employment law, employment policies, and relevant employment agreements.

Secure Relevant Records and Files

If the allegations merit a full internal investigation, the board must take steps to preserve evidence and maintain relevant records, including emails, handwritten notes, files, calendar entries, checks, financial statements, and related documents. Circulate a "litigation hold" notice requesting persons with access to relevant documents and information to maintain such materials and provide copies to the board. Consider restricting the employee's access to the organization's computer network and other books and records. Other security measures may be necessary, *i.e.*, changing passcodes, locks, and bank account signatories. Exercise caution to ensure these steps are taken in accordance with the organization's policies and bylaws.

Interview the Suspect and "Witnesses"

Once immediately available relevant information has been gathered and the board's preliminary findings reviewed, a senior member of the nonprofit or retained outside counsel should take the lead on interviewing the suspect. The interviewer should not promise confidentiality or make any such assurances to the subject. Have a second person take notes during the interview, if such activity is not disruptive. It is imperative to memorialize the suspect's inculpatory and exculpatory statements in a formal memorandum or legible notes. Use the same level of care when interviewing employees with first-hand knowledge of the unlawful conduct. These statements will be critical sources of information in subsequent litigation and/or a government investigation. Consider placing the suspected embezzler on a leave of absence immediately after the interview.

Recover Funds or Assets

The board has a fiduciary obligation to try to recover embezzled assets and will be expected to explain efforts taken in the reports to the relevant state attorney general and the IRS, as described below. Some nonprofits anticipate the risk of insider theft and obtain fidelity or crime insurance. If no insurance is available to compensate the nonprofit for the loss, the organization must weigh the benefits and drawbacks of litigation to collect the debt from a possibly judgment-proof (*i.e.*, financially insolvent) defendant. Private resignation/restitution arrangements can be negotiated, but this should be undertaken with the assistance of an attorney and fully documented under a settlement agreement and payment plan. Consult employment counsel before attempting to recover any funds from the embezzler's final paycheck or vacation time. Nonprofits should never threaten criminal prosecution as a negotiation tactic. Such threats could be construed as a type of extortion, which in and of itself is a crime. That being said, an organization should keep in mind that a successful criminal prosecution could be the most cost-effective way to recover stolen money or assets, as discussed below.

Consider Referring the Matter to Law Enforcement Authorities

Some states require directors to refer the matter to the local district attorney for possible criminal prosecution. Many nonprofits struggle with this expectation because they fear bad publicity or sympathize with the embezzler. Instead, a nonprofit may accept restitution and keep the fraud quiet in the hope they will not lose funders. This may seem to be in the best interest of the nonprofit, but failure to prosecute means the perpetrator can change employment and steal from another nonprofit. In addition, a criminal prosecution of the wrongdoer could result in the court ordering the individual to pay restitution to the organization. This may be the easiest, most cost-effective way for an organization to recover embezzled funds, particularly in the case of smaller thefts. An organization's board or audit committee should consult with outside counsel to evaluate whether a situation calls for a criminal referral to law enforcement authorities.

If a nonprofit receives funding from state and/or federal agencies, it must present its findings to the grant agency's OIG and take steps to ensure the incident does not disrupt the nonprofit's current funding or plans for renewal. Prompt and thorough investigation and disclosure of employee misconduct will inspire confidence in the grant agency and minimize potential funding problems for the organization.

Manage Public and Internal Disclosure

Because of the potential harm to a nonprofit's reputation, it will take significant care to determine how much to disclose and to whom. Select a spokesperson and develop a communication plan to assure key stakeholders of the nonprofit's plans to recover stolen assets and take steps to prevent future theft. Carefully consider the specific contents of any public disclosure, because a public accusation linking a specific employee to the theft, if proven false, could lead to a defamation action. Notify affected staff early on with "need-to-know" details to quash rumors. If litigation is likely, consider privately informing major funders before the news is made public.

Even if litigation or public media disclosure is unlikely, evaluate the possible impact of publicly available incident reports made to regulators. Have a general crisis communication plan prepared in advance to deal with any number of unexpected events.

Address Federal Reporting Requirements

Every 501(c)(3) tax-exempt organization must annually file a series 990 return with the IRS. Small organizations (annual gross receipts of $50,000 or less) are eligible to file a 990-N e-Postcard, which reports only very basic contact and operational status information. Organizations that normally have less than $200,000 of gross receipts and less than $500,000 of total assets can file a simplified return, the 990-EZ. Larger organizations must file the longer and more complex Form 990 return.

