Legal Structuring for Nonprofit Organizations: Creating Systems, Affiliates, and Subsidiaries

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Reasons for Adding Entities/Creating a System

- Adding a new line of business
- Undertaking an enterprise involving some legal risk
- Desire to separate functions
- Need/desire for additional board(s) of directors
- Undertaking an activity that presents a risk to 501(c)(3) status
- Need for centralized management/vision
- Tax planning

Issues to Consider

- Liability protection (real or perceived)
- Board structure and governance
- IRS classification of entities
- Tax issues (UBIT)
- Employee issues – payroll, benefits
- IP issues – trademarks
- Costs of maintaining additional entities – accounting, legal, time

Liability Protection

- Placing a risky enterprise in a separate legal entity may limit liability
- Be careful about “piercing the corporate veil”
- Separate entity must be treated as such- separate board (can be some overlap), separate corporate records, separate meetings

Board Structure and Governance

Issues to Consider:

- Size of board
- Overlapping board membership
- Appointment process
- "Special" qualifications and skills for particular boards (e.g., fundraising, operational knowledge)
- Need to avoid "meeting fatigue"

Roles of Different Corporate "Players"

- 501(c)(3) charitable organizations
- 501(c)(2) or 501(c)(25) title holding companies
- Supporting organizations
- Single-member LLCs
- For-profit subsidiaries

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Additional 501(c)(3) Entities

- Useful when separating "charitable" functions (e.g., separate schools or hospitals placed in separate legal entities)
- May want one separate charitable foundation to raise money for the various charitable entities in the "system"
- Separate charitable entity to hold and invest the endowment

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Title Holding Companies

- Tax-exempt under 501(c)(2) or 501(c)(25)
- Generally used to hold rental real estate
- Must turn over its income to its tax-exempt parent
- Limited in activities it can pursue
- With some exceptions, must avoid UBIT
- Need to consider eligibility for property tax exemption

Supporting Organizations

- Type of 501(c)(3) organization
- Supports other 501(c)(3) organizations
- Must be "controlled" in some fashion by the organizations it supports
- No need to fundraise to maintain public charity status
- Can be a useful parent organization of a system

Single-Member LLC

- Controlled by another tax-exempt entity in the system
- Treated as a disregarded entity for tax purposes- treated as part of its parent and included on parent's tax return
- Eligible to receive deductible charitable contributions (if sole member is 501(c)(3))
- For corporate purposes, treated as a separate entity with liability protection
- Flexible management
- No IRS exemption application required
- Consider local law for property tax exemption

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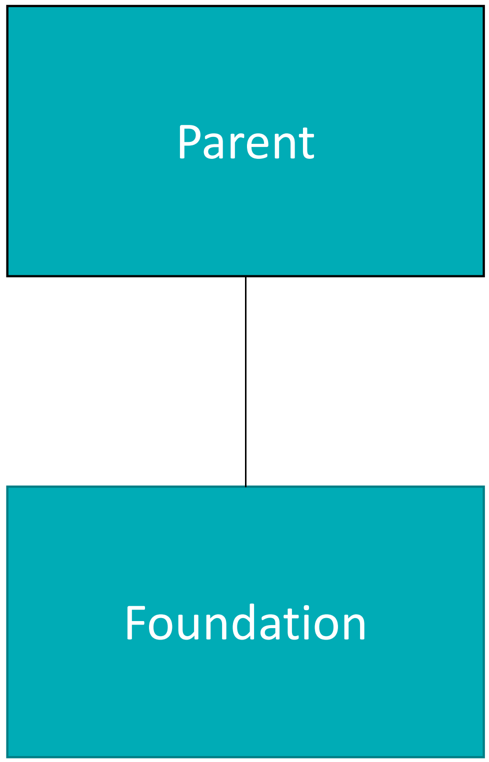
For-Profit Subsidiary

- Useful when entering a commercial business that would produce UBIT if operated within tax-exempt entity and possibly risk tax exemption
- Gives ability for more flexible compensation structures – i.e., equity-based compensation

Possible System Structures

Model 1



Options:

1) Member/parent appoints board of foundation

2) Overlapping boards – ex officio directors

3) "Freestanding" nonprofit populated by "friends" of parent

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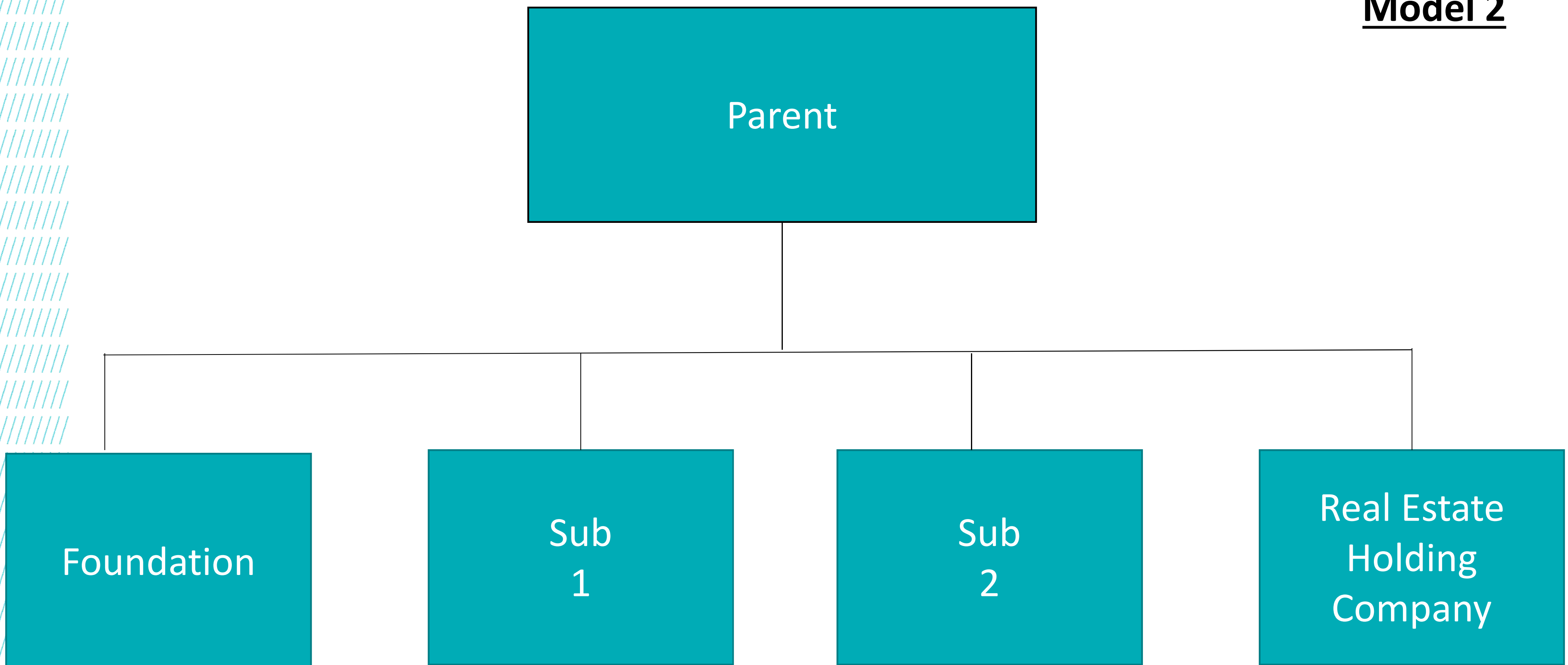
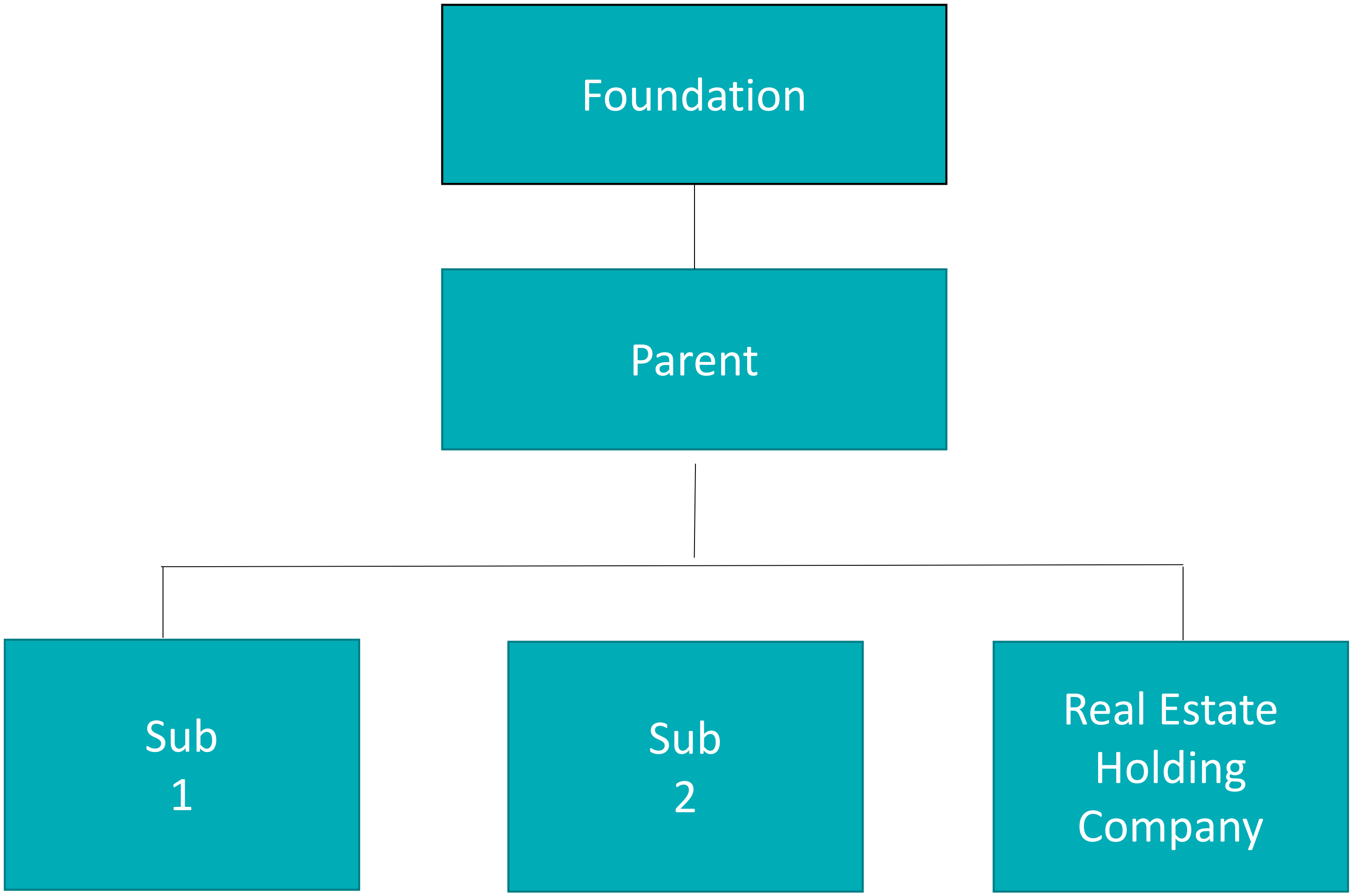
Model 2



