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Not-for-Profit Organizations: How to Avoid Common Errors and Adopt Strategies to Minimize Risk

Presented by:
Richard S. Caputo, Esquire

FORMATION

FORMATION

1. **Failing to incorporate your association**

   - Incorporating provides limited liability for your officers and directors.

   - If your organization was formed as a trust, make sure your trustees are covered under an insurance policy.

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FORMATION

2. **(a) Failing to qualify as a corporation or failing to form a corporation or a limited liability company in each state in which you operate**
   - Qualify to do business in such state(s) by filing a certificate of authority.
     - Liability concerns for headquarters
   - Form a nonprofit corporation, a for-profit corporation or a limited liability company in each such state.
     - Should the newly-created nonprofit corporation apply for tax exemption.
     - Is the LLC generating UBTI?

   (b) Forming a nonprofit corporation in New York or California

   (c) Failing to file solicitation of funds registration statements in the state(s) in which you solicit
   - Is soliciting different than engaging in business?

ENDOWMENTS, INVESTABLE ASSETS AND TRUSTS

ENDOWMENTS, INVESTABLE ASSETS AND TRUSTS

3. **Failing to identify donor designated funds, board restricted funds and unrestricted funds and failing to use unrestricted funds for the purposes set forth in the entity's governing documents**
4. **Failing to maximize distributions from endowed funds, other investments with temporal use restrictions and trusts**
   - An Act 141 election would permit an organization to invade principal
   - Uniform Prudent Management of Institutional Funds Act (UPMIFA): Permits an organization to disregard spending limitations and appropriate a percentage of the fair market value of the fund
   - Trusts: Act 141 election, state law equivalent, PF rules, SO rules
5. **Adopting a spending policy that violates the spending limitations imposed by a donor (PA concern only?)**
   - An Act 141 election would permit an organization to invade principal
   - Uniform Prudent Management of Institutional Funds Act (UPMIFA): Permits an organization to disregard spending limitations and appropriate a percentage of the fair market value of the fund

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ENDOWMENTS, INVESTABLE ASSETS AND TRUSTS

6. **Failing to ensure that your spending policy is consistent with your Act 141 election**
7. **Using the investment income earned on non-endowed restricted funds for general purposes of the charity without first notifying the donor**
8. **Failing to unrestrict restricted funds that are wasteful or incapable of fulfillment**

MERGERS / AFFILIATIONS / REORGANIZATIONS

Mergers/Affiliations with Third Parties:

9. **Failing to minimize liability exposure when affiliating with a third party**
   - Statutory Mergers: easy but risky.
   - Could manage operations and merge after the applicable statutes of limitations have expired.
   - Are there alternative reorganization structures to minimize risk?
     - Alternative reorganization structures
       - Transfer of Assets.
       - Liquidating Transfer of Assets.
       - Consolidation into NewCo.
       - Conversion to Sole Member Corporation.
       - Creation of Mutual Parent Entity.
       - Joint venture.
       - Virtual merger.
       - Virtual joint venture.
       - Sale of assets.
       - Management agreement.
     - Regardless of structure, do not affiliate without engaging in substantial due diligence

10. **Failing to obtain a board seat on the surviving entity post-merger**
    - Standing

Reorganization for UBIT Purposes:

Forming a for-profit c-corporation subsidiary to avoid revocation of exemption due to excessive unrelated business revenue and

11. **Having the subsidiary governed by the same individuals who govern the parent organization**

12. **Failing to consider other issues:**
    - **Deductibility of donations to the subsidiary (cash, stock, real estate);**
    - **Keeping the employees at the parent level (payroll benefit but asset protection issues);**
    - **failing to account for sales and use tax that will be due on purchases by the subsidiary and real property taxes;**
    - **charging the nonprofit more than fair market value consideration for any services performed by the subsidiary (and thereby causing income tax to be due and owing); and**
    - **failing to consider deferred compensation issues.**

Reorganization for Asset Protection Purposes:

13. **Dropping a substantial amount of assets into a newly-formed subsidiary for asset protection reasons**
    - While the assets of the parent organization should be protected from claims of the subsidiary's creditors, the assets of the subsidiary are not protected from claims of the parent organization's creditors
14. **Transferring all assets other than real estate and all activities to a newly-formed subsidiary for asset protection reasons**
    - While the assets of the parent organization should be protected from claims of the subsidiary's creditors, any real estate currently exempt from real property taxes will likely become subject to real property taxes because the owner of the real estate would no longer be directly using the real estate for charitable purposes
15. **Forming a brother-sister corporation for asset protection reasons without retaining a power to remove and reserved powers over amendments to the governing documents**
    - Is the power to remove even enforceable?

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BYLAWS/GOVERNANCE

BYLAWS/GOVERNANCE

16. **Failing to differentiate between “Ordinary Course of Business Decisions” (approval by officers), “Significant Decisions” (approval by board upon majority vote), and “Fundamental Decisions” (approval by board upon super-majority vote of all directors in office)**
   - “Ordinary Course of Business Decisions”
     - Officers should be able to make these types of decisions.
   - “Significant Decisions”
     - These types of decisions involve significant transactions/actions and should be made by the board of directors (not the officers).
     - A majority of the Directors in office shall be necessary to constitute a quorum for the transaction of business and, except as otherwise expressly provided in these Bylaws, the acts of a majority of the Directors present at a meeting at which a quorum is present shall be the acts of the Board of Directors.

BYLAWS/GOVERNANCE

- "Fundamental Decisions"
  - These types of decisions involve Fundamental Transactions/Actions and should be made by the board of directors (not the officers).
  - Any "Fundamental Transaction" (as defined herein) shall require the affirmative vote of two-thirds (2/3) or more of the Directors then in office.
    - A "Fundamental Transaction/Action" shall include the following:
      - » Any amendment to, or repeal and subsequent adoption of, any provision of the Articles or Bylaws;
      - » The increase or decrease in the authorized number of members of the Board of Directors;
      - » The removal of a member of the Board of Directors;
      - » The adoption of any plan for the merger, consolidation or reorganization of the Corporation;
      - » The adoption of any plan for the division or conversion of the Corporation;
      - » The sale of all or substantially all of the assets of the Corporation;
      - » The formation of a subsidiary of the Corporation;
      - » The adoption of any plan for the dissolution or liquidation of the Corporation;
      - » The creation of a membership class of the Corporation;
      - » The appointment of any members of the Corporation;
      - » The approval, modification or termination of the Signatory and Disbursement Policy of the Corporation; and
      - » The establishment of, increase in or decrease in, compensation for any management personnel of the Corporation.

BYLAWS/GOVERNANCE

17. Failing to limit your officers' power to bind your organization

– Generally, officers should not have the power to bind if the transaction/action at issue is a "significant" or "fundamental" one. In those cases, officers should only have the power to bind the corporation after the full board approves the transaction.

– "Ordinary Course of Business Transactions/Actions"

- All officers or certain officers may bind the organization.

BYLAWS/GOVERNANCE

- “Significant Transactions/Actions”
  - Officers designated by the board of directors may bind the organization, but only after the board of directors approves the transaction/action by majority vote of those directors present.
  - A majority of the Directors in office shall be necessary to constitute a quorum for the transaction of business and, except as otherwise expressly provided in these Bylaws, the acts of a majority of the Directors present at a meeting at which a quorum is present shall be the acts of the Board of Directors.
- “Fundamental Transactions/Actions”
  - Officers designated by the board of directors may bind the organization, but only after the board of directors approves the transaction/action by supermajority vote of the directors then in office.
  - Any “Fundamental Transaction/Action” (as defined herein) shall require the affirmative vote of two-thirds (2/3) or more of the Directors then in office.

BYLAWS/GOVERNANCE

18. Failing to adopt a Signatory and Disbursement Policy and if one is adopted, failing to confirm that your organization's Signatory and Disbursement Policy is consistent with the terms of your bylaws

- A Signatory and Disbursement Policy should reduce the risk of an officer, director or employee binding the organization without proper authorization.
- An organization can revise a Signatory and Disbursement Policy without notifying the IRS.
  - If an organization's bylaws contain signatory and disbursement provisions and such provisions are amended, the organization must notify the IRS.
- See sample Signatory and Disbursement Policy.
- See sample Bylaw provision.

Signatory and Disbursement Policy

- **Purpose**
- The purpose of this Signatory and Disbursement Policy of ____________________________ (the "Corporation") (this "Policy") is to expedite payments to the Corporation's vendors, partners, and beneficiaries; to ensure the proper accrual and/or payment of the expenses and liabilities of the Corporation; to ensure significant purchases are included in the Corporation's financial plans; and to set forth the agents of the Corporation that shall have the power to sign and execute contracts, checks, and other documents and thereby bind the Corporation.
- **Scope**
- This Policy applies to all directors, officers, employees and other agents of the Corporation ("Covered Persons"). It is the responsibility of all Covered Persons to comply with this Policy. Pursuant to Section 5.10(b) of the Corporation's bylaws (the "Bylaws"), the board of directors of the Corporation (the "Board of Directors") is responsible for setting and changing the authorization limits set forth in this Policy.
- **Contracts and Agreements**
- The signing, execution, acknowledgment, approval, modification or termination of any tax document, deed, mortgage, contract, employment agreement, grant agreement, lease agreement, license agreement, plan of merger, agreement of sale, letter of intent or other agreement or instrument to which the Corporation is a party (each, an "Agreement"), or a series of related Agreements, shall not be effective unless the Agreement(s) is (are) signed and/or approved by the parties as set forth in Table 1, as applicable. Only the signature and/or approval of the required parties listed in Table 1, as applicable, shall act to bind the Corporation. All authorization limits are listed in US Dollars and represent the total value of the Agreement or related Agreements or the total value of the assets and/or liabilities of the Corporation affected by the Agreement or related Agreements, as applicable.

- Table 1:

Total Value of Agreement(s)	Signature Required	Approval Required
$5,000,000 and up	Any officer or employee designated by the Board of Directors	Affirmative vote of two-thirds (2/3) or more of the members of the Board of Directors (the "Directors") then in office
$1,000,000 to $4,999,999	Any officer or employee designated by the Board of Directors	Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
$250,000 to $999,999	President of the Corporation, or Any officer or employee designated by the Board of Directors	No Board of Directors approval is required Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
Up to $249,999	Any officer or employee of the Corporation	No Board of Directors approval is required

[1] For the purposes of this Policy, the term "present" when used in relation to a Director shall mean those Directors who are present in person, by telephone, by video or by other similar means at a meeting of the Board of Directors.
[ALTERNATIVE: For the purposes of this Policy, the term "present" when used in relation to a Director shall mean those Directors who are present in person, by telephone, by video or by other similar means at a meeting of the Board of Directors or those Directors who have voted by mail in or e-mail ballot. ***(include if alternative 5.10(a) is selected)***

- **Incurrence of Debt**

  The incurrence of any debt, obligation, guaranty or lien (each, an "Obligation"), or series of related Obligations, shall not be effective unless the Obligation(s) is (are) signed and/or approved by the parties as set forth in Table 2, as applicable. Only the signature and/or approval of the required parties listed in Table 2, as applicable, shall act to bind the Corporation. All authorization limits are listed in US Dollars and represent the total value of the Obligation or related Obligations or the total value of the assets and/or liabilities of the Corporation affected by the Obligation or related Obligations, as applicable.