The type of Form 990 return a nonprofit files determines whether it must publicly report a significant asset diversion or excess benefit transaction. The Form 990 return, in Part VI, Section A.1.a, asks if, during the year, the nonprofit has become aware of a material diversion of its assets, regardless of whether the loss actually occurred during that tax year. If so, the nonprofit must explain the nature of the diversion, the amounts or property involved, the corrective actions taken to address the matter, and any other pertinent circumstances. If the diversion constituted private inurement or an excess benefit transaction, this must be disclosed in the relevant schedule of the form.

An organization that files a 990-EZ is only required to report an excess benefit transaction, but not a significant diversion of assets. An organization that files a 990-N e-Postcard is not required to report either excess benefit transactions or charitable asset diversions. However, any nonprofit can voluntarily report embezzlement to the IRS on Form 3949-A. This form is used for reporting suspected tax fraud, and an organization filing this form provides the contact information and details of the embezzler.

Avoid Federal Penalties

When the suspected embezzler is also a "disqualified person," the risk to the organization and its directors of IRS intervention and penalties increases. Under section 4958 of the Internal Revenue Code, if a section 501(c)(3) tax-exempted corporation provides an excess benefit, **the insider who receives the excess benefit is subject to excise taxes, as are any organization managers—including officers and directors—who approved the excess benefit**. With an automatic excess benefit transaction like embezzlement, where there was no literal approval of the action, directors are not likely to be personally subject to the excise tax (unless one or more were knowing participants in the scheme). Nevertheless, the board must be vigilant in their plans to explain and rectify the fraud.

The cost of receiving an excess benefit is severe. The disqualified person must correct the excess benefit by making a payment in cash or cash equivalents equal to the correction amount (no promissory note). The correction amount is the sum of the excess benefit, plus interest at a rate that equals or exceeds the applicable federal rate, compounded annually. The disqualified person is also taxed 25% of the excess benefit. The IRS notice of deficiency outlines the penalties imposed. Failure to make the correction to the nonprofit by the due date will result in an additional tax of 200% of the excess benefit.

No tax or penalty is imposed on a nonprofit that was victim to an excess benefit transaction. However, a tax equal to 10% (up to $20,000 per transaction) of the excess benefit may be imposed on each organization manager who participated in the transaction, knowing that it was an excess benefit transaction, unless the participation was not willful and was due to reasonable cause. The $20,000 is an aggregate figure; all organization managers participating in the transaction are jointly and severally liable.

While the Forms 990 or 990-EZ can alert the IRS and the public that an excess benefit transaction has occurred, these are not the only filings used to report such transactions. Form 4720 is a separate annual filing that must be made by disqualified persons or managers who owe the taxes described above. The victim nonprofit is not required to file Form 4720, but nonprofits may be able to use this form to try to trigger an IRS collection action against a fraud perpetrator who has made no attempt to repay embezzled funds.

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Nonprofit boards of directors should facilitate establishment and supervision of strong policies that support the best practices explained above. Nonprofit organizations should put policies and procedures in writing to clearly communicate the organization's stance. While the board should not micro-manage the day-to-day operations of an organization with paid staff, neither should it be complacent about its fiduciary obligation to *"act with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances*." Periodic review of financial reports and the Form 990 return, appointment of an audit committee, and hiring a strong chief staff executive who is in sync with all of these risk management measures are all actions a board can take to fulfill its duty of care and protect the charitable funds and other assets entrusted to it.

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COMBINATIONS AND ALLIANCES AMONG NONPROFIT ORGANIZATIONS

There is a wide array of ways in which nonprofit organizations can combine, affiliate, or otherwise come together. Some involve a complete integration of programs, activities, membership, donors, volunteer leadership, and staff, while some provide for maintaining varying degrees of separateness and autonomy. There are pros, cons, and considerations to take into account for each option. And sometimes one option can be a stepping stone to a fuller combination. Often the decisions are based on legal, tax, or economic concerns, sometimes power and politics will dominate the decision-making process, and usually it is a combination of all of these factors.

This article lays out some of the primary means by which nonprofit organizations frequently combine, affiliate, and otherwise come together in various ways. It explains what they each mean, and also highlights some of the primary considerations that come into play with each option.

I. Merger and Consolidation

A. General

Nonprofit corporations can fully and completely integrate their programs, functions, and membership by merging or consolidating. When two nonprofit entities *merge*, one entity legally becomes part of the surviving entity and dissolves. The surviving corporation takes title to all of the assets and assumes all of the liabilities, of the non-surviving entity.

