

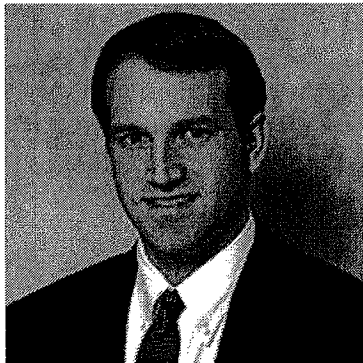
A BRAVE NEW WORLD: NONPROFIT ENTRY INTO THE COMMERCIAL MARKETPLACE

DARREN B. MOORE

**Attorney at Law
Bourland, Wall & Wenzel, P.C.
301 Commerce Street
Suite 1500
Fort Worth, Texas 76102
817.877.1088
dmoore@bwwlaw.com**

**Copyright ©2004
All Rights Reserved**

**March 16, 2004
Southern Baptist Business Officers Conference
Benevolent Institutions Division
Dallas, Texas**



DARREN B. MOORE

Associate
817.877.1088
dmoore@bwwlaw.com

Bourland, Wall & Wenzel, P.C.
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102

Mr. Moore's practice focuses on the areas of general litigation and representation of religious entities. In his litigation practice, he represents both plaintiffs and defendants in cases involving a wide array of claims. Mr. Moore represents clients before state and federal trial and appellate courts as well as various alternative dispute resolution forums including mediation, arbitration and Christian conciliation. Mr. Moore's nonprofit practice is concentrated on the representation of religious professionals and religious organizations. He advises clients on a wide range of matters including organization of various types of religious entities, operation of those entities, risk management, employment and human resources issues, and various other business issues.

Relevant Experience

- Frequent speaker to churches and church leaders on avoiding legal liability in Texas, Louisiana, Mississippi and Georgia
- Adjunct Professor, Baylor School of Law, 2000-present. Courses include "Legal Analysis, Research, and Communication" and "Nonprofit Organizations"
- Author of the seminar article, "Liability Issues For Religious Organizations and Religious Professionals"
- Author of the seminar article, "Keeping Your Church Out of Court: Avoiding Legal Landmines When Communicating"

Practice Areas

Litigation

Business & Commercial Litigation
Creditor Rights Litigation
Employment Litigation
Fiduciary Litigation
Probate & Trust Litigation
Marital Property Rights and Divorce

Nonprofit Organizations

Religious Organizations
Charitable Entity

Employment Law

Litigation
Employment Agreement
Covenants Not To Compete

Background & Education

Born in Lubbock, Texas - 1973
B.A. Texas A&M University, Cum Laude
J.D. Baylor University, Magna Cum Laude

Admissions & Certifications

Admitted: 2000, Texas
2001, United States District Court, Northern District of Texas
2001, United States Tax Court

Membership

State Bar of Texas
Texas Young Lawyers Association, Co-Chair,
Texas Law for Texas Clergy Committee, 2001
Tarrant County Bar Association
Fort Worth Tarrant County Young Lawyers Association

A Brave New World: Nonprofit Entry into the Commercial Marketplace

I. Introduction

- Nonprofits may conduct commercial activities either directly or through owned and/or controlled subsidiaries without jeopardizing their tax-exempt status

II. Engaging in Commercial Activities

A. Reasons Supporting

1. Purpose of organization

- a. Organization's charitable purpose involves carrying on commercial activities
- b. Examples: Nonprofit hospitals, nonprofit retirement centers, religious publisher, etc.

2. Financial benefit (vs. passive investing)

- a. Nonprofit does not mean "no profit" (drive to increase revenues)
- b. Investing in commercial enterprise often more profitable due to economies of scope, current tax policy, etc. (although an investigation of this is beyond the scope of this presentation)

B. Reasons to avoid

1. Costs

- Staffing, marketing, insurance, etc.