- Table 2:

Total Value of Obligation(s)	Signature Required	Approval Required
$5,000,000 and up	Any officer or employee designated by the Board of Directors	Affirmative vote of two-thirds (2/3) or more of the Directors then in office
$1,000,000 to $4,999,999	Any officer or employee designated by the Board of Directors	Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
$250,000 to $999,999	President of the Corporation, <u>or</u> Any officer or employee designated by the Board of Directors	No Board of Directors approval is required Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
Up to $249,999	Any officer or employee of the Corporation	No Board of Directors approval is required

- **Disbursement Authorization Limits**

  The signing, execution or approval of any check, transfer, withdrawal, disbursement, note, bill of exchange, purchase, gift or other instrument (each, a "Disbursement"), or related series of Disbursements, shall not be effective unless the Disbursement(s) is (are) signed and/or approved by the parties as set forth in Table 3, as applicable. Only the signature and/or approval of the required parties listed in Table 3, as applicable, shall act to bind the Corporation. All authorization limits are listed in US Dollars and represent the total value of the Disbursement or related Disbursements or the total value of the assets and/or liabilities of the Corporation affected by the Disbursement or related Disbursements, as applicable.

- Table 3:

Total Value of Disbursement(s)	Signature Required	Approval Required
$5,000,000 and up	Any officer or employee designated by the Board of Directors	Affirmative vote of two-thirds (2/3) or more of the Directors then in office
$1,000,000 to $4,999,999	Any officer or employee designated by the Board of Directors	Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
$250,000 to $999,999	President of the Corporation, or Any officer or employee designated by the Board of Directors	No Board of Directors approval is required Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
Up to $249,999	Any officer or employee of the Corporation	No Board of Directors approval is required

- **Government Filings**

  The preparation, execution or filing of *any* filing, form or document (each, a "Document") with any federal, state or local government agency, government unit, government entity, government-affiliated department, federal or state court, district justice or other local court, tax collector, state, political subdivision or integral part of a state or political subdivision, including but not limited to, the Internal Revenue Service, the Department of State, the Department of Revenue, the Department of Labor and Industry, the Bureau of Charitable Organizations and/or the Division of Taxation, shall not be effective unless such Document is signed and/or approved by the parties as set forth in Table 4, as applicable. Only the signature and/or approval of the required parties listed in Table 4, as applicable, shall act to bind the Corporation. The required signature and/or approval shall be determined by the nature of the underlying transaction that necessitates the preparation, execution or filing of the Document.

- Table 4:

Underlying Transaction	Signature Required	Approval Required
A "Fundamental Transaction" as that term is defined in Section 5.10(b) of the Bylaws	Any officer or employee designated by the Board of Directors	Affirmative vote of two-thirds (2/3) or more of the Directors then in office
Any transaction (other than a Fundamental Transaction) that requires the approval of the Board of Directors	Any officer or employee designated by the Board of Directors	Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
Any other transaction	President of the Corporation	No Board of Directors approval is required

- SIGNATORY AND DISBURSEMENT AUTHORITY. Unless otherwise set forth in the Signatory and Disbursement Policy, a Director and/or an officer, employee or representative of the Corporation shall have no authority, on behalf of and/or in the name of the Corporation, to: (a) sign, execute, acknowledge, modify and terminate tax documents, deeds, mortgages, contracts, employment agreements, grant agreements, lease agreements, license agreements, plans of merger, agreements of sale, letters of intent and other agreements and instruments; (b) incur debts, obligations, guaranties or liens; and/or (c) sign, execute and approve any check, transfer, withdrawal, disbursement, note, bill of exchange, purchase, gift or other order in writing.

BYLAWS/GOVERNANCE

19. **Failing to distinguish between the "directors who are present at a meeting at which a quorum exists" and "directors then in office" when describing the requirements for particular board actions.**
20. **Failing to provide that your organization will indemnify its directors/trustees, officers and committee members and failing to permit your organization to purchase liability insurance on behalf of its directors/trustees, officers and committee members.**

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HONORABLE MENTION

21. Failure to register to solicit.
22. Failure to comply with solicitation legend requirements.
23. Failure to register commercial co-ventures.
24. Failure to ensure enforceability of pledges.
25. Allowing individuals to serve as members to retain control.
26. Allowing the ED to be a voting member of the board (conflict issues).

RISK

27. Failing to minimize your liability exposure arising out of your operations, real estate activities, related businesses and unrelated businesses

- Types of risk
  - Risk from operations
    - Grant-making private foundations
      - » distributions
      - » investment management
        - investment loss
        - theft
      - » labor issues

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RISK

- Grant-making public charities
  - » Distributions
  - » Investment management
    - investment loss
    - theft
  - » labor issues
  - » fundraising events
    - golf outings, galas and dinners
      - does facility have a liquor license?

RISK

– Operating entities (churches, educational institutions, hospitals and medical clinics, medical research organizations, housing organizations, trade associations, country clubs, etc.)
  - » Distributions
  - » Investment management
    - Investment loss
    - Theft
  - » Labor issues
  - » Fundraising events
    - Golf outings, galas and dinners
      - Does facility have a liquor license
  - » Transactions with members, students, faculty, administrators, customers, patients, tenants, vendors, etc.

RISK

- Risk from real estate activities (own/lease)
- Risk from related business activities
- Risk from unrelated business activities
- Risk due to mergers
  - Successor liability
    - » Due diligence to minimize risk
    - » Select an affiliation structure that minimizes risk
    - » Create affiliate to merge with a third party

RISK

- Assets Available to Creditors: Insurance Proceeds
  - Insurance Proceeds: General Liability Coverage, D & O Coverage, Golf Outings and Other Special Events Coverage (Liquor Liability) and Cyber Liability Coverage
  - Considerations with respect to adequate insurance coverage
    - Amount of assets
    - The types of activities your organization conducts
      - » Are they high-risk activities (e.g., medical care, child care, elder care)?
    - If merging, the types of activities the target organization conducts
      - » Could the target organization have unknown liabilities (environmental, tax, labor, etc.)?
    - Cost of premiums
    - Occurrence-based or claims-made policy

RISK

- Issues with too much insurance:
  - Paying higher premiums, the cost of which could otherwise be used to fulfill the organization’s charitable purposes
  - Possible breach of fiduciary duties if the board authorizes higher insurance coverage that is not justifiable
- Issues with too little insurance:
  - If the insurance proceeds are less than the claims of creditors, then the organization’s assets will be used to pay any claims of creditors in excess of the insurance coverage. If the organization’s “unrestricted” assets are not sufficient to satisfy the claims of creditors, then the directors may have to personally satisfy the claims if the creditors are able to “pierce the corporate veil”
- Denial of Coverage Due to Policy’s Exceptions/Exemptions

RISK

– Assets Available to Creditors: Corporate Assets

- In the event there is no insurance coverage, the insurance coverage does not cover the claim due to an exception or an exemption, or the coverage simply is less than the claim, the creditor will seek to attach the assets of the corporation.
- Creditors are interested in funds (i.e., cash), not assets that have to be sold
  - Also, it is not in the best interest of the nonprofit to sell assets to pay off creditors because most of these sales are “fire sales,” and therefore, the nonprofit is selling at a discount

RISK

- Are Restricted Funds Available to Creditors?
  - Funds restricted for a particular purpose by the grantor
  - Must be used for the purposes for which they were given unless:
    - » The original purposes becomes unlawful, impractical or wasteful, and the grantor is alive and consents to a different use
      - Over time, restricted purposes may not conform to organization’s mission
      - The organization may petition the court to apply “cy pres,” which translates to “as near as possible”
        - Allows an organization to petition the court to change the purposes for which the funds were given
          - Advantage of Cy Pres: Redirects otherwise restricted funds for new purposes
          - Disadvantage of Cy Pres: Costly and time consuming, involves court and attorney general approval
    - » The grant agreement allows the organization to divert the funds for other purposes
  - It is difficult, if not impossible, for creditors to gain access to restricted funds
    - » This is good news if the creditors cannot “pierce the corporate veil”
    - » This is bad news if the creditors can “pierce the corporate veil”

RISK

- Are "Unrestricted Funds" available to creditors?
  - "Unrestricted funds" are funds that are not restricted for a particular purpose by the grantor, BUT are such funds really unrestricted?
  - These funds are still restricted for the purposes set forth in the organization's articles and bylaws (as such documents are drafted at the time of the gift) and, possibly, for the purposes set forth in the organization's Form 1023 application
    - » Example: The organization's articles state that the organization is organized to support the homeless in Philadelphia. The organization should not use "unrestricted" funds from donors to support the homeless in Pittsburgh because the organization's articles restrict the use of funds

RISK

- Can your organization expand its “unrestricted funds” by changing the purpose clauses in the articles and bylaws
  - File amended articles with Department of State, revise your bylaws and notify the IRS of the change in purpose
  - After changing your articles/bylaws, any funds received thereafter can be used for the new purposes set forth in the revised articles/bylaws
  - Example: the corporation is organized and operated exclusively for charitable purposes within the meaning of Section 501(c)(3) of the Code
  - However, existing “unrestricted funds” must continue to be used for the purposes set forth in your articles/bylaws/Form 1023 application at the time the funds were contributed, unless a cy pres proceeding is commenced
- Can unrestricted funds be used to pay a creditor, and if not, can the unrestricted purpose be expanded so that payment of the creditor is permissible? Yes and Yes.
- However, what if the “unrestricted funds” constitute “secured funds” (i.e., are they collateral for any financings)?

