


Affiliations Between Nonprofits and For-Profits: Possibilities & Problems

 October 11, 2019

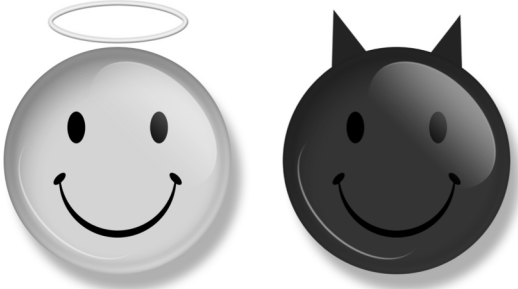
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Nonprofit vs. For-profit



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Nonprofit vs. For-profit

	Nonprofit – 501(c)(3)	For-profit
Ownership	None	Equity owners
Capital	Philanthropic	Equity, maybe philanthropic
Purpose	Charitable, educational, ...	Broad discretion
Activities/Market	501(c)(3) consistent	Commercial
Income tax	Exempt	Non-exempt
Transparency	Greater	Lesser

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Collaboration



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Contracts & MOUs

- Nonprofit contracts with for-profit for _____
- For-profit contracts with nonprofit for _____

- Memorandum of Understanding
 - Binding or non-binding or both? Be clear.

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Conflicts of Interest

- Private Benefit
- Private Inurement
- Excess Benefit Transactions
- Self-dealing (CA)



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No Prohibited Private Benefit

Organization must serve public, rather than private, interests

Treas. Reg. §1.501(c)(3)-1(d)(1)(ii)

May benefit individuals if incidental to furthering organization's exempt purposes

- Members of a class served by organization
- Reasonable pay for necessary services

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No Private Inurement

Net earnings cannot inure to the benefit of an "insider"

Treas. Reg. § 1.501(c)(3)-1(c)(2)

- "Insiders" – founders, Directors, and Officers, and other persons in a position to influence decisions of the organization

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Excess Benefit Transaction



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Excess Benefit Transaction (EBT)

- The term “excess benefit transaction” means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any *disqualified person* if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

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IRC §4958(c)(1)(A)

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EBT: Disqualified Person

The term “disqualified person” means, with respect to any transaction—

- (A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization,
- (B) a member of the family of an individual described in subparagraph (A),
- (C) a 35-percent controlled entity,
- (D) any person who is described in subparagraph (A), (B), or (C) with respect to an organization described in section 509(a)(3) and organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the applicable tax-exempt organization.[1]
- (E) which involves a donor advised fund (as defined in section 4966(d)(2)), any person who is described in paragraph (7) with respect to such donor advised fund (as so defined), and
- (F) which involves a sponsoring organization (as defined in section 4966(d)(1)), any person who is described in paragraph (8) with respect to such sponsoring organization (as so defined).

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IRC §4958(f)(1)

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Rebuttable Presumption of Reasonableness

TIP!

- (1) The compensation arrangement or the terms of the property transfer are **approved in advance** by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization within the meaning of § 53.4958-4(a)(2)(ii)(B)) composed entirely of individuals who **do not have a conflict of interest** (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;
- (2) The authorized body obtained and relied upon **appropriate data as to comparability** prior to making its determination, as described in paragraph (c)(2) of this section; and
- (3) The authorized body adequately **documented** the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

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Treas. Reg. §53.4958-6(a)

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Directors with Conflicts of Interest



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Director Conflict of Interest (CA)

Director(s) w/ material financial interest in venture

- Disclosure of interest
- Approval by majority of disinterested directors
- Determination that there is –
 - No more advantageous arrangement w/ reasonable effort
 - No excess benefit transaction

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Self-Dealing (CA)

- A self-dealing transaction means a transaction to which the corporation is a party and in which one or more of its directors has a material financial interest and which does not meet the requirements of paragraph (1), (2), or (3) of subdivision (d) of Corp. Code § 5233

- (1) Approval by AG or court
- (2) Approval by board
- (3) Approval by board committee or board-authorized person (consistent with the same standards as required of the board), if it was not reasonably practicable to obtain approval of the board prior to entering into the transaction and board later ratifies the transaction

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Corp. Code § 5233

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Self-Dealing: Approval by Board

- (A) The corporation entered into the transaction for its own benefit;
- (B) The transaction was fair and reasonable as to the corporation at the time the corporation entered into the transaction;
- (C) Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction. Except as provided in paragraph (3) of this subdivision, action by a committee of the board shall not satisfy this paragraph; and
- (D) (i) Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation **could not have obtained a more advantageous arrangement** with reasonable effort under the circumstances or (ii) the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances

Corp. Code §5233(d)(2)

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Parent– Subsidiary Structures