Unlike a merger, a *consolidation* of nonprofit entities involves the dissolution of each of the organizations involved, and the creation of an entirely new nonprofit corporation that takes on the programs, resources, and membership of the former entities. Although the net effect of a merger and consolidation are the same – one surviving entity with all the assets and liabilities of the two previous groups – many organizations prefer consolidation over merger because it tends to lend the perception that no organization has an advantage over the other. There is a new corporation which houses the activities of the two and each is dissolved pursuant to the consolidation.

B. Benefits of Merger or Consolidation

Merger or consolidation of entities with similar exempt purposes may offer a number of benefits to the participating organizations and their members. By merging or consolidating, organizations may combine their assets, reduce costs by eliminating redundant administrative processes, and provide enhanced, broader, or improved services and resources to the industry, profession, or cause that they represent. Furthermore, for membership organizations, members who paid dues and fees to participate in the formerly separate organizations are often able to reduce their membership dues and the costs and time demands of participation by joining a single, combined organization. Finally, merger or consolidation may allow nonprofits participating within the same field or industry to offer a wider array of educational programming, publications, advocacy, and other services to a larger constituency.

C. The Divisional Approach

The fact that two organizations have become a unified legal entity does not prohibit them from continuing with some measure of autonomy within the new corporation. Councils or divisions could be established to promote and protect the unique interests of the industry subsets. Under this approach, the organization's bylaws can cede certain distinct areas of authority to these subordinate bodies. Balancing these levels of authority, finances, and management can be challenging, but the model is frequently used.

D. Other Considerations

The law imposes stringent fiduciary responsibilities on the members of an organization's governing body to ensure that any merger or consolidation is warranted and in the best interests of the organization.

Directors and officers may be held personally and individually liable if they fail to act prudently and with due diligence. Due diligence generally requires an organization's governing body to ascertain the financial and legal condition of the organization with which the entity will be merged or consolidated. This includes examination of the other entity's books and records, governing documents, meeting minutes, pending claims, employment practices, contracts, leases, and insurance policies, and investigation into potentially significant financial obligations, such as the funding of retirement programs, binding commitments to suppliers, and the security of investment vehicles. Boards of directors often utilize accountants and attorneys to conduct due diligence reviews. The opinions of such experts may be relied upon when evaluating a plan of merger, provided that the board of directors establishes a full and accurate financial and legal profile of the other organization before approving the merger or consolidation.

In addition to conducting routine due diligence reviews, an organization's board of directors should have legal counsel review the impact of a proposed merger or consolidation on competition within the industry. Federal antitrust laws prohibit mergers or consolidations that may substantially lessen competition in any line of commerce. The U.S. Department of Justice, Federal Trade Commission, state attorneys general, and private plaintiffs may scrutinize any transaction that could lead to price fixing, bid rigging, customer allocation, boycotts, or other anticompetitive practices. That said, mergers and consolidations of nonprofit organizations typically do not pose an anticompetitive threat. If it can be shown that the joining of the two organizations will actually promote competition, there will be very little antitrust risk overall.

As described in more detail below, merger and consolidation are complex processes, which require the approval of the boards of directors and membership, if any, of each organization. As a practical matter, it can be difficult to combine and coordinate the governing bodies, staffs, and operations of two or more existing organizations. Additionally, the institutional loyalties of members, officers, and professional staffs often come into play, particularly when the organizations considering merger or consolidation are unequal in size and resources.

E. Procedural Requirements

To merge or consolidate with another organization, each organization must follow the procedures mandated under the nonprofit corporation law of its state of incorporation, as well as any specific procedures in its governing documents, provided such procedures are consistent with the nonprofit corporation statute.

While nonprofit corporation statutes differ by state, the laws governing merger and consolidation of nonprofits typically set forth certain core procedures. The board of directors of each precursor organization must develop and approve a plan of merger or consolidation according to the requirements set forth in the nonprofit corporation statute of the state, or states, where the organizations are incorporated. Typically, the details of the deal between the two organizations are set forth in a "Merger Agreement" that is not required to be filed. This document usually covers items such as integration of the staff and voluntary leadership, corporate governance changes, and programmatic consolidation. It often is quite detailed.

The plan of merger or consolidation also must be submitted to the voting members, if any, of each organization for their approval. While the conditions for member approval vary from state to state, statutes generally require a vote of two-thirds to effectuate the plan merger or consolidation – a number that can be difficult to reach for practical and political reasons. Assuming the members of *both* organizations approve the board's plan, "articles of merger" must be filed in the state where the new entity will be formally incorporated.