RISK

- Effect of Restricted v. "Unrestricted" Funds on Creditors
  - Restricted funds should not be used as security
  - Creditor has greater difficulty in attaching restricted funds (Attorney General generally defends donor intent)
  - If creditor cannot satisfy his/her/its judgment with insurance proceeds or corporate assets, the creditor will try to pierce the corporate veil

RISK

– Assets Available to Creditors: Personal Assets of Directors, Officers and Management
  - Piercing the Corporate Veil
    – If a deficiency exists (that is, a creditor's claim exceeds the insurance coverage and the fair market value of the available corporate assets), then creditors can try to attach the personal assets of the members of the organization's board of directors, the officers and/or the management team.
    – The likelihood that a creditor can successfully sue a director, officer or executive for the deficiency increases if the organization is undercapitalized, has no insurance or does not respect corporate formalities (e.g., holding board of directors meetings, keeping adequate records, not commingling corporate/personal accounts, using corporate funds to pay <u>only</u> corporate expenses and liabilities)

RISK

- How to limit liability exposure

  Personal Liability

  - Make sure the organization is incorporated
  - Adequately capitalize the corporation
  - Abide by corporate formalities
  - Make sure that the corporation purchases D&O, E&O and general liability insurance

  Corporate Liability

  - Adopt and comply with bylaws that require the board of directors to approve “significant” and “fundamental” decisions
  - Adopt and comply with Corporate Governance Policies
    - Conflict of Interest Policy
    - Investment Policy
    - Signatory and Disbursement Policy
      - » Adopt Signatory and Disbursement Policy in order to restrict who can bind the corporation
        - Restrict based on the type of transaction (contracts and agreements, incurrence of debt, disbursements, and fundamental transactions), the value of the transaction and whether board approval is necessary.

Total Value of Agreement(s)	Signature Required	Approval Required
$5,000,000 and up	Any officer or employee designated by the Board of Directors	Affirmative vote of two-thirds (2/3) or more of the members of the Board of Directors (the "Directors") then in office
$1,000,000 to $4,999,999	Any officer or employee designated by the Board of Directors	Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
$250,000 to $999,999	President of the Corporation, or Any officer or employee designated by the Board of Directors	No Board of Directors approval is required Affirmative vote of a majority of the Directors present at a duly called meeting of the Board of Directors where a quorum is present
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RISK

–Investment Committee

–Development Committee

–Finance Committee

–Audit Committee and annual audits

–Review of Form 990/990-PF Return

–Employee handbook

RISK

- Obtain adequate insurance coverage to protect corporate assets
- Keep good records to substantiate restricted assets, secured assets and unrestricted assets
- Consider reorganizational structures other than statutory mergers when affiliating with third parties
  - **Rich will discuss in more detail**
- Modify your organizational structure by creating affiliates
  - General Rule: transfer litigious activities to affiliates
    - » Foundation Model: Transfer litigious activities to subsidiaries, have the parent corporation hold the restricted and unrestricted funds (to the extent possible), and limit the parent's activities to non-litigious activities (investment management, strategic planning, budgeting, short-term planning, long-term planning, finance, etc.)
    - » Holding Company Model: Transfer litigious activities to subsidiaries, transfer the restricted and unrestricted funds (to the extent possible) to a newly-created subsidiary that will not engage in activities other than investment management and passive fundraising, and limit the parent's activities to non-litigious activities (strategic planning, budgeting, short-term planning, long-term planning, finance, etc.)
    - » These structures will limit liability exposure to creditors of the high-risk activities. Such creditors should only be able to attach the "unrestricted" assets held by the subsidiary engaging in the high-risk activities and any insurance proceeds payable to such affiliate; provided, however, that the subsidiary is adequately capitalized, has insurance and complies with all corporate formalities
  - **Rich will discuss in more detail**

Richard S. Caputo Bio

Mr. Caputo is a Partner in the Chester County office of Fox Rothschild LLP and he is the Chairman of Fox's Nonprofit Organizations practice group. He specializes in tax-exempt organizations, trust administration and Orphans' Court litigation. He primarily devotes his practice to forming public charities, private foundations, supporting organizations and other tax-exempt organizations; addressing tax-exempt compliance issues such as intermediate sanctions, self-dealing, excess business holdings, qualifying distributions and taxable expenditure responsibility; assisting corporate fiduciaries in obtaining tax-exempt status for the charitable trusts they administer; and representing corporate fiduciaries in various Orphans' Court proceedings, such as cy pres proceedings, court accountings, and trust reformations. An active speaker, Mr. Caputo regularly presents to tax-exempt clients and corporate fiduciaries and has spoken for the Berks County Bar Association, the Lancaster County Bar Association, the Lehigh County Bar Association, the Bucks County Bar Association, the Lehigh County Estate Planning Council, the Chester County Bar Association, the Chester County Estate Planning Council, the Montgomery County Estate Planning Council, the Philadelphia Estate Planning Council, the Committee of Banking Institutions on Taxation, the Fiduciary Education Foundation, the PBA Wealth Management & Trust Conference, the Pennsylvania Bar Institute and the Partnership for Philanthropic Planning of Greater Philadelphia. Mr. Caputo's presentations focus on a variety of tax-exempt organization topics, such as The ABC's and 123's of Nonprofit Organizations; Charitable Trust Administration: How to Avoid Surcharge; New Developments Affecting Public Charities, Private Foundations, and Supporting Organizations; The Changing Face of Philanthropy; Advanced Private Foundation Issues; Code Section 4958 Intermediate Sanctions; Using Charitable Trusts In Estate Planning: Traps for the Unwary; Advanced Philanthropic Planning Opportunities: The Good, the Bad and the Ugly; Esoteric Fundraising Vehicles: Pitfalls and Opportunities; The 50 Most Common Errors Made By Nonprofit Organizations; The 20 Most Common Errors Made by Nonprofit Organizations; The ABC's of Solicitation of Funds Registration Statements; Mergers and Reorganizations of Nonprofit Organizations; and Nonprofit Governance: Don't Get Left in the Dark. Mr. Caputo is a director of the Olivet Boys and Girls Club, The Gilmore Henne Fund, The Wilson Education Foundation and the Berkshire Country Club and is a member of The Gift Planning Advisory Council at Penn State University. He received his B.S. from Penn State University, his J.D. from Dickinson School of Law and his LLM from Villanova University School of Law.

Contact Information

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ATTORNEYS AT LAW

Mergers and Affiliations of Nonprofit Organizations

Richard S. Caputo, Esq.

Outline

- Types of Mergers/Affiliations
- State Approvals Needed
- State/Federal Notice Requirements
- Accounting Considerations
- Miscellaneous Considerations
- Questions

Types of Mergers/Affiliations

- Option 1: Statutory Merger
- Option 2: Transfer of Assets
- Option 3: Liquidating Transfer of Assets
- Option 4: Consolidation into NewCo
- Option 5: Conversion to Sole Member Corporation
- Option 6: Creation of Mutual Parent Entity

Other Options: Joint Venture
Virtual Merger
Virtual Joint Venture
Sale of Assets
Management Agreement

Option 1: Statutory Merger

- Target entity dissolves “into” surviving entity
- All assets of target entity become the surviving entity’s assets
- All contracts, including employment contracts, and licenses of target entity automatically transfer to the surviving entity
- Surviving entity assumes the target entity’s liabilities
- Advantage – streamlined process
- Disadvantages – surviving entity assumes liabilities, including lawsuits and unknown liabilities (environmental, payroll taxes, etc.) and no going back (corporation dissolves by operation of law)

Option 2: Transfer of Assets

- Transferor entity uses its assets to pay its liabilities and then transfers its remaining assets to transferee entity
- Transferor entity ***remains in existence***
- Transferor can receive any known and unknown gifts and then transfer such gifts to transferee entity upon receipt

Option 2: Transfer of Assets (Cont'd)

- Advantages
  - Limited liability for transferee entity
    - Exceptions: transferee liability and fraudulent conveyances
  - Cy pres proceedings are not needed for known and unknown gifts to transferor organization
- Disadvantages
  - Could be time consuming to transfer assets, contracts and licenses
  - Duplicative costs of having two organizations (insurance premiums, tax returns, financial reporting, etc.)
  - Who will serve as directors of both organizations?
    - Overlapping directors: piercing the corporate veil?
    - Appointment power: is this enforceable?
  - Realty transfer taxes and real property tax exemption

Option 3: Liquidating Transfer of Assets

- Transferor entity uses its assets to pay its liabilities and then transfers its remaining assets to surviving entity
- ***Transferor entity dissolves***

Option 3: Liquidating Transfer of Assets (Cont'd)

- Advantages
  - Limited liability for surviving entity
    - Exceptions: transferee liability and fraudulent conveyances
  - No duplicative costs of having two organizations (insurance premiums, tax returns, financial reporting, etc.)

- Disadvantages
  - Cy Pres Proceedings: Gifts made to transferor entity do not automatically transfer to the surviving entity unless Court Order provides for automatic transfers
  - Could be time consuming to transfer assets, contracts and licenses
  - Realty transfer taxes and real property tax exemption

Option 4: Consolidation into NewCo

- Both entities merge into a third entity, NewCo
- Both entities dissolve “into” NewCo
- All assets of target entities become NewCo’s assets
- All contracts, including employment contracts, and licenses of target entity automatically transfer to the surviving entity
- NewCo assumes the target entities’ liabilities
- Qualify NewCo as a Code Section 501(c)(3) organization

Option 4: Consolidation into NewCo (Cont'd)

- Advantages
  - Streamlined process
  - Cy Pres proceedings are not needed for known and unknown gifts to target entities
- Disadvantages
  - NewCo assumes liabilities, including lawsuits, employment contracts and unknown liabilities (environmental, payroll taxes, etc.)
  - Need two plans of merger/consolidation
  - Fees and costs to form NewCo and apply for tax-exempt status on behalf of NewCo

Option 5: Conversion to Sole Member Corporation

- Target entity converts into a single-member nonprofit corporation and makes the “surviving” entity its sole member
- As sole member, the “surviving” entity has the power to appoint and remove the target entity’s directors and approve/veto any fundamental transactions in which the target entity desires to engage
- Creates parent/sub structure

Option 5: Conversion to Sole Member Corporation (Cont'd)

- Advantages
  - Separate corporations, resulting in limited liability for both entities
  - Cy pres proceedings are not needed for known and unknown gifts to target entity (i.e., the subsidiary organization)
  - Assets, contracts and licenses do not have to be transferred
  - Can de-affiliate if both parties agree

Option 5: Conversion to Sole Member Corporation (Cont'd)

- Disadvantages
  - Fees and costs to convert non-member target corporation into a membership corporation and issue a membership interest to surviving entity, or to transfer existing membership interests to surviving entity
  - Who will serve as directors of both organizations
    - Overlapping directors: piercing the corporate veil?
    - Appointment power
  - Attribution issues (lobbying, UBTI)
  - Organizational complexity/duplicative costs of having two organizations (insurance premiums, tax returns, financial reporting, etc.)
  - Employees for both organizations: will economies of scale be derived? Payroll costs?
  - Branding and name identification issues

    (d/b/a certificates)

