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Creating a for-profit subsidiary was once considered unusual and niche but it has become somewhat mainstream and even standard for tax exempt organizations in the past few decades. This arrangement emerged as a solution to the various challenges tax exempt organizations face regularly. Those range from managing an unrelated business activity, separating activities from the exempt parent that stray from the original exempt purpose, protecting the assets of the organization from legal liability, and more.

By far the most common reason to create a for-profit subsidiary is to separate an unrelated business activity from the parent to protect it from violating the “primary purpose test”, and to a lesser extent, the “commensurate test.” The former test looks at the actual activities of the organization and requires that it not be organized or operated for the primary purpose of carrying on an unrelated trade or business. It must be primarily engaged in fulfilling of its exempt mission. What exactly constitutes ‘primary’ is determinant by facts and circumstances which will include the size and extent of the unrelated business activity. Ultimately no more than an insubstantial amount of activities can be devoted to an unrelated trade or business. Insubstantial is not defined by a fixed percentage, and this uncertainty may be a motivating factor for some exempt organization managers and boards to gravitate towards the for-profit subsidiary solution.

The formation and subsequent administration of a for-profit subsidiary will require planning and proper guidance from legal and accounting professionals. Depending on the underlying purpose of creating the new entity, your considerations may vary. However, below are some of the most common issues to address during this process.

I. Structure

Initially the parent will need to decide how ownership of the new entity will be structured. The entity can be either wholly owned, majority or minority owned. For simplicity sake, only wholly owned and majority owned are considered in this article as most parent organizations will want to maintain control over the new subsidiary. There are three primary methods for establishing control of a newly formed corporation. The parent could control the subsidiary by way of board overlap, or by having the governing documents for the subsidiary stipulate that the parent has the ability to appoint the board. Secondly, the subsidiary could be a membership organization with the parent appointed as the sole member, granting it the ability to control composition of board at will. Finally, the subsidiary could issue stock, with the majority or all of it being retained by the parent.
II. Capitalization and Transfers

Once the entity has been legally formed, the parent may next consider infusing the new subsidiary with funds to pay vendors, staff and generally operate as a for-profit corporation. IRS rulings indicate that exempt parents may form, capitalize and operate an affiliate corporation in furtherance of the charity’s charitable mission.¹ The parent has a few options that it may use to accomplish this. The first option is to loan the money to the subsidiary, using terms that are at “arms-length”, or in terms that are generally offered to the public. This means having a written document govern the loan, stipulating the interest rate charged and the repayment schedule. The interest paid by the subsidiary would be deductible. However, typically interest, rent, royalty, annuity and similar payments create taxable income to the parent when paid by their subsidiary.² There are a few exceptions to this rule. For example, if the activity being conducted by the subsidiary is one already being conducted by the parent and isn’t considered unrelated to the parent’s mission, such payments are excluded from taxation. Another example would be to argue the subsidiary is a ‘loss corporation’. This argument would require showing that the subsidiary is producing losses consistently, and therefore reaps no tax benefit in deducting interest payments.

The other option to capitalize a subsidiary is to simply make a contribution or grant to the organization. However in most cases the subsidiary will be conducting unrelated business activities, and therefore such a grant by the parent would not be compatible with their exempt purpose. The most prudent capitalization may involve some combination of the two methods above.

III. Attribution

It is important that the subsidiary establish itself as a separate legal and tax entity from the parent. This is because the IRS scrutinizes parent-subsidiary relationships that appear to lack bona fide intent to have real and substantial business functions.³ In a ruling published in 1986, a scientific research organization and its subsidiary were examined. The subsidiary worked to develop and manufacture products that were derived from technology generated out of the parent’s research activities.⁴ The activities of the subsidiary were attributed to the parent because the parent maintained a controlling interest in the subsidiary, there were overlapping employees between the two entities, and there was sharing of facilities and equipment.

More recently, the IRS has moved away from taking such aggressive stances. As long as there is no “clear and convincing” evidence that shows the subsidiary is acting as an agent or integral part of the tax-exempt parent, the IRS has ruled that the subsidiaries activities will not be attributed to the parent. However, in situations where the parent controls the affairs of the subsidiary so closely, like when the parent is directly involved in the day-to-day management activities.

¹ Ltr. Ruls. 9316052 and 9240001  
² §512(b)(13)  
³ Britt v. United States 431 F. 2d 227 (5th Cir. 1970)  
⁴ Priv. Ltr. Rul 8606056
of the subsidiary, the subsidiary may not be regarded as a separate entity and therefore be disregarded for tax purposes.