Where merging nonprofits are each tax-exempt under different tax classifications (e.g., a 501(c)(3) and a 501(c)(6)), the resulting merged entity will generally need to file a new application for federal tax exemption with the Internal Revenue Service ("IRS"). Likewise, a new, consolidated entity must apply to the IRS for recognition of tax-exempt status. On the other hand, where merging entities share the same tax-exempt classification, the tax-exempt status of the surviving organization is typically not affected. Instead, following the merger, all parties to the transaction must notify the IRS of the merger and provide supporting legal documentation. If the newly merged entity will carry out substantially the same activities as its predecessors, the IRS will typically grant expedited approval on a *pro forma* basis and there will be no lapse in the tax-exempt status.

II. Acquisition of a Dissolving Corporation's Assets

A. General

Another legal mechanism for "absorption" is the *dissolution and distribution of assets* of a target organization. This statutory procedure generally involves the adoption of a plan of dissolution and distribution of assets, satisfaction of outstanding liabilities, transfer of any remaining assets to another nonprofit entity, and dissolution. Where the dissolving nonprofit is exempt from federal income taxation under Internal Revenue Code Section 501(c)(3), the dissolving organization is required to distribute its assets for one or more tax-exempt purposes under Code Section 501(c)(3).

B. Benefits and Other Considerations

While the dissolving entity must adhere to specific statutory procedures, dissolution and transfer of assets is much less onerous on the entity that acquires the dissolving entity's assets (the "successor" entity) than a merger or consolidation. Because the successor entity is merely absorbing the assets of another organization, a vote of the membership and accompanying state filings are typically not required for that corporation. Furthermore, receipt of a dissolving nonprofit corporation's assets typically does not affect an organization's tax-exempt status. However, just as with merger or consolidation, a tax-exempt organization must be cautious when taking on programs or activities to ensure that they support its stated tax-exempt purposes.

Asset transfer and dissolution may be strategically preferable for combining organizations when one organization is of a much smaller size than the other. In addition, this type of transaction is particularly useful when an organization wishes to acquire the assets of another organization with significant future contingent liabilities, because the successor organization does not, by operation of law, assume the liabilities of the dissolving corporation. Further, the successor organization may seek to limit the liabilities it will assume in a written agreement, as discussed below.

While a successor organization is typically shielded from its predecessor's debts and liabilities, an asset transfer always poses some risk of *successor liability*, particularly if adequate provision has not been made for pre-existing liabilities. A court may determine that an organization that acquired the assets of a dissolved corporation impliedly agreed to assume the dissolved corporation's liabilities. Alternatively, a court may find that the successor corporation serves as a "mere continuation" of the dissolved corporation, that the asset transfer amounts to a *de facto* merger, or that the transaction was actually a fraudulent attempt to escape liability. It is also often problematic to extinguish liabilities, such as employee benefit programs, rather than assuming them.

C. Procedural Requirements

Like a merger or consolidation, an asset transfer and dissolution must follow the applicable state nonprofit corporation laws and each entity's governing documents. The procedure for dissolution and asset distribution is fairly simple for the successor entity, as it will simply be entering into a transaction – albeit a significant one – to acquire assets and absorb members, if any. Member approval for such a transaction is typically unnecessary unless the organization's bylaws require otherwise. The due diligence requirements imposed on the successor entity are also less stringent. Nevertheless, the governing body of the successor corporation should conduct a due diligence review of the dissolving corporation as a matter of course, particularly if the acquisition of the dissolving organization's assets will significantly alter the nature of the successor organization's operations.

The process is more complicated, however, for the dissolving entity. In most instances, the nonprofit corporation statute of the dissolving entity's state of incorporation imposes the following requirements to effectuate a transfer and dissolution:

- The governing body of the dissolving corporation is obligated to exercise the same level of due diligence as in a proposed merger or consolidation, as discussed above.
- After the governing body of the dissolving corporation has determined that dissolution and transfer of its assets are in the best interests of the organization, it must develop and approve a "plan of dissolution" (or "plan of distribution" according to some states). The number of directors that must vote to accept the plan varies by state.
- If the dissolving corporation has members, it must obtain member approval of the dissolution plan. Again, the requisite margin of member approval varies from state to state; most states require a two-thirds majority.
- The dissolving corporation must file "articles of dissolution" with the state in which it is incorporated. States typically accept articles of dissolution only after all remaining debts and liabilities of the dissolving entity are satisfied or provisions for satisfying such debts have been made.
- As part of the plan of dissolution, the dissolving corporation will transfer all of its remaining assets to

a designated corporation.

- Once the plan of dissolution is executed, the dissolving entity is generally prohibited from carrying on any further business activity, except as is necessary to wind up its affairs or respond to civil, criminal, or administrative investigation.