Option 6: Creation of Mutual Parent Entity

- Create NewCo as a nonprofit corporation and qualify NewCo as an organization described in Code Sections 501(c)(3) and 509(a)(3)
- Two entities convert into single-member nonprofit corporations and name NewCo as the sole member of each entity
- NewCo, as sole member of each entity, has the power to appoint and remove each target entity's directors and approve/veto any fundamental transactions in which the target entities desire to engage
- Creates parent/sub relationship between NewCo and each entity
- Creates brother/sister relationship between the two existing entities

Option 6: Creation of Mutual Parent Entity (Cont'd)

- Advantages
  - Separate corporations, resulting in limited liability for all three entities
  - Cy Pres proceedings are not needed for known and unknown gifts to target entities (i.e., the subsidiary organizations)
  - Potential reduction in Form 990 tax preparation fees if the "group" can qualify for a group exemption (need two (2) subsidiaries to qualify)
  - Assets, contracts and licenses do not have to be transferred
  - Can de-affiliate if all affiliates agree

Option 6: Creation of Mutual Parent Entity (Cont'd)

- Disadvantages
  - Fees and costs to form NewCo and apply for tax-exempt status on behalf of NewCo
  - Fees and costs to convert non-member target corporations into membership corporations and issue a membership interest to NewCo, or to transfer existing membership interests to NewCo
  - Who will serve as directors of both organizations
    - Overlapping directors: piercing the corporate veil?
    - Appointment power
  - Attribution issues (lobbying, UBTI)
  - Organizational complexity/triplicate costs of having three organizations (insurance premiums, tax returns, financial reporting, etc.)
  - Employees for all three organizations: will economies of scale be derived? Payroll costs?
  - Complex organizational structure to explain to donors
  - Branding and name identification issues (d/b/a certificates)

Other Merger or Affiliation Options

- Joint Venture
- Virtual Merger
- Virtual Joint Venture
- Sale of Assets
- Management Agreement

State Approvals

- Attorney General Approval
  - Request for a “no objection” letter
  - Time-consuming process
  - Requires disclosure of transaction documents, financials and other information
  - Special information requested when health care entities are involved
- Court approval
  - Usually required
  - Can be costly and time-consuming if Attorney General or other parties contest the transaction
- **Note: Each state is different, some states require both Attorney General and court approval, others require just one to approve, some don’t require either**

State/Federal Notice Requirements

- Federal
  - Notify IRS Customer Service of “merger” or “affiliation” on next Form 990 return
  - File final Form 990 for each dissolving target entity, if any
- State (not all may be necessary)
  - Update articles of incorporation
  - Update bylaws
  - Update and/or close state business accounts and unemployment accounts
  - Update and/or withdraw solicitation registrations in every state in which entities are/were registered to solicit
  - Update real property and/or sales tax exemptions
  - File certificate of merger, articles of consolidation, articles of dissolution, etc. (as applicable)
  - File annual report

Accounting Considerations

- Consolidated Reporting Requirements - director overlap/control issues
- Ability to obtain group exemption and file consolidated Form 990 Return on behalf of “subordinate units”

Miscellaneous Considerations

- Is target entity or transferor entity a non-501(c)(3) organization?
- Should target entity/transferor entity, prior to the proposed merger or affiliation, transfer its "endowment" funds to a newly-created foundation that will be controlled by the current board of directors of target entity/transferor entity?
- Should there be some form of consideration for the affiliation?
- Does the entity have existing voting members?
  - If so, what approvals are needed?
  - What powers, if any, will the voting members have post-merger/post-affiliation?
- Did target entity engage in high-risk activities (work with children, elderly, etc.)?
  - If so, how is the surviving entity protecting its assets from potential liabilities of target entity?
- Are there restricted assets?
  - Donor-designated?
  - Board-designated?
- Are there "unrestricted assets" – Are they really unrestricted?
    - Look at purpose clause in the articles and bylaws and review Form 1023 application
    - Are the unrestricted assets collateral?

Miscellaneous Considerations

- Will target entity have representation on surviving entity's board?
  - For how long? Will survivor entity have the power to remove?
  - Will target entity's representatives have standing to enforce the terms of the merger/affiliation agreement?
- Does management for the target entity have employment contracts?
  - If no, should they?
  - If yes, what do they say?

Miscellaneous Considerations

- Duplicative staff – how is this going to be handled? How is payroll going to be handled?
- Indemnification clauses – may be meaningless if there are no assets
- Severance Agreements: intermediate sanctions
- Employment Contracts: intermediate sanctions
- Update insurance coverage/obtain tail coverage
- Liabilities – payroll, environmental, employment contracts, employee benefits
- Future funding for programs and capital improvements
- Financial commitments/obligations of surviving entity
  - Is the commitment/obligation limited?
- Charity care policy
- Realty transfer tax and real property tax exemptions

Questions

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MODIFY YOUR ORGANIZATIONAL STRUCTURE BY CREATING AFFILIATES

Presented By: Richard S. Caputo, Esquire

Operational activities, real estate activities, related businesses, unrelated businesses and investments all under one corporation shell

- Creditor from one activity can attach the assets used in the other activities
  - Creditors arising out of real estate activities can attach operations assets, related business assets, unrelated business assets and/or investable assets
  - Creditors arising out of operations can attach real estate, related business assets, unrelated business assets and/or investable assets
  - Etc.

- Goal: Minimize asset exposure by forming affiliated corporations

Considerations:

  - Will realty transfer tax be incurred on the transfer?
  - How long will it take to form a new entity and how much will it cost?
  - How much will it cost to prepare return for the new entity?
  - Will the new entity be able to obtain a real property tax exemption?
  - Will the entity provide maximum asset protection?
  - Will the new entity pay tax on its net income, will the existing nonprofit pay UBIT on the new entity's net income or will the net income derived by the new entity be exempt from income tax and UBIT?

Liability Exposure Due to Real Estate

- **Assume: Existing nonprofit is concerned about liability exposure due to real estate activities (slip and fall, major construction project, departure of tenants, etc.)**

Liability Exposure Due to Real Estate

Possible solution #1: Form an entity to house the real estate activities.

Considerations

Realty transfer tax will be incurred in Pennsylvania and may be incurred in New Jersey upon the transfer of the real estate to the newly-created entity, regardless of the type of entity created.

Formation costs, timing, tax preparation fees, real property tax exemption, asset protection and income tax/UBIT consequences will depend upon the type of entity formed to house the real estate.

Formation of Title Holding Company to Own Real Estate

- The newly-created entity should be able to qualify as a tax-exempt Code Section 501(c)(2) title holding company or a tax-exempt Code section 501(c)(25) title holding company

  Formation Costs: It will be costly to form a title holding company.

  Timing: It will take about five months to form the entity and obtain a tax exemption on its behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually.

  Real Property Tax Exemption: The title holding company most likely will not be able to obtain a real property tax exemption.

  Tax Consequences: The income derived from the real estate activities should be exempt from income tax and UBIT unless the real estate is debt-financed.

Formation of Title Holding Company to Own Real Estate

Asset Protection: A Code Section 501(c)(2) or 501(c)(25) title holding company must be formed as a subsidiary of the existing nonprofit. Therefore, the title holding company will be a nonprofit, non-stock, member corporation. The existing nonprofit will be the sole member of the title holding company. The existing nonprofit will control the title holding company because the existing nonprofit, as the sole member of the title holding company, can appoint the directors of the title holding company, can fill director vacancies and can remove the directors of the title holding company at any time, with or without cause. Under this structure, creditors of the title holding company (also known as the real estate subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

» **Caveat:** Keep in mind, however, that creditors of the existing nonprofit can attach the existing nonprofit's membership interest in the title holding company, dissolve the title holding company and attach the assets of the title holding company.

Formation of Supporting Organization to Own Real Estate

- The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization
  - Formation Costs: It will be costly to form a supporting organization.
  - Timing: It will take five to six months to form the entity and obtain a tax exemption on its behalf.
  - Tax Prep Fees: A Form 990 return must be prepared and filed annually.
  - Real Property Tax Exemption: The supporting organization should be able to obtain a real property tax exemption.
  - Tax Consequences: The income derived from the real estate activities should be exempt from income tax and UBIT unless the real estate is debt-financed.
  - Asset Protection: The ability to limit liability exposure depends upon whether the Code Section 509(a)(3) supporting organization is formed as a subsidiary of the existing nonprofit, as a "brother-sister" affiliate or as a parent corporation of the existing nonprofit.

Formation of Subsidiary Supporting Organization of Existing Nonprofit to Own Real Estate

» If the supporting organization is formed as a subsidiary of the existing nonprofit, the supporting organization will be a nonprofit, non-stock, member corporation. The existing nonprofit will be the sole member of the supporting organization. The existing nonprofit will control the supporting organization because the existing nonprofit, as the sole member of the supporting organization, can appoint the directors of the supporting organization, can fill director vacancies and can remove the directors of the supporting organization at any time, with or without cause. Under this structure, creditors of the supporting organization (also known as the real estate subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

- **Caveat**: Keep in mind, however, that creditors of the existing nonprofit can attach the existing nonprofit's membership interest in the supporting organization, dissolve the supporting organization and attach the assets of the supporting organization.

Formation of Brother-Sister Supporting Organization to Own Real Estate

- If maximum asset protection is the goal, the Code Section 509(a)(3) supporting organization can be formed as a “brother-sister” corporation. The supporting organization will be a nonprofit, non-stock, non-member corporation. The existing nonprofit will, on its face, control the supporting organization because, under the supporting organization rules, a majority of the directors of the supporting organization must be appointed by the board of directors of the existing nonprofit or must consist of the existing nonprofit’s directors. Under this structure, creditors of the supporting organization (also known as the real estate affiliate) should not be able to attach the assets of the existing nonprofit unless such creditors can “pierce the corporate veil”. Therefore, this structure protects the existing nonprofit’s assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.
- In addition, creditors of the existing nonprofit should not be able to attach the assets of the “brother-sister” supporting organization unless such creditors can “pierce the corporate veil”.
- Caveat: Although this structure provides maximum asset protection, this structure comes with a cost: a potential lack of control over the supporting organization.

Formation of Brother-Sister Supporting Organization to Own Real Estate

Control: The existing nonprofit will, on its face, have control over the supporting organization because, under the supporting organization rules, a majority of the directors of the supporting organization must be appointed by the board of directors of the existing nonprofit or must consist of the existing nonprofit's directors. However, rogue directors cannot be controlled as effectively under a "brother-sister" corporation structure because the existing nonprofit is not the supporting organization's member under state law. As such, state law does not give the existing nonprofit the power to appoint directors, the power to fill director vacancies or the power to remove directors at any time, with or without cause. To minimize the risk of losing control over the supporting organization, the bylaws of the "brother-sister" supporting organization should provide the board of directors of the existing nonprofit with the power to appoint all directors, the power to fill vacancies and the power to remove the directors of the supporting organization at any time, with or without cause.