There is no one factor that determines whether attribution should occur, but rather, the IRS examines the facts and circumstances and weighs multiple factors in making this determination. These include:

1. The officers, trustees or employees of the tax-exempt parent constitute a majority of the for-profit subsidiary’s board of directors. This level of control demonstrates that the subsidiary is acting as an agent or integral part of the parent.
2. The boards between the two organizations are identical.
3. The activities between the parent and subsidiary are conducted at arm’s length.
4. The parent is involved in the day-to-day management of the subsidiary. This factor looks at the similarity of activities, location, and identity of the names of entities.

The use of for-profit subsidiaries by exempt organizations has become commonplace, and attribution is mostly reserved for cases of extreme abuse. However, tax exempt parents should take care to factor the above considerations into the structure and operations of the subsidiary so as to minimize the potential for attribution in the future when the IRS may have more incentive to examine the issue.

IV. Exempt Status

Exempt organization parents have the burden of demonstrating that they have plans to use the substantial assets of their subsidiaries to further their mission. In some cases this means making dividend payments to the parent, in other cases the IRS has suggested that a subsidiary's asset or stock be sold in order to generate proceeds to fund program activity at the parent. Ultimately, the parent should not use its exempt assets, which could have been sourced from charitable donations or membership dues amongst others, to expand the commercial business of the subsidiary. It will need to translate the subsidiary's net income into expansion of its own activities.

Of greater concern to the IRS is the potential for personal enrichment of founders by closely held subsidiaries. Specifically in question are structures where founders of a nonprofit create a subsidiary and benefit unreasonably from accumulated gains in the subsidiary. This sort of abuse triggers intermediate sanctions under §4958 and can jeopardize the exemption of the nonprofit parent due to private inurement. Factors that would indicate potential abuse include de minimis levels of exempt activities by the parent nonprofit, loans by the subsidiary to closely held affiliates or disqualified persons, with or without formal repayment arrangements, and in general the lack of intent to use any of the earnings of the subsidiary for exempt purposes of the parent.

5 Gen. Couns. Mem 39598
6 Tech. Adv. Mem 200437040
V. **Compensation**

A 501(c)(3) exempt parent should be aware that the structure of a tax-exempt parent and taxable subsidiary may create issues with regards to compensation of employees. §501(c)(3) organizations are subject to limitations on how they may compensate their employees, an area which is governed by private inurement, private benefit and/or excess benefit transaction doctrines. In general, compensation must be reasonable and not exceed fair value of the services rendered to the payor. These ideas translate to the taxable subsidiary. Any compensation paid to officers, directors, trustees or key employees of the parent by the subsidiary would be reported on the annual information return of the parent. This is because wholly or majority owned subsidiaries will be listed as a related entity. Although generally more scrutinized due to the potential for unreasonable levels of compensation, stock options to employees of the taxable subsidiary are an available option, as well as providing an employee stock ownership plan. Ownership of stock by anyone other than the exempt parent does increase risk in a number of areas and should be analyzed carefully before offering these options.

VI. **Minority Ownership**

If the subsidiary is formed as a stock based corporation, it will have the opportunity to issue stock and ownership to third parties. This can be helpful in raising funds for the subsidiary, or to attract the skills and talent necessary to successfully run the organization that it would not otherwise be able to attract. Generally, this sort of stock issuance is permissible and would not jeopardize the exempt status of the parent. An exempt parent should know the inherent risk involved with third-party stockholders is that the tax-exempt parent can create private benefit, or in other words, unduly enrich private third-parties using charitable assets. This activity can jeopardize the exempt status of the parent and would be detrimental to the overall activities of the subsidiary.

VII. **Cost Sharing**

Exempt parents will be able to share resources, either via a cost-sharing or management services arrangement, with the taxable subsidiary without additional risk. This could include shared staff, offices, facilities, equipment and others. Any §501(c)(3) parent must ensure that it is reimbursed for full fair market value on any goods or services shared with the subsidiary. This must be done on an actual use basis rather than by allocation. Any receivable from the subsidiary should be paid timely, preferably with no amounts outstanding as of the end of the tax year.

**Conclusion**

The creation of a for-profit subsidiary is commonly prescribed for nonprofit organizations with the potential for earning large sums of unrelated business income. The corporate subsidiary

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7 E.G., Priv. Ltr. Rul. 9308047
is also a good choice as it provides a shield against liability for management and the exempt parent, as well as allowing the parent to own the subsidiary by holding all or a majority of its stock. There are multiple factors to consider when operating a for-profit subsidiary. The above article provides a good framework for the issues involved with such an endeavor.

If your organization is considering forming such an entity, or has questions about an existing structure, please contact the Raffa Nonprofit Tax Department.

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