As part of the asset distribution process, the parties typically execute a written agreement detailing their understanding of the transfer of the dissolving corporation's assets. The parties may utilize such an agreement where they wish to obtain warranties regarding the absence of liabilities to be assumed by the successor corporation; account for any outstanding contractual obligations of the dissolving entity; provide for third-party consents where necessary to transfer any contractual obligations to the successor organization; or detail terms for the integration of the dissolving entity's members. Note that in the event of any breach of warranties by the dissolving corporation, it generally will not be possible for the successor corporation to obtain redress unless the agreement specifically obligates some third party to indemnify the successor corporation, as the dissolving corporation will no longer exist.

III. Federation

A. General

A federation is generally an association of nonprofit associations. Federations are most often structured along regional lines (*e.g.*, a national nonprofit association whose members are state or local nonprofit associations). In some cases, a federation consists of special interest groups that represent discrete segments of the industry represented by the" umbrella" association. The national or umbrella association's relationship with its affiliated associations is governed by formal affiliation agreements.

An affiliation agreement is a binding contract that sets forth the nature of the relationship between the parties. Most affiliation agreements include provisions that address the following: term and termination of the relationship; use of the organization's intellectual property; the provision of management services; treatment of confidential information; coordinated activities; and tax and/or financial issues, among other provisions. Where an affiliated association fails to adhere to the terms of its affiliation agreement with the national association, the affiliate could lose privileges (*e.g.*, loss of ability to use the association's intellectual property), become disaffiliated, or suffer some other penalty. Similarly, where a national association violates the terms of an affiliation agreement with its affiliate, it may be liable for such breach.

B. Benefits and Other Considerations

In the federation context, the national association is, for tax and liability purposes, a separate legal entity from its affiliated associations. There are instances, however, in which the separateness between two entities (even though each entity may have separate corporate and tax statuses) will be disregarded by a court or the IRS, thus creating exposure to potential legal and tax liability to both entities. Specifically, the separateness can be disregarded where the national association so controls the affairs of its affiliates, rendering it a "merely an instrumentality" of the national association.

There are two primary areas of concern for national associations that are governed by a federated structure. First and foremost, because the national association is primarily (if not completely) comprised of other associations, the income and membership of the national is generally controlled by its affiliates. Without control over these two vital areas, the national association could be susceptible to secession by an affiliate (resulting in attendant loss of income), or have its power and authority undermined by an affiliate. Second, the federated structure could cause legal or policy problems if factionalism among affiliated associations arose. Additionally, the federated structure lends itself to diluted membership loyalty toward the national association.

C. Procedural Requirements

Preliminarily, all steps must be taken to form the national association in accordance with applicable state nonprofit corporation laws. Generally, this requires a minimum of filing articles of incorporation, selecting an initial board of directors, and developing bylaws for the association. Once the association is formed, it must apply to the IRS for recognition of tax-exempt status.

After formation, the national organization must execute detailed affiliation agreements with each of its affiliated organizations. There are generally no statutory requirements mandating the exercise of due diligence by any entity that chooses to enter into an affiliation agreement. Rather, the relationship is generally governed by the terms of the affiliation agreement and the general principles of contract law.

IV. Management Company Model

Nonprofit organizations with similar interests can affiliate through a common management structure, whereby the groups would realize the efficiencies of coordinated "back office" operations such as accounting, meeting management, IT, human resources, and other supportive functions, possibly through the ownership of the nonprofits by a for-profit umbrella organization. Although there are mechanisms that could be used to effect the coordinated operations that many organizations seek, the idea of for-profit corporate "ownership" is problematic for several reasons, most notably tax law inhibitions on private inurement from a tax-exempt entity and state corporate law restrictions.

Some for-profit entities – association management companies ("AMCs") – manage the day-to-day business of numerous nonprofit organizations. The models vary depending on the resources and needs of the nonprofits, but in almost all settings the AMCs provide the finance and accounting, meeting planning, correspondence, communications, staffing, and office requirements. In some cases, the nonprofit will have a separate office identity, including signage and limited access, while in others there will be common nonprofit offices with shared employees. Employees are formally employed by the AMC, but, at least in part, report to the boards of the nonprofit organizations.

One critical aspect of this organizational model is that the AMC does not have an ownership interest in the nonprofit organizations. AMCs operate under management agreements that typically can be terminated with relatively short notice or at the conclusion of a stated term. The contractual arrangements are based on arm's-length compensation, depending on the services provided.