Formation of Brother-Sister Supporting Organization to Own Real Estate

» However, to ensure that these powers are not removed by the board of directors of the supporting organization, the bylaws (and the articles) of the supporting organization should provide that any amendments to the bylaws or articles must be approved by the board of directors of the supporting organization by super majority vote <u>and</u> by the board of directors of the existing nonprofit.

- **<u>Caveat</u>**: Keep in mind, however, that it is unclear under state law whether the provisions recommended above (the power to appoint directors, the power to fill vacancies, the power to remove directors and the power to veto amendments) are enforceable as the entity given such powers (the existing nonprofit) is not the sole member of the entity providing such powers (the supporting organization). We have been unable to find any guidance as to whether a corporation can retain certain reserve powers over another nonprofit corporation that is <u>not</u> a subsidiary of the nonprofit corporation that retained such powers.

Formation of Parent Supporting Organization to Own Real Estate

» While the entity can be formed as a parent corporation of the existing nonprofit and the real estate can be transferred to the newly-created parent corporation, this structure makes no sense because the creditors of the newly-created parent (i.e., the creditors arising from the real estate activities) will be able to attach the membership interest the newly-created parent corporation has in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Formation of Disregarded LLC to Own Real Estate

- If the existing nonprofit does not want to form the new real estate entity as a tax-exempt entity (for whatever reason, although it is generally because of formation costs and the time it takes to get an exemption), then the new entity can be formed as a disregarded LLC.

  Formation Cost: It will not be costly to form a single member limited liability company.

  Timing: It will take no more than a few days to form a limited liability company.

  Tax Prep Fees: The LLC is a disregarded entity so all revenues, expenses, assets and liabilities flow through to the existing nonprofit's return.

  Real Property Tax Exemption: The LLC will not be able to obtain a real property tax exemption.

Formation of Disregarded LLC to Own Real Estate

Tax Consequences: The income derived from the real estate activities should flow through to the existing nonprofit and should be exempt from income tax and UBIT unless the real estate is debt-financed.

- » Is the real estate debt-financed? If so, the income, or at least a portion of the income, derived from the debt-financed real estate, will flow through to the existing nonprofit and will be treated as UBTI to the existing nonprofit
  - The existing nonprofit will pay UBIT on its UBTI
  - Any losses from unrelated activities or debt-financed activities?
  - Revocation due to excessive UBTI
    - 20% rule

Formation of Disregarded LLC to Own Real Estate

Asset Protection: A disregarded LLC must be formed as a subsidiary of the existing nonprofit. The existing nonprofit will own 100% of the membership interest in the LLC, and therefore, will be the sole owner of the LLC. The existing nonprofit will control the LLC because the existing nonprofit can appoint the managers of the LLC, can fill manager vacancies and can remove the managers of the LLC at any time, with or without cause. Under this structure, creditors of the limited liability company (also known as the real estate subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

» Caveat: Keep in mind, however, that creditors of the existing nonprofit can attach the membership interest in the LLC, dissolve the LLC and attach the assets of the LLC.

Formation of C-Corporation to Own Real Estate

- If the existing nonprofit does not want to form the new real estate entity as a tax-exempt entity (for whatever reason, although it is generally because of formation costs and the time it takes to get an exemption) or as a LLC (for whatever reason, although it is generally because of revocation of exemption concerns due to excessive UBTI), then the new entity can be formed as a c-corporation.

  Formation Cost: It will not be costly to form a wholly-owned c-corporation.

  Timing: It will take no more than a few days to form the c-corporation.

  Tax Prep Fees: A Form 1120 return must be prepared and filed annually.

  Real Property Tax Exemption: The c-corporation will not be able to obtain a real property tax exemption.

Formation of C-Corporation to Own Real Estate

Tax Consequences: The c-corporation will pay income tax on the income derived from the real estate activities, even if the real estate is not debt-financed.

- » The c-corporation will pay income tax at corporate tax rates (which are the tax rates the existing nonprofit's UBTI would be subject to if the nonprofit was formed as a corporation)
- » Revocation due to excessive UBTI will not be an issue because attribution is blocked (corporate breaker)
- » Corporate breaker
  - Attribution of activities due to director overlap: No more than a minority of the Sub's directors may be appointed by the directors of the parent and no more than a minority of the Sub's directors may be directors of the parent.
  - Code Section 512(b)(13) controlled corporation rules
- » Potentially beneficial tax rates
  - If the existing nonprofit is not concerned about asset protection or revocation of exemption due to excessive UBTI, gains and losses from other unrelated business activities and debt financed activities should be considered in determining whether or not to form a c-corporation.

Formation of C-Corporation to Own Real Estate

Asset Protection: While a c-corporation can technically be formed as a brother-sister corporation (i.e., as a for-profit, non-stock, non-member corporation), we do not recommend this structure because of the potential for losing control over the newly-created c-corporation. Therefore, the c-corporation should be formed as a subsidiary of the existing nonprofit. The existing nonprofit will own 100% of the stock of the c-corporation, and therefore, will be the sole owner of the c-corporation. The existing nonprofit will control the c-corporation because the existing nonprofit can appoint the directors of the c-corporation, can fill director vacancies and can remove the directors of the c-corporation at any time, with or without cause.

Under this structure, creditors of the c-corporation (also known as the real estate subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

- <u>Caveat</u>: Keep in mind, however, that creditors of the existing nonprofit can attach the stock of the c-corporation, dissolve the c-corporation and attach the assets of the c-corporation.

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Liability Exposure Due to Real Estate

– **Possible solution #2: Retain the activities causing liability exposure (real estate activities) in the existing nonprofit, form a parent entity and transfer all activities other than the real estate activities to the newly-created parent organization.**

Considerations

Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.

The newly-created parent entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Parent Supporting Organization to Engage in All Non-Real Estate Activities

- Form parent supporting organization to engage in all non-real estate activities.
  - Formation Costs: It will be costly to form a supporting organization.
  - Timing: It will take five to six months to form the entity and obtain a tax exemption on its behalf.
  - Tax Prep Fees: A Form 990 return must be prepared and filed annually.
  - Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.
  - Tax Consequences: The income derived by the existing nonprofit from the real estate activities should be exempt from income tax and UBIT unless the real estate is debt-financed.

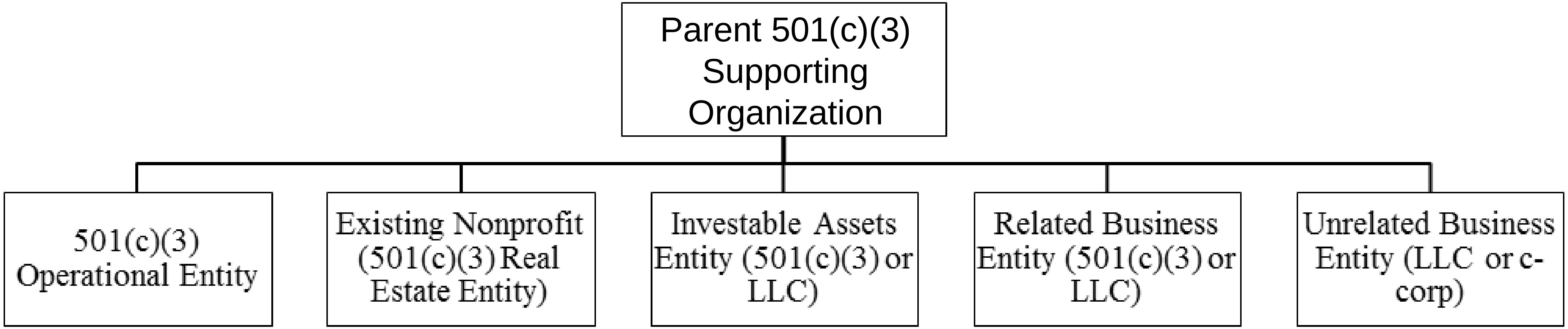
Formation of Parent Supporting Organization to Engage in All Non-Real Estate Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be formed as a parent corporation of the existing nonprofit. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit because the newly-created supporting organization, as the sole member of the existing nonprofit, can appoint the directors of the existing nonprofit, can fill director vacancies and can remove the directors of the existing nonprofit at any time, with or without cause. Under this structure, creditors of the existing nonprofit (also known as the real estate subsidiary) should not be able to attach the assets of the newly-created supporting organization unless such creditors can “pierce the corporate veil”. Therefore, this structure protects the newly-created supporting organization’s assets (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

- Caveat: Keep in mind, however, that creditors of the newly-created supporting organization can attach the newly-created supporting organization’s membership interest in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Liability Exposure Due to Real Estate

- Possible Solution #3: Retain the activities causing liability exposure (real estate activities) in the existing nonprofit, form a mutual parent entity and transfer to the newly-created parent organization all activities other than the real estate activities and all assets other than the real estate. The newly-created parent organization would then create several subsidiaries (Code Section 501(c)(3) organizations, limited liabilities or c-corporations) and transfer to such subsidiaries all of its activities other than its management activities (strategic planning, budgeting, etc.) and all of its assets other than those assets that are needed to perform the management activities. The ownership/organizational structure should look like this:


Parent 501(c)(3) Supporting Organization
501(c)(3) Operational Entity
Existing Nonprofit (501(c)(3) Real Estate Entity)
Investable Assets Entity (501(c)(3) or LLC)
Related Business Entity (501(c)(3) or LLC)
Unrelated Business Entity (LLC or c-corp)

Liability Exposure Due to Real Estate

Considerations

- Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.
- The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Real Estate Activities

- Form a mutual parent supporting organization and subsidiaries to engage in all non-real estate activities.

  Formation Costs: It will be costly to form a supporting organization. It will also be costly to form the subsidiaries unless they will be formed as LLCs or c-corporations.

  Timing: It will take five to six months to form the supporting organization and its tax-exempt subsidiaries and obtain a tax exemption on their behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually on behalf of the supporting organization and each tax-exempt subsidiary. A Form 1065 return must be filed on behalf of each LLC created and a Form 1120 must be filed on behalf of each c-corporation created.

  Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.

