Key Considerations for Creating a For-Profit Subsidiary of a Public Charity

Description

By Elizabeth Manchester, Russell Stein, Brian Reilly, and Madeline Ursini

OpenAI, an artificial intelligence research nonprofit, has recently garnered media attention for considering a restructuring strategy involving the formation of a taxable subsidiary. The establishment of for-profit taxable subsidiaries by nonprofit organizations qualified as tax-exempt under Internal Revenue Code ("IRC") Section 501(c)(3)[1] has been a growing trend across the nonprofit sector in recent years. This strategy allows nonprofits to engage in revenue-generating business ventures and diversify their income stream, rather than relying exclusively on traditional income from charities, like donations. Other advantages associated with isolating for-profit activities in a separate entity include potential limitation of legal liability and better ability to attract outside investors, obtain loans, and expand into new business opportunities that may be beyond the nonprofit's tax-exempt purpose. For purposes of this alert, the analysis will focus on subsidiary formation for public charities ("Public Charities").

Establishing a for-profit subsidiary often introduces additional costs, complexities, and other considerations related to public perception of the nonprofit. For instance, while representatives of OpenAI have expressed that their proposed shift is motivated by a desire to support the company's charitable arm by attracting investments, critics have expressed concern that the nonprofit is damaging its public perception by appearing to be profit-motivated.[2]

There are various legal, structural, financial, and operational considerations for Public Charities to consider when determining whether and how to execute the formation of a taxable subsidiary. This article provides a brief outline of some of the benefits, challenges, and best practices associated with operating a for-profit subsidiary, but consulting with experienced advisors is a must before forming any for-profit subsidiary.

Legal and Structural Considerations

- *Public Support Test:* The "public support test" for certain IRC § 501(c)(3) organizations to maintain their status as Public Charities generally requires that 33.33% of an organization's revenue come from the general public.[3] Prior to forming any taxable subsidiary, any Public Charity should model the economics of the structure and confirm with a certified public accountant that the income will not cause the organization to violate the public support test, jeopardizing the parent's tax-exempt status, as discussed below in "*Unrelated Business Taxable Income*".
- *Entity Choice and Formation:* A taxable subsidiary should be formed as a C corporation controlled by the parent tax-exempt entity as the majority shareholder or a limited liability company ("LLC") taxed as a C corporation with the parent as the sole member. Single member LLCs that are not taxed as a corporation are generally not treated as taxable subsidiaries, as they are considered "disregarded entities" under the IRC and are treated as an extension of the parent's 501(c)(3) status.[4] Thus, single member LLCs are often used by nonprofits to isolate certain liabilities, such as those in connection with real estate ownership, rather than as taxable subsidiaries. Charities investing in a partnership or LLC taxed as a partnership should seek counsel prior to investing, as these flow-through entities present special challenges for Public Charities.
- *Status:* Although not generally required, the Public Charity should consider having its subsidiary's status related to its own tax-exempt status. In any case, the subsidiary's status should not jeopardize or be contrary to the parent's status. For example, a Public Charity with an environmental charitable purpose of reducing greenhouse gas emissions should not create a taxable subsidiary to start drilling or fracking

for oil. Investing in the opposite type of entity may have an effect on the parent's tax-exempt status and sway the public perception of the parent.

- *Organizational Documents:* The charter and bylaws of the Public Charity should include a provision authorizing the entity to form and own taxable subsidiaries, and to make loans to the for-profit subsidiary. Further, the Public Charity should have the right to appoint the board of directors, remove directors without cause at any time, and approve any amendments as provided for in the newly formed entity's operating documents. The parent should also make a reasonable contribution to the subsidiary's capital, as discussed below in "*Funding the Taxable Subsidiary*".
- *Corporate Governance:* The majority of the subsidiary's board of directors should be members outside of and unrelated to the Public Charity parent to demonstrate that the entity is independent of its parent and to permit the two entities to manage conflicts of interest between them. The Public Charity parent should abstain from the day-to-day management of the subsidiary.
- *Liability Protection:* Public Charities often own significant assets and do not want to jeopardize those assets by introducing liability risks associated with a new for-profit business. Creating a separate legal entity can help to insulate the nonprofit parent from liability claims and lawsuits associated with the revenue-generating activities.