2. Liability concerns

- a. Putting charitable assets at risk (beware charitable fiduciary standards and the state attorney general)
- b. All investments carry some risk – care should be taken in planning

3. Tax concerns
 - a. Potential loss of exempt status
 - b. Potential creation of taxable income through UBTI
4. Loss of focus
 - Risk focus being put on business or maximization of profit rather than on charitable goals (potential liability)

III. Determining the Structure

A. Operating within the existing structure

1. Examining purposes/powers
 - a. Articles of Incorporation
 - Amend and file with Secretary of State
 - b. Bylaws
 - Amend in accord with AoI
 - c. Tax Exemption Determinations (Federal, State, Local)
 - Letter & notice to IRS (may have to reapply or request a private letter ruling if inconsistent)
2. Taxation Issues (i.e. effect on exempt status)
 - a. Related vs. Unrelated Business
 - i. A related business is one which “contributes importantly” to the organization’s charitable purposes; conducted as a means to accomplish the organization’s exempt purposes
 - What about a business that is conducted in order to provide the organization necessary funding to carry out its exempt purposes?

- ii. To “contribute importantly” must consider the size and extent of the activity involved in relation to the nature and extent of the exempt function which they purport to serve
- b. Substantial vs. Insubstantial
 - No bright line rule but a good rule of thumb is 15%
- c. Commerciality Doctrine
 - i. Related to the “exclusivity” requirement for operations
 - ii. Business activities grow too large in relation to charitable activities such that they become a primary purpose
 - iii. “Commercial Hue”: *See Scripture Press Foundation v. United States* [organization formed to improve teaching materials for Protestant Sunday Schools – became highly successful and IRS revokes exempt status]
 - (a) direct competition with commercial firms (including in same locales)
 - (b) pricing structure designed to produce a profit
 - (c) extensive advertising and use of commercial advertising materials
 - (d) lack in the record of any showing of donations to the parent organization
 - Is there a potential Catch-22?
- d. Commercial activities so large in relation to “public support” as to negatively effect ratios for public charity support (thus jeopardizing exempt status)
- e. The rules
 - i. Insubstantial and related = okay
 - ii. Insubstantial and unrelated = UBTI
 - iii. Substantial and related = okay to a point
 - iv. Substantial and unrelated = loss of exempt status if done within the existing organization

B. Forming a subsidiary

3. Reasons for Creating

- a. Avoid jeopardizing tax-exempt status (when engaging in substantial and unrelated business activities or highly profitable business activities)
- b. Liability insulation
 - Particularly useful for isolating high risk activities including short-term high risk activities
- c. Fundraising/Lenders
 - i. Some funders/lenders prefer to see a single purpose business entity with a dedicated board and officers
 - ii. Small Business Administration loans only available to for-profit businesses
 - iii. Attract private investors who want an interest in the project
- d. Flexibility in competition
 - i. More easily adaptable to competitive market
 - ii. Attract staff competitively with marketplace by offering higher salaries, bonus compensation, incentive plans, etc.
- e. Regulatory/Licensing Issues
 - Schools, counseling centers, etc.
- f. Focus/specialized skill
 - Particularly with board members and officers
- g. Avoid opening up books through 990T
- h. Other (e.g. lobbying, etc.)

4. Downside
 - a. Costs/complexity
 - Incorporation and filing fees; administrative maintenance, etc.
 - b. Inability to directly receive grants from many charities if not itself a 501(c)(3)
 - c. Public perception
 - Does the goodwill of the nonprofit transfer?
 - d. Taxation
 - Profits and passive income taxed (versus only unrelated profits over \$1000)
 - e. Less day to day control
 - f. New reporting and filing requirements
 - g. Other (Diversion of funds from primary purpose)

IV. Determining the Legal Structure

A. For profit vs. nonprofit

1. Certain activities may be charitable (or nonprofit) activities yet distinct or incompatible with parent activities
2. May be charitable or nonprofit but creating substantial revenues and want to avoid impact on public support test (supporting organizations do not have to meet ratios and do not count toward support for parent)
3. Taxable nonprofit to counter negative perception or if demanded by funding source
4. For profit if a commercial activity that is non-exempt or desire to take advantage of for profit structure
 - Can the parent's charitable purpose affect the subsidiary to achieve exemption of the subsidiary (i.e. downstream effect)?