  Tax Consequences: The income derived from the real estate activities should be exempt from income tax and UBIT unless the real estate is debt-financed.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Real Estate Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be the parent corporation of the existing nonprofit and all other entities created. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The other subsidiaries created will be nonprofit, non-stock, member corporations, LLCs or c-corporations. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit and all other entities created because the newly-created supporting organization, as the sole member/stockholder of such entities, can appoint the directors/managers of such entities, can fill director/manager vacancies and can remove the directors/managers of such entities at any time, with or without cause. Under this structure, creditors of the existing nonprofit and all other entities created (known as the subsidiaries) should not be able to attach the assets of the newly-created supporting organization unless such creditors can “pierce the corporate veil”. Therefore, this structure protects the newly-created supporting organization’s assets (management assets) and the assets of the subsidiaries (operations assets, related business assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Real Estate Activities

- Caveat: While creditors of the newly-created supporting organization can attach the newly-created supporting organization's membership or stock interests in the various subsidiaries, dissolve such subsidiaries, and attach the assets of such subsidiaries, the risk of this happening is remote because the newly-created supporting organization will only be engaging in non-litigious management activities.

Liability Exposure Due to Operations/ Related Businesses

- **Assume: Existing nonprofit is concerned about liability exposure due to its operations (medical care, daycare, low-income housing project, etc.) or its related businesses**

Liability Exposure Due to Operations/Related Businesses

- **Possible solution #1: Form an entity to house the litigious operating activities or the related businesses, as applicable (assume that the existing nonprofit will engage in enough non-litigious, charitable activities to retain its exemption and that no real estate will be transferred).**

- Considerations

  Realty transfer tax will not be incurred.

  Formation costs, timing, tax preparation fees, real property tax exemption, asset protection and income tax/UBIT consequences will depend upon the type of entity formed to house the litigious operating activities or the related business activities, as applicable.

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Formation of Public Charity to House Litigious Operating Activities

- The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(1) or 509(a)(2) public charity.

  Formation Costs: It will be costly to form a Code Section 509(a)(1) or 509(a)(2) public charity.

  Timing: It will take about five months to form the entity and obtain a tax exemption on its behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually.

  Real Property Tax Exemption: A real property tax exemption is not necessary as the Code Section 509(a)(1) or 509(a)(2) public charity will not own any real property.

  Tax Consequences: The income derived from the litigious operating activities/related business activities should be exempt from income tax and UBIT.

  Asset Protection: The ability to limit liability exposure depends upon whether the Code Section 509(a)(1) or 509(a)(2) public charity is formed as a subsidiary of the existing nonprofit, as a "brother-sister" affiliate or as a parent corporation of the existing nonprofit.

Formation of Subsidiary Public Charity of Existing Nonprofit to House Litigious Operating Activities

» If the public charity is formed as a subsidiary of the existing nonprofit, the public charity will be a nonprofit, non-stock, member corporation. The existing nonprofit will be the sole member of the public charity. The existing nonprofit will control the public charity because the existing nonprofit, as the sole member of the public charity, can appoint the directors of the public charity, can fill director vacancies and can remove the directors of the public charity at any time, with or without cause. Under this structure, creditors of the public charity (also known as the litigious operating subsidiary or the related businesses subsidiary, as applicable) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the litigious operating activities or the related business activities, as applicable.

- Caveat: Keep in mind, however, that creditors of the existing nonprofit can attach the existing nonprofit's membership interest in the public charity, dissolve the public charity and attach the assets of the public charity.

Formation of Brother-Sister Public Charity to House Litigious Operating Activities

» If maximum asset protection is the goal, the Code Section 509(a)(1) or 509(a)(2) public charity can be formed as a "brother-sister" corporation. The public charity will be a nonprofit, non-stock, non-member corporation. Under this structure, creditors of the public charity (also known as the litigious operating affiliate or the related business affiliate, as applicable) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the litigious operating activities or the related business activities, as applicable.

» In addition, creditors of the existing nonprofit should not be able to attach the assets of the "brother-sister" public charity unless such creditors can "pierce the corporate veil".

Caveat: Although this structure provides maximum asset protection, this structure comes with a cost: a potential lack of control over the public charity.

Formation of Brother-Sister Public Charity to House Litigious Operating Activities

» Control: The governing documents of the newly-created public charity should reflect that a majority of the directors of the public charity must be appointed by the board of directors of the existing nonprofit or must consist of the existing nonprofit's directors. However, rogue directors cannot be controlled as effectively under a "brother-sister" corporation structure because the existing nonprofit is not the public charity's member under state law. As such, state law does not give the existing nonprofit the power to appoint directors, the power to fill director vacancies or the power to remove directors at any time, with or without cause. To minimize the risk of losing control over the public charity, the bylaws of the "brother-sister" public charity should provide the board of directors of the existing nonprofit with the power to appoint all directors of the public charity, the power to fill director vacancies and the power to remove the directors of the public charity at any time, with or without cause. However, to ensure that these powers are not removed by the board of directors of the public charity, the bylaws (and the articles) of the public charity should provide that any amendments to the bylaws or articles must be approved by the board of directors of the public charity by super majority vote and by the board of directors of the existing nonprofit.

Formation of Brother-Sister Public Charity to House Litigious Operating Activities

- Caveat: Keep in mind, however, that it is unclear under state law whether the provisions recommended above (the power to appoint directors, the power to fill director vacancies, the power to remove directors and the power to veto amendments) are enforceable as the entity given such powers (the existing nonprofit) is not the sole member of the entity providing such powers (the public charity). We have been unable to find any guidance as to whether a corporation can retain certain reserve powers over another nonprofit corporation that is not a subsidiary of the nonprofit corporation that retained such powers.

Formation of Parent Public Charity to House Litigious Operating Activities

» While the Code Section 509(a)(1) or 509(a)(2) public charity can be formed as a parent corporation of the existing nonprofit and the litigious operating activities or the related business activities, as applicable, can be transferred to the newly-created parent public charity, this structure makes no sense because the creditors of the newly-created parent public charity (i.e., the creditors arising from the litigious operating activities or the related business activities, as applicable) will be able to attach the membership interest the newly-created parent public charity has in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Formation of Supporting Organization to House Litigious Operating Activities

- The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

  Formation Costs: It will be costly to form a supporting organization.

  Timing: It will take five to six months to form the entity and obtain a tax exemption on its behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually.

  Real Property Tax Exemption: A real property tax exemption is not necessary as the supporting organization will not own any real property.

  Tax Consequences: The income derived from the litigious operating activities/related business activities should be exempt from income tax and UBIT.

  Asset Protection: The ability to limit liability exposure depends upon whether the Code Section 509(a)(3) supporting organization is formed as a subsidiary of the existing nonprofit, as a “brother-sister” affiliate or as a parent corporation of the existing nonprofit.

Formation of Subsidiary Supporting Organization of Existing Nonprofit to House Litigious Operating Activities

» If the supporting organization is formed as a subsidiary of the existing nonprofit, the supporting organization will be a nonprofit, non-stock, member corporation. The existing nonprofit will be the sole member of the supporting organization. The existing nonprofit will control the supporting organization because the existing nonprofit, as the sole member of the supporting organization, can appoint the directors of the supporting organization, can fill director vacancies and can remove the directors of the supporting organization at any time, with or without cause. Under this structure, creditors of the supporting organization (also known as the litigious operating subsidiary or the related business subsidiary, as applicable) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil".

» Therefore, this structure protects the existing nonprofit's assets (real estate, non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the litigious operating activities or the related business activities, as applicable.

- Caveat: Keep in mind, however, that creditors of the existing nonprofit can attach the existing nonprofit's membership interest in the supporting organization, dissolve the supporting organization and attach the assets of the supporting organization.

Formation of Brother-Sister Supporting Organization to House Litigious Operating Activities

» If maximum asset protection is the goal, the Code Section 509(a)(3) supporting organization can be formed as a "brother-sister" corporation. The supporting organization will be a nonprofit, non-stock, non-member corporation. The existing nonprofit will, on its face, control the supporting organization because, under the supporting organization rules, a majority of the directors of the supporting organization must be appointed by the board of directors of the existing nonprofit or must consist of the existing nonprofit's directors. Under this structure, creditors of the supporting organization (also known as the litigious operating affiliate or the related business affiliate, as applicable) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the litigious operating activities or the related business activities, as applicable.

» In addition, creditors of the existing nonprofit should not be able to attach the assets of the "brother-sister" supporting organization unless such creditors can "pierce the corporate veil".

- Caveat: Although this structure provides maximum asset protection, this structure comes with a cost: a potential lack of control over the supporting organization.

Formation of Brother-Sister Supporting Organization to House Litigious Operating Activities

» Control: The existing nonprofit will, on its face, have control over the supporting organization because, under the supporting organization rules, a majority of the directors of the supporting organization must be appointed by the board of directors of the existing nonprofit or must consist of the existing nonprofit's directors. However, rogue directors cannot be controlled as effectively under a "brother-sister" corporation structure because the existing nonprofit is not the supporting organization's member under state law. As such, state law does not give the existing nonprofit the power to appoint directors, the power to fill director vacancies or the power to remove directors at any time, with or without cause. To minimize the risk of losing control over the supporting organization, the bylaws of the "brother-sister" supporting organization should provide the board of directors of the existing nonprofit with the power to appoint all directors of the supporting organization, the power to fill vacancies and the power to remove the directors of the supporting organization at any time, with or without cause.

Formation of Brother-Sister Supporting Organization to House Litigious Operating Activities

However, to ensure that these powers are not removed by the board of directors of the supporting organization, the bylaws (and the articles) of the supporting organization should provide that any amendments to the bylaws or articles must be approved by the board of directors of the supporting organization by super majority vote <u>and</u> by the board of directors of the existing nonprofit.

- <u>Caveat</u>: Keep in mind, however, that it is unclear under state law whether the provisions recommended above (the power to appoint directors, the power to fill vacancies, the power to remove directors and the power to veto amendments) are enforceable as the entity given such powers (the existing nonprofit) is not the sole member of the entity providing such powers (the supporting organization). We have been unable to find any guidance as to whether a corporation can retain certain reserve powers over another nonprofit corporation that is <u>not</u> a subsidiary of the nonprofit corporation that retained such powers.

Formation of Parent Supporting Organization to House Litigious Operating Activities

- While the Code Section 509(a)(3) supporting organization can be formed as a parent corporation of the existing nonprofit and the litigious operating activities or the related business activities, as applicable, can be transferred to the newly-created parent corporation, this structure makes no sense because the creditors of the newly-created parent (i.e., the creditors arising from the litigious operating activities or the related business activities, as applicable) will be able to attach the membership interest the newly-created parent corporation has in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Formation of Disregarded LLC to House Litigious Operating Activities

- If the existing nonprofit does not want to form the new litigious operating/related business entity as a tax-exempt entity (for whatever reason, although it is generally because of formation costs and the time it takes to get an exemption), then the new entity can be formed as a disregarded LLC.

  Formation Cost: It will not be costly to form a single member limited liability company.

  Timing: It will take no more than a few days to form a limited liability company.

  Tax Prep Fees: The LLC is a disregarded entity so all revenues, expenses, assets and liabilities flow through to the existing nonprofit's return.