-501(c)(2)
-LLC
-509(a)(3)

Model 3



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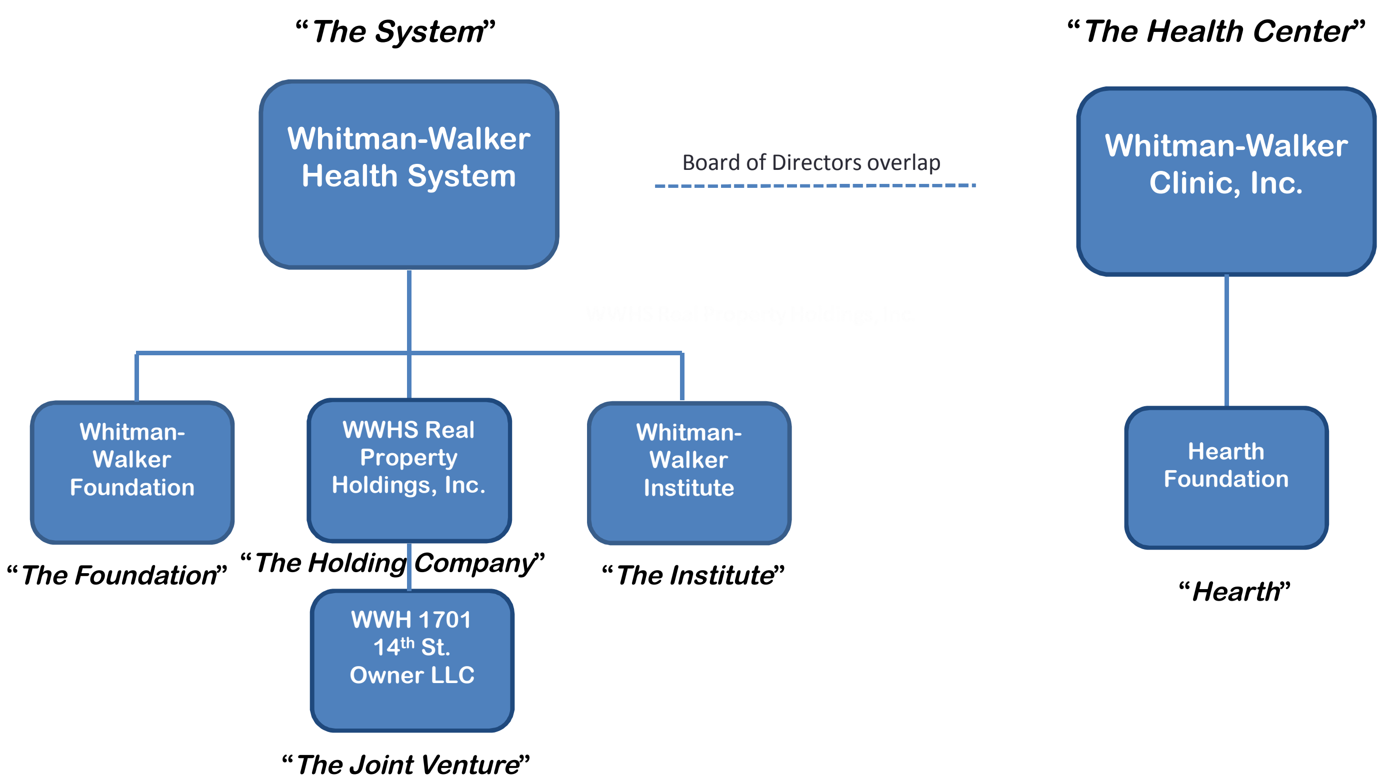
Whitman-Walker Health

Community Health System

(Effective January 1, 2018)



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