Using Affiliates to Expand Your Nonprofit Reach

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Agenda

- Creating Affiliated Entities
  - Why Do Nonprofits Create Affiliated Entities?
  - Potential Benefits
  - Potential Downsides
  - Managing Affiliates – Key Considerations
    - Separateness
    - Control
- Creating a For-Profit Enterprise
- Creating Nonprofit Affiliates

Creating Affiliated Entities

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Why Do Nonprofits Create Affiliated Entities?

- Reasons for creating new entities varies, often driven by the intersection of tax-exempt status and business needs

- Types of tax-exempt organizations considered for this presentation
  - 501(c)(3) – Charitable and educational organizations
  - 501(c)(4) – Social welfare / advocacy organizations
  - 501(c)(6) – Trade associations / business leagues
  - 527 – Political organizations

- Affiliated entities
  - Corporation – Tax-exempt or for-profit
  - LLCs – Disregarded/pass-through or S-Corp

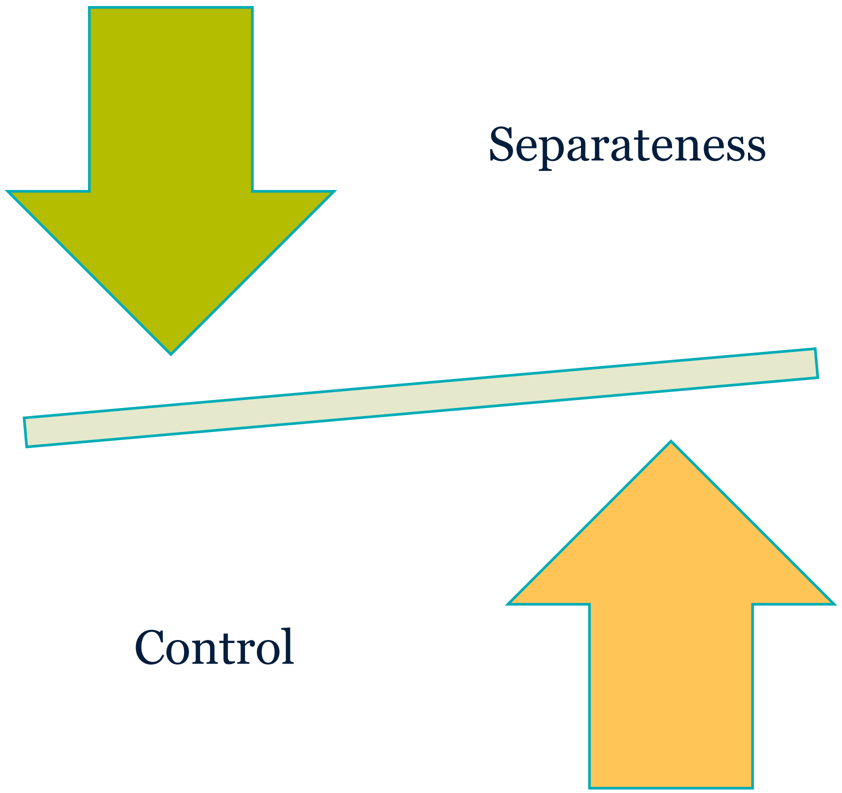
Potential Benefits

- **Programmatic expansion**
  - Advocacy – Lobbying and political activities
  - Professional Certification Activities – Protect 501(c)(3) from private benefit risks
- **Risk containment**
  - Brand distance for controversial programming or advocacy
  - Asset protection/insulation
  - Substantial unrelated activity
  - Creation of supporting organization if main organization is facing challenges
- **Revenue generation – For-profit**
  - Mitigate UBIT
  - Attract outside investment; easier to sell/spin off
  - Attract talent; can offer equity and market compensation
- **Revenue generation – Nonprofit**
  - Supporting organization
  - Foundation affiliate
  - Engage new donors
- **Other business reasons**
  - International expansion

Potential Downsides

- **Administrative burden**
  - Must manage multiple entities – Separate bank accounts, books, records, activities board meetings
  - Must manage the sharing of resources between organizations (time tracking, cost tracking)
  - File multiple IRS Form 990s, tax reports, and state registrations
- **Cost**
  - Startup and ongoing maintenance costs
  - Infrastructure buildout and need for additional management resources
- **Mission creep**
  - Are the affiliated entities serving the mission of the main entity?
- **Mission drift / loss of control**
  - Different leadership, boards, missions can lead to different priorities over time