  Real Property Tax Exemption: A real property tax exemption is not necessary as the LLC will not own any real property.

  Tax Consequences: The income derived from the litigious operating activities/related business activities should flow through to the existing nonprofit and should be exempt from income tax and UBIT.

Formation of Disregarded LLC to House Litigious Operating Activities

Asset Protection: A disregarded LLC must be formed as a subsidiary of the existing nonprofit. The existing nonprofit will own 100% of the membership interest in the LLC, and therefore, will be the sole owner of the LLC. The existing nonprofit will control the LLC because the existing nonprofit can appoint the managers of the LLC, can fill manager vacancies and can remove the managers of the LLC at any time, with or without cause. Under this structure, creditors of the limited liability company (also known as the litigious operating subsidiary or the related business subsidiary, as applicable) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the litigious operating activities or the related business activities, as applicable.

» **Caveat:** Keep in mind, however, that creditors of the existing nonprofit can attach the membership interest in the LLC, dissolve the LLC and attach the assets of the LLC.

Formation of C-Corporation to House Litigious Operating Activities

- If the existing nonprofit does not want to form the new real estate entity as a tax-exempt entity (for whatever reason, although it is generally because of formation costs and the time it takes to get an exemption) or as a LLC (for whatever reason, although it is generally because of revocation of exemption concerns due to excessive UBTI), then the new entity can be formed as a c-corporation. However, this option does not make sense as the c-corporation will have to pay income tax on its net income and the c-corporation will not be eligible to receive tax-deductible donations or grants from private foundations, public charities or government units.

Considerations

Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.

The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Liability Exposure Due to Operations/Related Businesses

– **Possible solution #2: Retain the activities causing liability exposure (litigious operating activities or related business activities, as applicable) in the existing nonprofit (along with the real estate), form a parent entity and transfer to the newly-created parent organization all activities other than the real estate activities and the litigious operating activities or the related business activities, as applicable.**

<u>Considerations</u>

Confirm that realty transfer tax will not be incurred due to the "change" in the beneficial ownership of the real estate.

The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Parent Supporting Organization to Engage in All Non-Litigious Operating Activities and Non-Real Estate Activities

- Form parent supporting organization to engage in all activities other than the litigious operating activities, the related business activities and the real estate activities.

  Formation Costs: It will be costly to form a supporting organization.

  Timing: It will take five to six months to form the entity and obtain a tax exemption on its behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually.

  Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.

  Tax Consequences: The income derived by the existing nonprofit from the real estate activities and the litigious operating activities or the related business activities, as applicable, should be exempt from income tax and UBIT unless the real estate is debt-financed.

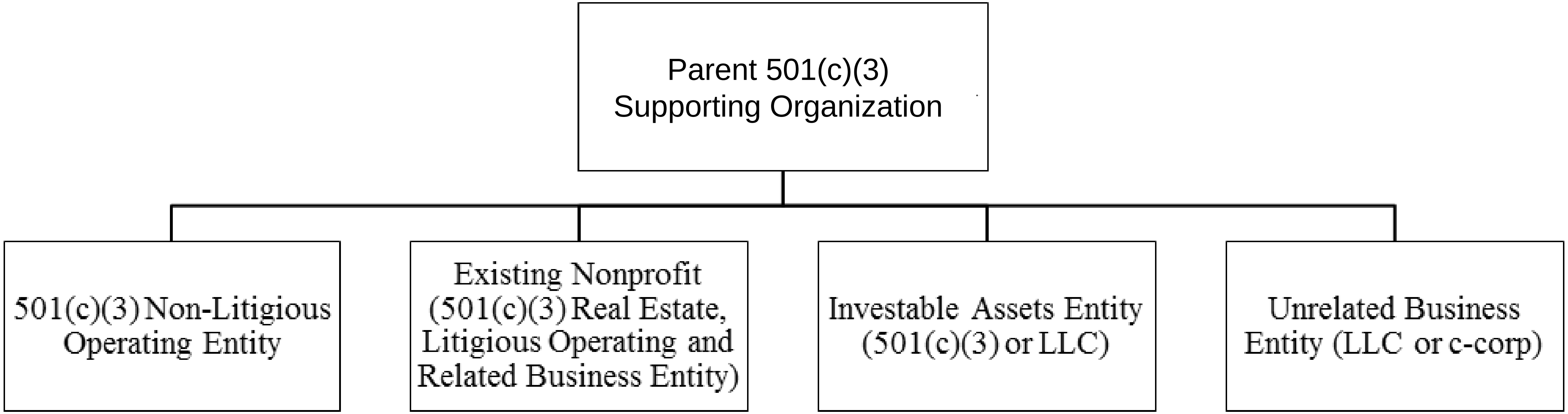
Formation of Parent Supporting Organization to Engage in All Non-Litigious Operating Activities and Non-Real Estate Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be formed as a parent corporation of the existing nonprofit. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit because the newly-created supporting organization, as the sole member of the existing nonprofit, can appoint the directors of the existing nonprofit, can fill director vacancies and can remove the directors of the existing nonprofit at any time, with or without cause. Under this structure, creditors of the existing nonprofit (also known as the real estate, litigious operating and related business subsidiary) should not be able to attach the assets of the newly-created supporting organization unless such creditors can "pierce the corporate veil". Therefore, this structure protects the newly-created supporting organization's assets (non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities and the litigious operating activities or the related business activities, as applicable.

- **Caveat:** Keep in mind, however, that creditors of the newly-created supporting organization can attach the newly-created supporting organization's membership interest in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Liability Exposure Due to Operations/Related Businesses

– **Possible Solution #3: Retain the activities causing liability exposure (litigious operating activities or related business activities, as applicable) in the existing nonprofit (along with the real estate), form a mutual parent entity and transfer to the newly-created parent organization all activities other than the real estate activities and the litigious operating activities or the related business activities, as applicable, and all assets other than the real estate, litigious operations assets and related business assets. The newly-created parent organization would then create several subsidiaries (Code Section 501(c)(3) organizations, limited liabilities or c-corporations) and transfer to such subsidiaries all of its activities other than its management activities (strategic planning, budgeting, etc.) and all of its assets other than those assets that are needed to perform the management activities. The ownership/organizational structure should look like this:**


Parent 501(c)(3) Supporting Organization
501(c)(3) Non-Litigious Operating Entity
Existing Nonprofit (501(c)(3) Real Estate, Litigious Operating and Related Business Entity)
Investable Assets Entity (501(c)(3) or LLC)
Unrelated Business Entity (LLC or c-corp)

Liability Exposure Due to Operations/Related Businesses

Considerations

- Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.
- The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Litigious Operating Activities and Non-Real Estate Activities

- Form a mutual parent supporting organization and subsidiaries to engage in all activities other than the litigious operating activities, the related business activities and the real estate activities.

  Formation Costs: It will be costly to form a supporting organization. It will also be costly to form the subsidiaries unless they will be formed as LLCs or c-corporations.

  Timing: It will take five to six months to form the supporting organization and its tax-exempt subsidiaries and obtain a tax exemption on their behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually on behalf of the supporting organization and each tax-exempt subsidiary. A Form 1065 return must be filed on behalf of each LLC created and a Form 1120 must be filed on behalf of each c-corporation created.

  Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.

  Tax Consequences: The income derived by the existing nonprofit from the real estate activities and the litigious operating activities or the related business activities, as applicable, should be exempt from income tax and UBIT unless the real estate is debt-financed.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Litigious Operating Activities and Non-Real Estate Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be the parent corporation of the existing nonprofit and all other entities created. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The other subsidiaries created will be nonprofit, non-stock, member corporations, LLCs or c-corporations. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit and all other entities created because the newly-created supporting organization, as the sole member/stockholder of such entities, can appoint the directors/managers of such entities, can fill director/manager vacancies and can remove the directors/managers of such entities at any time, with or without cause. Under this structure, creditors of the existing nonprofit and all other entities created (known as the subsidiaries) should not be able to attach the assets of the newly-created supporting organization unless such creditors can "pierce the corporate veil". Therefore, this structure protects the newly-created supporting organization's assets (management assets), the existing nonprofit's assets (real estate, litigious operations assets and related business assets) and the assets of the subsidiaries (non-litigious operations assets, unrelated business assets and investable assets) from creditors arising out of the real estate activities, and the litigious operating activities or the related business activities, as applicable.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Non-Litigious Operating Activities and Non-Real Estate Activities

- **Caveat:** While creditors of the newly-created supporting organization can attach the newly-created supporting organization’s membership or stock interests in the various subsidiaries, dissolve such subsidiaries, and attach the assets of such subsidiaries, the risk of this happening is remote because the newly-created supporting organization will only be engaging in non-litigious management activities.

Liability Exposure Due to Unrelated Businesses

- **Assume: Existing nonprofit is concerned about liability exposure due to its unrelated businesses.**

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Liability Exposure Due to Unrelated Businesses

- **Possible solution #1: Form an entity to house the unrelated businesses (assume that no real estate will be transferred).**
  - Considerations
  - Realty transfer tax will not be incurred.
  - Formation costs, timing, tax preparation fees, real property tax exemption, asset protection and income tax/UBIT consequences will depend upon the type of entity formed to house the unrelated business activities.

Formation of Disregarded Entity to House Unrelated Businesses

- The new unrelated business entity can be formed as a disregarded LLC.

  Formation Cost: It will not be costly to form a single member limited liability company.

  Timing: It will take no more than a few days to form a limited liability company.

  Tax Prep Fees: The LLC is a disregarded entity so all revenues, expenses, assets and liabilities of the unrelated business entity flow through to the existing nonprofit's return.

  Real Property Tax Exemption: A real property tax exemption is not necessary as the unrelated business entity will not own any real property.

Formation of Disregarded Entity to House Unrelated Businesses

Tax Consequences: The income derived by the existing nonprofit from the unrelated business activities should flow through to the existing nonprofit and should be subject to UBIT.

- » The existing nonprofit will pay UBIT on its UBTI
- » Any losses from unrelated activities or debt-financed activities?
- » Revocation due to excessive UBTI
- • 20% rule

Asset Protection: A disregarded LLC must be formed as a subsidiary of the existing nonprofit. The existing nonprofit will own 100% of the membership interest in the LLC, and therefore, will be the sole owner of the LLC. The existing nonprofit will control the LLC because the existing nonprofit can appoint the managers of the LLC, can fill manager vacancies and can remove the managers of the LLC at any time, with or without cause. Under this structure, creditors of the limited liability company (also known as the unrelated business subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, operations assets, related business assets and investable assets) from creditors arising out of the unrelated business activities.

»Caveat: Keep in mind, however, that creditors of the existing nonprofit can attach the membership interest in the LLC, dissolve the LLC and attach the assets of the LLC.