The advantage of this model is the professionalism that an AMC can provide, particularly to nonprofit that have limited means. On the other hand, there is a lack of permanency. A nonprofit generally can fairly easily terminate its management company agreement and move on to a different AMC or hire its own employee(s) directly. In contrast, a merged or consolidated group has the solemnity of a corporate transformation which cannot be easily unraveled.

V. Other Types of Strategic Alliances

Merger, consolidation, acquisitions, and the creation of a federation involve a substantial level of commitment – but organizations need not go so far in order to engage in alliances with one another. Nonprofit organizations may enter into other strategic alliances that are temporary or permanent, and allow both entities to “test the waters” before binding themselves to a more involved or permanent arrangement.

A. Partial Asset Purchase or Transfer

A lesser alternative to dissolution and transfer of all of a nonprofit’s assets is a limited asset purchase or transfer from one entity to another. In general, an asset purchase may be advantageous where one nonprofit entity wishes to acquire a discrete property, activity, program, or business unit of another. The directors of both organizations owe their members a significant level of due diligence prior to finalizing the deal, but, unless required under the organization’s governing documents, partial asset transfers typically do not require the approval of an organization’s membership. The transfer is executed pursuant to a written asset purchase agreement between the parties.

This approach has an obvious negative for the ceding organization in terms of prestige and justification for the hand-off.

B. Joint Venture

In a joint venture, two or more nonprofit organizations lend their efforts, assets, and expertise in order to carry out a common purpose. The organizations involved may develop a new entity (such as a limited liability company or a partnership) to carry out the endeavor. Such new entity may receive tax-exempt status if it is organized and operated for exempt purposes. Generally, however, organizations commit certain resources to a joint venture without forming a new entity. A well-structured joint venture is codified in a written agreement that details the precise obligations and allocation of risk between the organizations involved. Joint ventures can be permanent, set to expire on a given date or after the accomplishment of a certain goal, or structured with an increasingly overlapping set of commitments and an eye towards an eventual merger. Although the bylaws of an organization might specify otherwise, joint ventures do not usually require the approval of the general membership.

In a *whole joint venture*, one or more of the partnering entities contribute all of their assets to the enterprise. Nonprofits commonly engage in *ancillary joint ventures* with other organizations. Ancillary joint ventures are essentially small-scale joint ventures – enterprises that do not become the primary purpose of the organizations involved which are often for a limited duration. Tax-exempt organizations seeking additional sources of revenue may also enter into ancillary joint ventures with for-profit corporations, provided that the joint venture furthers the tax-exempt organization's purposes, and the tax-exempt organization retains ultimate control over, at a minimum, the exempt purposes of the joint undertaking.

C. Joint Membership Programs

Joint membership programs generally allow individuals to join two organizations for a reduced fee. These initiatives allow the members of one organization to become more familiar with another, and are typically conducted in the context of other jointly run programs and activities. Programs in this vein are designed to bring organizations closer together, often as a precursor to a more formal alliance, but allow the entities to modify the arrangement or disengage altogether if circumstances or expectations change.

VI. General Tax Issues

Tax-exempt organizations that choose to become affiliated with other taxable or tax-exempt entities must be mindful of certain legal requirements in order to ensure that the affiliation does not jeopardize the organization's tax-exempt status. This section discusses three key tax-related concepts that organizations must consider prior to affiliating with another entity: unrelated business income tax, control by the tax-exempt organization, and private inurement.

A. Unrelated Business Income Tax

In general, tax-exempt organizations are exempt from federal taxes on income derived from activities that are substantially related to their exempt purposes. Nevertheless, a tax-exempt organization may still be subject to unrelated business income tax ("UBIT") on income received from the conduct of a trade or business that is regularly carried on, but is not substantially related to the organization's exempt purposes.

For the purposes of determining UBIT, an activity is considered a "trade or business" if it is carried on for the production of income from the sale of goods or performance of services. Income from a passive activity – *e.g.*, an activity in which the exempt organization allows another entity to use its assets, for which the organization receives some payment – is not considered a business. The Code specifically excludes certain types of passive income – dividends, interest, annuities, royalties, certain capital gains, and rents from non-debt financed real property. UBIT also does not include income generated from volunteer labor, qualified corporate sponsorship payments, or qualified convention or trade show income.

An activity that is substantially related to an organization's tax-exempt purposes will not be subject to UBIT. A "substantially related" activity contributes directly to the accomplishment of one or more exempt purposes. Alone, the need to generate income so that the organization can accomplish other goals is not a legitimate tax-exempt purpose.