Financial Considerations

- *Funding the Taxable Subsidiary:* The Public Charity parent should infuse the taxable subsidiary with necessary funds to pay operating expenses, including employee salaries. This funding may be accomplished by means of either a loan or a contribution. Any loan must be well-documented to demonstrate that the terms have been negotiated at arm's length, which requires a written agreement, market interest rate, and defined payment schedule. Any capital contribution must be compatible with the organization's tax-exempt purpose. Because a for-profit subsidiary will likely be conducting business activities that are unrelated to the tax-exempt section 501(c)(3) purpose, it is important to carefully consider and monitor how the for-profit entity is funded by the nonprofit parent.
- *Transactions Between Entities:* All transactions and financial arrangements between the Public Charity parent and taxable subsidiary should be made at arm's length and be carefully documented.
- *Financial Separation:* Strict financial separation between the Public Charity parent and the taxable subsidiary must be maintained. The two entities must use separate financial books and records, distinct letterhead, and avoid commingling of assets by using separate bank accounts.

Operational Considerations

- *Management and Staff:* As mentioned previously, separate management and staff should be established for the subsidiary. An advantage of forming a for-profit subsidiary is that the entity may be able to attract a wider range of employees due to flexibility in offering equity compensation and less concern regarding the excess compensation rules that apply to Public Charities.
- *Shared Offices:* The taxable subsidiary may use the parent's existing offices, provided that the subsidiary reimburses the parent for its allocable share of rent, office equipment, and utilities pursuant to a written arm's length agreement.
- *Administrative Costs:* There may be additional administrative costs associated with operating two entities rather than one, such as costs associated with maintaining a separate governing body and conducting separate board and committee meetings.

Tax Considerations

- *Flow of Profits:* A taxable subsidiary pays the normal corporate income tax (currently equal to a 21% Federal rate, with additional state income taxes) on the net income generated by its for-profit activities. Then, the taxable subsidiary remits after-tax profits to the Public Charity parent as dividends.[5] The dividends are not tax-deductible business expenses by the subsidiary[6] and are generally exempt from unrelated business taxable income ("UBTI") of the Public Charity.
- *Unrelated Business Taxable Income:* Certain income from a taxable subsidiary could be treated as UBTI, such as if the investment in the taxable subsidiary was financed with debt. In addition, having too

much income from dividends could affect a Public Charity's "public support test".[7] Prior to forming a taxable subsidiary, a Public Charity should consult with the organization's accountants to confirm the anticipated income will not adversely affect the Public Charity's 501(c)(3) status.
- *Public Disclosure:* Public Charities are required to file an annual Form 990 which requires disclosure of any related party payments, including any income that the Public Charity's officers, directors, and employees earn from the taxable subsidiary. Further, the Public Charity must disclose the name of the subsidiary that it owns and all income received from the subsidiary. The disclosure of profits earned by the subsidiary may be undesirable from a public perception perspective.

Private Foundations

- While this article focuses on Public Charities, private foundations may also consider forming a taxable subsidiary. However, private foundations are subject to additional rules that may curtail the ability or usefulness of forming a taxable subsidiary.[8] For instance, excess business holdings rules generally prevent private foundations from wholly owning taxable entities, and private foundations are subject to excise tax on investment income[9] and certain other distribution requirements.[10]

Creating a for-profit subsidiary may allow Public Charities to expand their activities while protecting their tax-exempt status. However, nonprofits must carefully consider the costs and complexities involved, ensuring they remain focused on their core mission.

For additional information regarding this topic, please reach out to Elizabeth Manchester, Russell Stein, Brian Reilly, or Madeline Ursini. Partridge Snow & Hahn offers a multifaceted Nonprofit & Tax-Exempt Group to guide you through the advice necessary to address the complex legal needs unique to your situation.

[1] IRC § 501(c)(3).

[2] Broughel, James. "OpenAI Is Now Unambiguously Profit-Driven, and That's a Good Thing." Forbes, Forbes Magazine, 9 May 2024, www.forbes.com/sites/jamesbroughel/2023/12/09/openai-is-now-unambiguously-profit-driven-and-thats-a-good-thing/.

[3] IRC § 509(a)(2).

[4] IRC § 301.7701-2(a)(1).

[5] IRC § 509(a)(2).

[6] Dividends paid by a subsidiary to its parent are not ordinary and necessary business expenses deductible under IRC § 162(a).

[7] IRC § 509(a)(2).

[8] Under IRC § 509, a private foundation is an IRC § 501(c)(3) tax-exempt organization that does not meet the "public support test".

[9] IRC § 4940.

[10] IRC § 4942.

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