Managing Affiliates – Key Considerations



- Balance Separateness vs. Control
- Ensure affiliates remain aligned in mission
- Protect integrity of each entity's distinct existence and tax status
- Ensure political activities of 501(c)(4)/501(c)(6) are not imputed to 501(c)(3)
- Balance will influence decisions regarding how affiliates are structured and managed

Separateness

- Provide adequate capitalization of new entity given its goals and operations
- Avoid commingling of assets; maintain separate accounts
- Separate boards and governance
- Separate board meetings and minutes
- Separate policies and contracts
    - Policies should be adopted by each entity
    - Helpful to use same policies for consistency
- Contracts between entities
- Resource sharing can cause issues, including private benefit, inurement, and prohibited political campaign intervention, in addition to general corporate separateness issues
    - Shared services agreement is essential!

Control

- Control and alignment through governance:
  - Member / manager relationship
    - Appointment of Board, approval of fundamental corporate decisions
    - Operational authority over LLC
  - Board of Directors
    - Appointment authority
    - Overlapping Board
    - Ex officio positions on affiliate board
    - Majority vs. minority overlap; independent board members
  - Shared executive leadership
  - Shared services

Creating a For-Profit Enterprise

Considerations – Protect Nonprofit Tax Exemption

- Nonprofit must not:
  - (i) be substantially engaged in commercial activities that do not primarily serve its tax-exempt purpose(s) and
  - (ii) create impermissible private benefit for any private person or entity
    - Private benefit: Substantial benefit to a private person or interest
    - Private inurement: Any unreasonable benefit to an organizational "insider" (e.g., directors, officers, and key employees)

- Potential consequences:
  - Imposition of unrelated business income tax (UBIT)
  - Imposition of excise taxes (including excise tax on managers)
  - Revocation of tax-exempt status

Considerations – Capitalizing the New Entity

- Nonprofit will need to capitalize the new entity and transfer programmatic assets for the new entity to become operational
  - The capitalization could be through a loan, or financing and equity agreement, such as a simple agreement for future equity (SAFE)
  - Note that any transfer of assets or loans to the new entity should be made at arm’s length (independently), subject to fair market value, and pursuant to written agreements
  - Existing IP developed by Nonprofit may be licensed or sold to the new entity at fair market value (through equity, note, future revenues, etc.)

- Nonprofit and for-profit entity may contractually share resources, services, IP, or personnel through inter-entity agreements that must be negotiated at an arm’s-length distance and must be able to be amended easily over time

Considerations – Unrelated Business Income

- UBIT: Tax imposed on the income that a tax-exempt organization earns from a business activity <u>not related</u> to its tax-exempt purpose
- An exempt organization cannot engage in more than an insubstantial amount of activity unrelated to its exempt purpose without risk of losing its tax-exempt status
- If an activity is substantial and unrelated to the parent's exempt purposes, it can be carried out by a subsidiary without jeopardizing the parent's tax-exempt status
- Income that flows back to Nonprofit from for-profit entity must be structured in a way to mitigate UBIT/substantial unrelated activity
    - Dividends

Considerations – Compensation and Equity

- Total compensation paid by a nonprofit must be reasonable:
  - Under IRS limits, overall compensation for executives of Nonprofit must be "reasonable" as compared with other, similarly situated nonprofits
    - This includes total compensation for individuals who are paid from both Nonprofit and for-profit-related affiliates or subsidiaries
  - Nonprofit directors and executives may be subject to penalty excise taxes if they receive excessive benefits/compensation from the organization
  - Any dual employment relationship should be negotiated by disinterested individuals on behalf of the entities
  - No IRS limits would apply to compensation paid to persons employed solely by the new entity who have had no role at the Nonprofit
    - Note 5-year lookback period for IRS imposing intermediate sanctions (penalties) for nonprofit excess benefit transactions

Considerations – Structure Examples

Limited Liability Company (LLC)

Pros:

- If a nonprofit is the sole member, the LLC is disregarded for federal income tax purposes
- Provides protection from personal liability
- Greater flexibility than a corporation in equity incentives, governance, and economics

Cons:

- Less attractive to institutional investors
- Pass-through taxation can result in excess UBIT

C-Corporation

Pros:

- Limited personal liability for shareholders
- Ability to issue equity options and different classes of stock (including employee stock options)
- Preferred entity type for investors
- Well-developed case law provides greater predictability in corporate governance

Cons:

- Subject to *double taxation* — profits taxed at both corporate and shareholder levels
- More statutory and formal requirements than an LLC; corporate formalities must be followed to maintain liability protection

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Creating Nonprofit Affiliates

Why might you need a nonprofit affiliate?

- You want to expand programmatic reach.
- You are a 501(c)(3) and it's important to your mission to have an entity with an aligned mission that can do more lobbying or engage politically.
- You are a 501(c)(4)/501(c)(6), and having a research/educational affiliate will help bolster your mission.
- You have donors/supporters/members who have encouraged you to expand your work.
- You are a 501(c)(4), and there are potential donors who would like to support your mission but will give only to public charities.

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Why might you wait?

- You can use an existing entity
  - Grantee
  - Coalition partner
  - Existing affiliate

- Insufficient funds to form and sustain a new organization
  - Consider a pilot program to test scalability or longevity
  - Create a new brand

- The risk doesn’t justify the cost
  - The administrative burden is too great
  - Affiliate’s mission is incompatible or will divert critical funds from supporting your current projects and priorities
  - Donors, staff, or members may not be supportive of the new entity

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Bolstering Nonprofit Advocacy

- Increased advocacy is one of the primary reasons to create affiliated entities.

- Why do organizations do it?
  - Protect and advance their organization/members/interests/issues
  - New opportunities
  - Lobbying/political activities
  - Enhance reputation
  - Promote favorable regulatory climate
  - Engage with different supporters and donors

What type of entity do you need?

501(c)(3): Public Charity	**501(c)(4): Social Welfare** **501(c)(6): Trade Association**	**527 Political Committee**
Charitable deduction may be available	No charitable deduction; portion of dues attributable to lobbying not deductible as business expense	No charitable deduction
No "campaign intervention" • No endorsements • No contributions, expenditures, or use of corporate resources • No communications to support candidates or parties • No "biased" communications or activities designed to benefit a candidate or party Can engage in nonpartisan GOTV, debates, voting records, and questionnaires	Campaign intervention permitted, but limited • May not be primary purpose • May contribute to candidates (if allowed under state law) • May establish PAC (SSF, super PAC) • May make communications to support candidates (beware of registration and donor disclosure)	Campaign intervention is primary purpose • Used to engage electorally in a way that supports the mission of the organization • Connected (SSF) and nonconnected PACs; super PACs • Requires registration, disclosure of contributions and expenditures
Lobbying may not be "substantial part" of activities • Unlimited issue advocacy ok as long as not "lobbying"	Unlimited lobbying and issue advocacy	Limited lobbying and issue advocacy are ok • Must have the primary purpose of influencing elections
May establish and share services with 501(c)(4) and 501(c)(6) May NOT establish or share resources or services with 527	May establish and share services with either 501(c)(3) or 527 organizations	May be established by and share services with 501(c)(4) or 501(c)(6) May NOT share services or resources with 501(c)(3)

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Consider the Risks

- Loss of tax-exempt status
  - 2020 PLR – Entity that used 501(c)(3) resources to support 527 organization owned by for-profit subsidiary could lose its tax exemption, even where 527 paid fair market value for resources provided by 501(c)(3)
  - Must use caution when sharing services!
- Tax penalties
  - Excess lobbying, tax on political expenditures
- Reputational risk
- Donor or member complaints
- Donor disclosure

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Practical Approaches to Managing Risk

- Balance separateness with control
- Control to avoid affiliates going rogue
  - Governance overlap
  - Authority to appoint/remove directors
  - Revoke IP rights
  - Strong termination provisions shared services agreements
  - Maintain fidelity to mission and tax status

- Separateness to avoid affiliate's activities imputed to your organization
  - Corporate Governance
  - Branding
  - Website
  - IP
  - Resource Sharing
  - Record Keeping

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