In the context of trade and professional organizations, an activity is "substantially related" if it is directed toward the improvement of its members' overall business conditions. The receipt of income from particular services performed to benefit individual members, although often helpful to their individual businesses, usually results in UBIT to the organization where those services do not improve the business conditions of the industry overall.

An organization jeopardizes its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is "substantial" in relation to the organization's tax-exempt purposes. Although the "substantial" criterion has not been defined by statute or by the IRS, commentators generally agree that a level of 25-30% gives rise to concern. In an effort to prevent loss of exempt status, many tax-exempt organizations choose to create one or more taxable subsidiaries in which they house unrelated business activities. Taxable subsidiaries are separate but affiliated organizations. Generally, a taxable subsidiary can enter into partnerships and involve itself in for-profit activities without risking the tax-exempt status of its parent. Moreover, the taxable subsidiary can remit the after-tax profits to its parent as tax-free dividends. It is also beneficial in some situations to immunize the organization from potential liability, by putting certain commercial activities in a separate subsidiary corporation.

B. Control

Where a nonprofit organization partners with another entity, it will continue to qualify for tax exemption only to the extent that (1) its participation furthers its exempt purposes, and (2) the arrangement permits the organization to act exclusively in furtherance of its exempt purposes. If a tax-exempt entity cedes "control" of partnership activities to a for-profit entity, the IRS will consider the partnership to serve private aims, not public interests.

In any arrangement with a for-profit entity that involves *all or substantially all* of a tax-exempt organization’s assets, the IRS requires the tax-exempt organization to retain majority control over the entire undertaking – *e.g.*, majority voting control. However, where the arrangement involves only an insubstantial portion of the tax-exempt organization’s assets, the IRS has approved a structure in which the for-profit and tax-exempt organizations shared management responsibilities, but left the exempt organization in control of the exempt aspects of the arrangement.

Nonprofit organizations frequently enter into short-term partnerships with for-profit corporations in order to conduct a particular activity. These ventures should not jeopardize a nonprofit’s tax-exempt status in most cases – even if the nonprofit does not maintain operational control over the ventures – as such activities generally are not substantial activities of the organization.

C. Private Inurement and Private Benefit

In general, organizations recognized as tax-exempt under Code Sections 501(c)(3) and 501(c)(6) are prohibited from entering into any transaction that results in “private inurement.” Private inurement occurs where a transaction between a tax-exempt organization and an “insider" – *i.e.*, someone with a close relationship with or an ability to exert substantial influence over the tax-exempt organization – results in a benefit to the insider that is greater than fair market value. A nonprofit organization's affiliate or partner may be considered an insider. The IRS closely scrutinizes arrangements between tax-exempt organizations and taxable entities to determine whether the activities contravene the prohibition on private inurement. Thus, an arrangement with a for-profit entity, such as a management company, must be entered at arm's-length and carefully reviewed to ensure that any benefits to insiders are at or below fair market value.

Code Section 501(c)(3) and 501(c)(4) organizations also are not permitted to confer impermissible private benefit on one or more individuals, entities, industries, or the like; doing so can jeopardize the organization’s tax-exempt status. While a fuller discussion of the private benefit doctrine is outside of the scope of this article, it is an important consideration that needs to be taken into consideration in these kinds of transactions and arrangements.

VII. Conclusion

There is an array of possible mechanisms for combinations and alliances that nonprofits can enter into with other organizations, both nonprofit and for-profit. The selection of an appropriate structure is heavily dependent on fully identifying the goals of the transaction and the potential ramifications for both groups. While the underlying legal and tax issues are complex and nuanced, a good understanding of them is critical in order to be able to effectively weigh the pros and cons of various alternatives in this area.

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UNRELATED BUSINESS INCOME TAX FOR NONPROFITS: THE BASICS

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Overview

A tax-exempt organization is generally exempt from federal corporate income tax on income derived from activities that are substantially related to the organization's tax-exempt purposes. However, a tax-exempt organization may be subject to a federal corporate income tax on income derived from unrelated trade or business activities. This is known as the Unrelated Business Income Tax ("UBIT").

Definitions

An "unrelated trade or business" is any activity that meets all of the following three conditions:

- The activity must be a trade or business;
- The trade or business must be regularly carried on; and
- The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from federal income tax.

An activity is considered a "trade or business" if the activity is carried on for the production of income from the sale of goods or the performance of services. Note that it is immaterial whether the activity generates a profit for purposes of determining whether the gross revenue derived from the activity is subject to UBIT. Further, if an organization engages in a substantial amount of non-exempt activities, it could potentially lose its tax-exempt status even if those activities do not generate a profit.

