CREATING A FOR-PROFIT SUBSIDIARY OF A TAX-EXEMPT ORGANIZATION

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Your tax-exempt organization might consider creating a for-profit subsidiary for legal and practical reasons. A subsidiary can be used to segregate the subsidiary's liabilities from the parent's assets – or vice versa. Creating a for-profit subsidiary facilitates maintaining separate lines of business, which in turn simplifies compliance by the tax-exempt with government funding requirements, permits branding of the separate businesses, and allows the for-profit to incentivize employees by offering ownership interests. Tax-exempt entities can also enter into arrangements with other tax-exempts whereby they jointly own taxable entities.

There are several ways to structure a subsidiary relationship, each with attendant advantages and disadvantages:

Single-Member Disregarded Limited Liability Company (LLC): An organization might choose to create a single-member "disregarded" LLC (a single-member LLC that has not elected to be treated as a separate corporation) because it protects the parent against the subsidiary's liabilities. Under this structure, the subsidiary shares in its parent's tax exempt status without obtaining its own tax exemption. Disadvantages of this structure are that real estate owned by the LLC is not exempt from real estate taxation, and the subsidiary's operations are treated as unrelated business taxable income to the parent.

The "Pass-Through" Subsidiary: A tax-exempt may joint venture with other entities to create a pass-through subsidiary using the following structures:

- *Partnership:* If the tax-exempts form a partnership, the subsidiary files its own tax return but does not pay income tax. Any gains, losses, and income are "passed through" to the partners. General partners are subject to liability.
- *Multi-Member LLC*: A multi-member LLC is treated as a partnership that is managed by its members, unless members elect to be treated differently (in which case the entity

may become a C or S corporation). Tax-exempts may choose this structure because it protects against liability and is subject to one level of taxation, and it offers extreme flexibility in ownership interests, profit/loss allocations, income/equity distributions, etc.

- *Subchapter S Corporation*. This form is not typically used by tax-exempt organizations, because income to S corporations is always treated as unrelated business taxable income to the tax-exempt parents.

Subchapter C Corporation: This structure has less flexibility than an LLC or partnership, but it is also easier to create. Additionally, C corporation structure reduces the risk of endangering the parent entity's exempt status through operation of an unrelated business activity.

Although establishment of for-profit subsidiaries can offer many rewards, there is a minefield of potential issues to consider. Tax, legal, and practical considerations will govern the choice of entity and structure. Once the structure is created, corporate formalities must be instituted and followed to ensure separation between the entities. These include maintaining separate governing boards that meet regularly and keep their own record books, avoiding mixing of assets, and formalizing any space-sharing arrangements, to name a few.

When considering forming a for-profit subsidiary, care must be taken to realize the full benefits and mitigate the risks. Working closely with counsel, you can ensure that your organization creates and maintains the subsidiary in a manner consistent with you tax-exempt status and mission.