B. Choice of entity

1. Corporation (nonprofit or for profit); Corporate Separate-Identity Rule
2. Partnership – Attribution principle
3. Joint Venture
 - a. Attractive because of opportunity to raise capital outside of giving while offering third parties a stake in the enterprise; gain expertise and revenue of for profit joint venturers (e.g. University research parks)
 - b. Cannot cede control of nonprofit charitable assets to for profit or private purposes
 - i. Governance control
 - ii. Day to day control
 - iii. Management of conflicts of interest
 - iv. Priority of charitable purpose
 - v. Veto Right
 - c. St. David’s Health Care System v. United States
4. Other (LLC, LP, etc.)

V. Managing the Relationship to Avoid Pitfalls

A. Maintaining Separateness

1. Important to be recognized by parent as well as third parties as independent and a bona fide separate entity for tax purposes as well as for liability purposes (avoid having the corporate veil pierced)
2. IRS “blueprint” [25 factors]
 - a. Majority of the subsidiary’s board or executive committee not current officers or directors of the parent (although the parent’s CEO can serve)
 - b. One person not to be CEO of both organizations
 - c. No high degree of sharing employees

- d. Exempt parent may provide space and administrative services to subsidiary, paid for by subsidiary at cost
- e. Exempt parent may furnish all of the subsidiary's capital as equity contributions so that the subsidiary need not pay interest on the contributions
- f. Exempt parent may furnish intellectual property (including mailing lists) as a capital contribution
- g. Subsidiary's board of directors controls day to day operations (although still accountable to parent)
- h. Arms-length transactions
- i. Avoid commingling funds
- j. Officers of the subsidiary report to the subsidiary's board of directors

- How does the parent maintain control of the enterprise?

B. Undercapitalization Concerns

1. Failing to provide enough cash or capital to allow the subsidiary to effectively carry on its business and meet financial obligations
2. A basis for holding the parent liable for the subsidiary's debts

C. Fraudulent Transfer Issues

1. State-specific law (although a uniform act)
2. Act generally allows creditors to attack a debtor's transfer of assets to a third party (including from a subsidiary to a parent or from a parent to a subsidiary) and thereby nullify the transfers for the purpose of applying the amounts or property transferred to satisfaction of the creditor's claim; also awards attorneys' fees
3. Claim is more than a current right to payment; creditor includes current and future creditors

4. Three types of transfer subject to attack:
 - a. Transfers made by a debtor with an actual intent to hinder, delay or defraud any creditor
 - i. transfer to an insider
 - ii. debtor retains possession or control of the property
 - iii. debtor had been sued or threatened with suit
 - iv. value of the consideration received was not reasonably equivalent to the value of the asset transferred
 - b. Transfers made by the debtor while insolvent without receiving a reasonably equivalent value in exchange
 - c. Transfers made while insolvent to an insider

D. Attribution in Partnership Relationship (discussed above)

E. Maintaining Control in Joint Venture Relationship (discussed above)

VI. Conclusion

1. Determine if you want to engage in commercial activities
2. Determine if the activities can be accomplished within the current structure
3. Weigh the pros and cons of forming a separate subsidiary
4. Determine the type of entity best suited for the activity
5. Make appropriate filings
6. Set up appropriate controls and appoint appropriate board members
7. Draft appropriate contracts (with indemnification language)
8. Obtain insurance
 - At least 2-8 should be done in consultation with legal counsel

This document is intended to provide current and accurate information about the subjects covered. However, such information is not intended to be sufficient for dealing with a particular legal problem, and the author does not warrant or represent its suitability for such purpose. This document is being distributed with the understanding that the author is not rendering legal, accounting or other professional advice for any particular legal problem, and the readers should not rely upon this document as a substitute for independent legal consultation.