Formation of C-Corporation to House Unrelated Businesses

- If the existing nonprofit does not want to form the new unrelated business entity as a LLC (for whatever reason, although it is generally because of revocation of exemption concerns due to excessive UBTI), then the new entity should be formed as a c-corporation.

  Formation Cost: It will not be costly to form a wholly-owned c-corporation.

  Timing: It will take no more than a few days to form the c-corporation.

  Tax Prep Fees: A Form 1120 return must be prepared and filed annually.

  Real Property Tax Exemption: A real property tax exemption is not necessary as the unrelated business entity will not own any real property.

Formation of C-Corporation to House Unrelated Businesses

Tax Consequences: The c-corporation will pay income tax on the income derived from the unrelated business activities.

- » The c-corporation will pay income tax at corporate tax rates (which are the tax rates the existing nonprofit's UBTI would be subject to if the nonprofit was formed as a corporation)
- » Revocation due to excessive UBTI will not be an issue because attribution is blocked (corporate breaker)
- » Corporate breaker
  - Attribution of activities due to director overlap
  - Code Section 512(b)(13) controlled corporation rules
- » Potentially beneficial tax rates
  - If the existing nonprofit is not concerned about asset protection or revocation of exemption due to excessive UBTI, gains and losses from other unrelated business activities and debt financed activities should be considered in determining whether or not to form a c-corporation.

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Formation of C-Corporation to House Unrelated Businesses

Asset Protection: While a c-corporation can technically be formed as a brother-sister corporation (i.e., as a for-profit, non-stock, non-member corporation), we do not recommend this structure because of the potential for losing control over the newly-created c-corporation. Therefore, the c-corporation should be formed as a subsidiary of the existing nonprofit. The existing nonprofit will own 100% of the stock of the c-corporation, and therefore, will be the sole owner of the c-corporation. The existing nonprofit will control the c-corporation because the existing nonprofit can appoint the directors of the c-corporation, can fill director vacancies and can remove the directors of the c-corporation at any time, with or without cause. Under this structure, creditors of the c-corporation (also known as the unrelated business subsidiary) should not be able to attach the assets of the existing nonprofit unless such creditors can "pierce the corporate veil". Therefore, this structure protects the existing nonprofit's assets (real estate, operations assets, related business assets, and investable assets) from creditors arising out of the unrelated business activities.

- Caveat: Keep in mind, however, that creditors of the existing nonprofit can attach the stock of the c-corporation, dissolve the c-corporation and attach the assets of the c-corporation.

Liability Exposure Due to Unrelated Businesses

– **Possible solution #2: Retain the activities causing liability exposure (unrelated business activities) in the existing nonprofit (along with the real estate), form a parent entity and transfer to the newly-created parent organization all activities other than the real estate activities and the unrelated business activities.**

Considerations

Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.

The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Parent Supporting Organization to Engage in All Activities Other Than Real Estate Activities and Unrelated Business Activities

- Form parent supporting organization to engage in all activities other than the real estate activities and the unrelated business activities.

  Formation Costs: It will be costly to form a supporting organization.

  Timing: It will take five to six months to form the entity and obtain a tax exemption on its behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually.

  Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.

  Tax Consequences: It is unclear whether the real estate activities are charitable enough for the existing nonprofit to retain its charitable exemption. Assuming the existing nonprofit retains its exemption, the income derived by the existing nonprofit from the real estate activities should be exempt from income tax and UBIT (unless the real estate is debt-financed) and the income derived by the existing nonprofit from the unrelated business activities should be subject to UBIT.

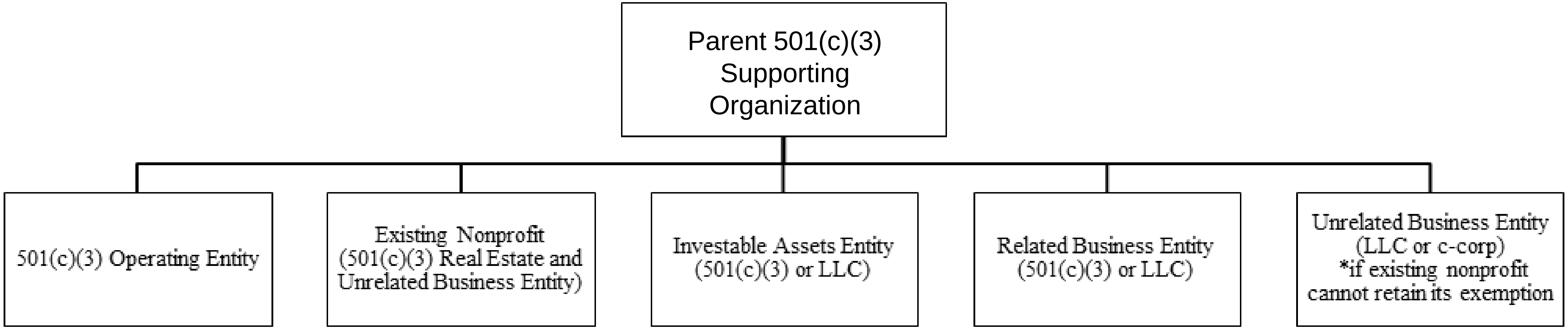
Formation of Parent Supporting Organization to Engage in All Activities Other Than Real Estate Activities and Unrelated Business Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be formed as a parent corporation of the existing nonprofit. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit because the newly-created supporting organization, as the sole member of the existing nonprofit, can appoint the directors of the existing nonprofit, can fill director vacancies and can remove the directors of the existing nonprofit at any time, with or without cause. Under this structure, creditors of the existing nonprofit (also known as the real estate and unrelated business subsidiary) should not be able to attach the assets of the newly-created supporting organization unless such creditors can "pierce the corporate veil". Therefore, this structure protects the newly-created supporting organization's assets (operations assets, related business assets and investable assets) from creditors arising out of the real estate activities and the unrelated business activities.

- **Caveat:** Keep in mind, however, that creditors of the newly-created supporting organization can attach the newly-created supporting organization's membership interest in the existing nonprofit, dissolve the existing nonprofit and attach the assets of the existing nonprofit.

Liability Exposure Due to Unrelated Businesses

- Possible Solution #3: Retain the activities causing liability exposure (unrelated business activities) in the existing nonprofit (along with the real estate), form a mutual parent entity and transfer to the newly-created parent organization all activities other than the real estate activities and the unrelated business activities, and all assets other than the real estate and the unrelated business assets. The newly-created parent organization would then create several subsidiaries (Code Section 501(c)(3) organizations, limited liabilities or c-corporations) and transfer to such subsidiaries all of its activities other than its management activities (strategic planning, budgeting, etc.) and all of its assets other than those assets that are needed to perform the management activities. The ownership/organizational structure should look like this:


Parent 501(c)(3)
Supporting
Organization
501(c)(3) Operating Entity
Existing Nonprofit
(501(c)(3) Real Estate and
Unrelated Business Entity)
Investable Assets Entity
(501(c)(3) or LLC)
Related Business Entity
(501(c)(3) or LLC)
Unrelated Business Entity
(LLC or c-corp)
*if existing nonprofit
cannot retain its exemption

Liability Exposure Due to Unrelated Businesses

Considerations

Confirm that realty transfer tax will not be incurred due to the “change” in the beneficial ownership of the real estate.

The newly-created entity should be able to qualify as a tax-exempt Code Section 509(a)(3) supporting organization.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Activities Other than Real Estate Activities and Unrelated Business Activities

- Form a mutual parent supporting organization and subsidiaries to engage in all activities other than the real estate activities and the unrelated business activities.

  Formation Costs: It will be costly to form a supporting organization. It will also be costly to form the subsidiaries unless they will be formed as LLCs or c-corporations.

  Timing: It will take five to six months to form the supporting organization and its tax-exempt subsidiaries and obtain a tax exemption on their behalf.

  Tax Prep Fees: A Form 990 return must be prepared and filed annually on behalf of the supporting organization and each tax-exempt subsidiary. A Form 1065 return must be filed on behalf of each LLC created and a Form 1120 must be filed on behalf of each c-corporation created.

  Real Property Tax Exemption: The existing nonprofit should continue to qualify for a real property tax exemption.

  Tax Consequences: It is unclear whether the real estate activities are charitable enough for the existing nonprofit to retain its charitable exemption. Assuming the existing nonprofit retains its exemption, the income derived by the existing nonprofit from the real estate activities should be exempt from income tax and UBIT (unless the real estate is debt-financed) and the income derived by the existing nonprofit from the unrelated business activities should be subject to UBIT.

Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Activities Other than Real Estate Activities and Unrelated Business Activities

Asset Protection: The newly-created Code Section 509(a)(3) supporting organization will be the parent corporation of the existing nonprofit and all other entities created. The existing nonprofit will become a membership corporation and the newly-created supporting organization will become the sole member of the existing nonprofit. The other subsidiaries created will be nonprofit, non-stock, member corporations, LLCs or c-corporations. The supporting organization will be a nonprofit, non-stock, non-member corporation. The supporting organization will control the existing nonprofit and all other entities created because the newly-created supporting organization, as the sole member/stockholder of such entities, can appoint the directors/managers of such entities, can fill director/manager vacancies and can remove the directors/managers of such entities at any time, with or without cause. Under this structure, creditors of the existing nonprofit and all other entities created (known as the subsidiaries) should not be able to attach the assets of the newly-created supporting organization unless such creditors can "pierce the corporate veil". Therefore, this structure protects the newly-created supporting organization's assets (management assets), the existing nonprofit's assets (real estate and unrelated business assets) and the assets of the subsidiaries (operations assets, related business assets and investable assets) from creditors arising out of the real estate activities and the unrelated business activities.

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Formation of Mutual Parent Supporting Organization and Subsidiaries to Engage in All Activities Other than Real Estate Activities and Unrelated Business Activities

- **Caveat:** While creditors of the newly-created supporting organization can attach the newly-created supporting organization's membership or stock interests in the various subsidiaries, dissolve such subsidiaries, and attach the assets of such subsidiaries, the risk of this happening is remote because the newly-created supporting organization will only be engaging in non-litigious management activities.

Miscellaneous Considerations

- **Miscellaneous Issues to Consider When Forming Affiliates**
  - Should an affiliate be formed by the existing nonprofit to purchase, or merge with an entity that owns, real estate, litigious operating assets, related business assets and/or unrelated business assets?
  - Employee issues: payroll and insurance
    - General liability, D&O, workers compensation, unemployment compensation, etc.
  - Sales and use tax issues
  - Real property tax exemption issues
  - Realty transfer tax issues
  - Union issues
  - Tax-exempt bond issues

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