Nonprofit can wholly own a for-profit subsidiary

For-profit can control who is on the board of a nonprofit



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For-profit control – Nonprofit subsidiary

- **Sole member** – may elect/remove all directors
- **Designator** – may designate (appoint)/remove one or more directors
- Overlapping directors

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Sole Member Rights

- Elect and remove directors
- Approve major corporate changes (e.g., mergers, transfers of substantially all assets, dissolution)
- Amend bylaws
- Approve amendments to articles and certain amendments to the bylaws
- Annual report (financials)
- Inspection of documents
- Standing to sue derivatively

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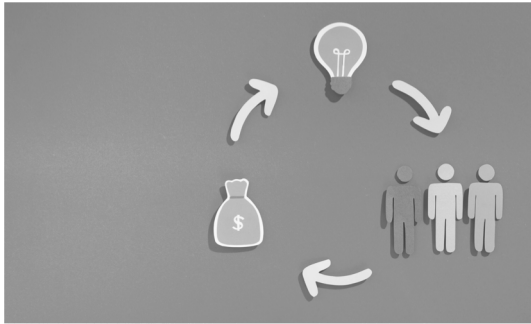
Nonprofit Parent – For-profit Sub

Rationales:

- Nonexempt activities that might jeopardize the nonprofit's tax-exemption
- Activities that have a different risk profile from the nonprofit's other activities
- Different types of nonexempt activities for which net income from some types can be offset by losses from other types (Recent laws creating UBIT silos no longer permit this within the nonprofit)

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Capitalization Issues for the Nonprofit



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Nonprofit: Unrelated Business Venture

Venture does not further exempt purposes
(and is primarily operated to generate revenues)

...

may trigger prudent investment laws

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Prudent Investment Rules – Corp. Code

- Subject to provisions of the gift instrument, the board shall avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital – Corp. Code § 5240(b)(1)
- Compliance with UPMIFA will be deemed to be compliance the above – Corp. Code § 5240(e)

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Prudent Investment Rules - UPMIFA

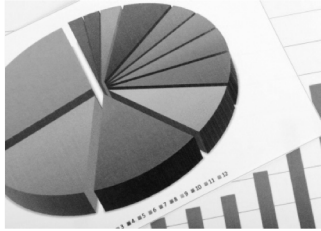
- In managing and investing an institutional fund, all of the following factors, if relevant, must be considered:
 - (A) General economic conditions.
 - (B) The possible effect of inflation or deflation.
 - (C) The expected tax consequences, if any, of investment decisions or strategies.
 - (D) The role that each investment or course of action plays within the overall investment portfolio of the fund.
 - (E) The expected total return from income and the appreciation of investments.
 - (F) Other resources of the institution.
 - (G) The needs of the institution and the fund to make distributions and to preserve capital.
 - (H) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

Cal. Prob. Code §18503(e)

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Prudent Investment

Portfolio Theory



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Program-Related Investment (PRI)

Law applicable to private foundations, but if okay for a private foundation, should be okay for a public charity?

1. The primary purpose is to accomplish one or more of the foundation's exempt purposes;
2. Production of income or appreciation of property is not a significant purpose; and
3. The purpose of the funds must not be to lobby or electioneer.

IRC Sec. 4944(c)

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For-profit Parent – Nonprofit Sub

Rationales:

- Exempt activities can be funded with philanthropic capital (i.e., donations, grants)
- Better positioning relative to certain markets
- Staffing and other resources may be better bifurcated
- Less pressure from shareholders re: profitability
- Goodwill benefit to for-profit (e.g., common name)

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For-profit Parent – Nonprofit Sub

Example of Problematic Rationale:

- To broaden the market for the for-profit by providing subsidies to the for-profit (e.g., dentist creates nonprofit that raises money so the dentist can take low-income clients but still make the same pay after receiving a grant from the nonprofit, which does not provide grants to other dentists for the same purpose)

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Fiscal Sponsorship

Instead of creating a nonprofit subsidiary, a for-profit might seek a “fiscal sponsorship” arrangement with an existing 501(c)(3) fiscal sponsor



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What is fiscal sponsorship ... really?

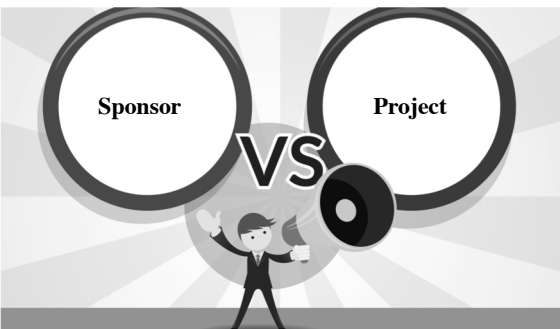


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Who fundraises and gets the money?