In determining whether an activity is "regularly carried on," the IRS will examine whether the activity is conducted often and continuously and how it is pursued. The IRS will compare these factors with the same or similar business activity of non-tax-exempt organizations. Discontinuous or periodic activities are generally not considered to be regularly carried on. However, periodic activities that are seasonal in nature will be considered to be regularly carried on if an exempt organization's periodic participation in such activities coincides with the participation of taxable businesses.

For an activity to be "substantially related" to the tax-exempt organization's exempt purposes, it must contribute importantly to the accomplishment of one or more of the organization's exempt purposes. If an activity is substantially related to the tax-exempt organization's exempt purposes, then the income from that activity will not be subject to UBIT. The organization's need to generate money to use for tax-exempt purposes is not sufficient to qualify as "substantially related."

Exceptions

Subject to certain limitations, the following activities are specifically excluded from the definition of unrelated business income (the code sections in brackets represent the applicable provisions of the Internal Revenue Code where these exceptions are defined):

- Dividends, interest, and annuity income [512(b)(1)]
- Royalties [512(b)(2)]
- Certain capital gains [512(b)(5)]
- Rents from non-debt financed real property [512(b)(3)]
- Certain research-generated income [512(b)(7), 512(b)(8), and 512(b)(9)]
- Qualified corporate sponsorship payments [513(i)]
- Qualified convention or trade show income [513(c)(3)]
- Income generated from volunteer labor [513(a)(1)]
- Income from certain bingo games [513(f)]
- Sales from donated merchandise [513(a)(3)]

- A trade or business carried on by a 501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees [513(a)(2)]
- The exchange or rental of member and donor lists among other organizations tax-exempt under 501 (c)(3) [513(h)(1)(B)]
- Distribution of low-cost items in connection with charitable solicitation [513(h)(1)(A)]
- Certain hospital services provided at or below cost [513(e)]
- Qualified public entertainment activity [513(d)(2)]
- Income from services provided under a federal license by a religious order or its educational institution [512(b)(15)]
- Qualified pole rentals by a mutual or cooperative telephone or electric company [513(g)]
- Member income of mutual or cooperative electric companies [512(b)(18)]
- Certain debt management plan services [513(j)]

Payment

Organizations that generate at least $1,000 of gross unrelated business income must file a Form 990-T, Exempt Organization Business Income Tax Return, to report unrelated business income and pay any tax due. The organization must file Form 990-T in conjunction with its annual information return (i.e., Form 990, Form 990-EZ, or Form 990-PF).

An organization may take a number of tax deductions when computing UBIT. The IRS permits a specific deduction of $1,000. Similarly, the IRS permits deductions for net operating losses, provided that it does not take into account any amount of income or deduction that has been excluded from the unrelated business income calculation.

Organizations may take a charitable contribution deduction of up to 10 percent of the amount of unrelated business taxable income, computed without regard to the deduction for contributions. In addition, the IRS permits deductions for expenses that are “directly connected” with the carrying on of the unrelated trade or business. Note that special rules are applicable to the calculation of UBIT from advertising in periodicals.

If an organization regularly conducts two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to such activities. Where the value of the income exceeds the allowable deductions, the organization must pay a tax on the net unrelated business taxable income. This tax is generally imposed at the applicable (graduated) federal corporate income tax rates. An organization must pay quarterly estimated taxes prior to its annual information return filing date if its expected tax for the year will be $500 or more.

Protecting Tax-Exempt Status

A tax-exempt organization could jeopardize its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is “substantial” in relation to the organization’s tax-exempt functions. To avoid jeopardizing its tax-exempt status, an organization substantially engaged in one or more unrelated business activities should consider creating one or more taxable corporate subsidiaries in which to house and carry out such activities.

Such subsidiaries are separate but affiliated organizations, generally wholly-owned by the parent tax-exempt organization. A subsidiary will pay corporate income tax on its net income. But the tax-exempt parent’s exempt status will remain. Moreover, the subsidiary can remit the after-tax profits to its parent as tax-free dividends. Note that using a pass-through entity – such as an LLC – to house unrelated business activities will not necessarily offer the same tax-related protections as a subsidiary organized as a C corporation.

Conclusion

Evaluating whether a particular activity may generate UBIT requires a fact-intensive review. While this article provides an overview of UBIT and its exceptions, all entities are encouraged to carefully analyze the impact of activities on the organization’s tax-exempt status and its potential tax obligations.

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For more information, please contact authors **Jeffrey Tenenbaum**, **Matthew Journy** and **Lisa Hix**.

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