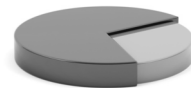
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Comprehensive (Model A)

- Project is an internal part of Sponsor
- Sponsor is responsible for all Project liabilities ... and for unlawful activities of Project
- Only agents of Sponsor –
 - can fundraise for Project
 - should manage Project



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Pre-Approved Grant Relationship (Model C)

- Project is part of a subgrantee of Sponsor
 - Subgrantee pre-approved by Sponsor
- Funders make purpose-restricted grant to Sponsor
- Sponsor exercises control & discretion to re-grant



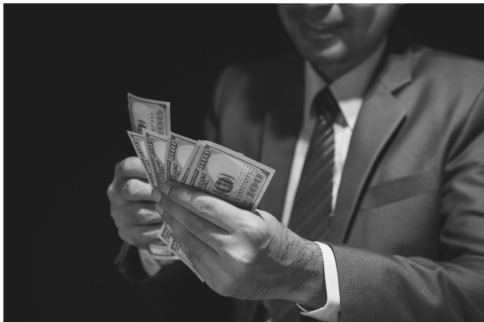
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Model A Project & Affiliated For-Profit



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Nonprofit – Unrelated Business Activities



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UBIT Basics

- Subject to certain exceptions, modifications, and deductions, the term *unrelated business taxable income (UBTI)* = gross income derived by any organization from:
 1. A trade or business
 2. Regularly carried
 3. Not substantially related to furthering the organization's exempt purpose

IRC §512(a)(1)

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UBIT: Trade or Business

- Any activity carried on for the production of income from selling goods or performing services
- Even if carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes

Treas. Reg. §1.513-1(b)

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UBIT: Regularly Carried On

- Activities conducted with a similar frequency and continuity, and in a similar manner, with which a for-profit conducts the same activity

Treas. Reg. §1.513-1(c)

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UBIT: Not Substantially Related

- Substantially related when the conduct of the business activities has a substantial causal relationship to achieving exempt purposes (other than through the production of income)
- The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related

Treas. Reg. §1.513-1(d)

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Substantially related?

IRS considers factors such as:

- Nature and size of business
- Fees
- Business operations
- Who is served

... for each activity!

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Tax Cuts and Jobs Act (TCJA)

Calculating unrelated business taxable income –

- Pre-TCJA: Can aggregate income and deductions from all unrelated businesses
- Under TCJA: A deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year

Notice 2018-67

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Nonprofit – For-profit Joint Ventures



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Whole Entity Joint Venture

All of the nonprofit's assets are contributed

1. Participation in the JV must further the nonprofit's charitable purposes, and
2. The partnership arrangement must permit the nonprofit to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of its for-profit partner(s)

IRS Rev. Rul. 98-15

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Ancillary Joint Venture

Part of the nonprofit's assets are contributed; nonprofit has other activities

- **Substantial**
 - See whole entity JV requirements
 - Majority control of the entire AJV is not essential to protect exempt status
 - Nonprofit must control the exempt activities of the AJV (the nonexempt entity can control the nonexempt activities)
- **Insubstantial**
 - Whole entity JV requirements don't apply

Rev. Rul. 2004-51

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Typical Commercial Coventure Program

- For-profit sells product or service
- States that portion of the revenues from the sales will be donated to a “charity”

“Every time you buy a bottle of Ethos® Water, you contribute \$.05US ... to the Ethos® Water Fund, part of the Starbucks Foundation.”



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Commercial Coventurer

- Any person who, for profit, is regularly and primarily engaged in trade or commerce other than in connection with the raising of funds, assets, or property for charitable organizations or charitable purposes, and who represents to the public that the purchase or use of any goods, services, entertainment, or any other thing of value will benefit a charitable organization or will be used for a charitable purpose.

Gov. Code §12599.2(a)

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Commercial Coventurer

1. Registration and annual reporting; or
2. All of the following:
 - Written contract with charity
 - Transfer of funds to charity within 90 days and every 90 days thereafter
 - Written accounting to charity with each transfer

Gov. Code §12599.2(b), (c)

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Additional Key Contract Terms

- License of use of charity’s name/marks
- Identification of applicable goods/services
- Precise language of representation to public of what will be donated to the charity, including reference to any minimum and/or maximum amounts to be donated
- Starting and end dates of campaign
- Timing and manner of transfer of funds to charity

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Commercial Fundraisers & Fundraising Counsel

- Vendors providing fundraising-related services may be subject to their own state registration and reporting requirements
 - Do they solicit charitable contributions?
 - Do they receive and/or control charitable contributions?
 - Do they plan, manage, or advise on fundraising?

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