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Section 501(c)(3) Tax-Exempt Entities Forming Affiliations With Other Entities: Benefits, Risks, and Structural Considerations

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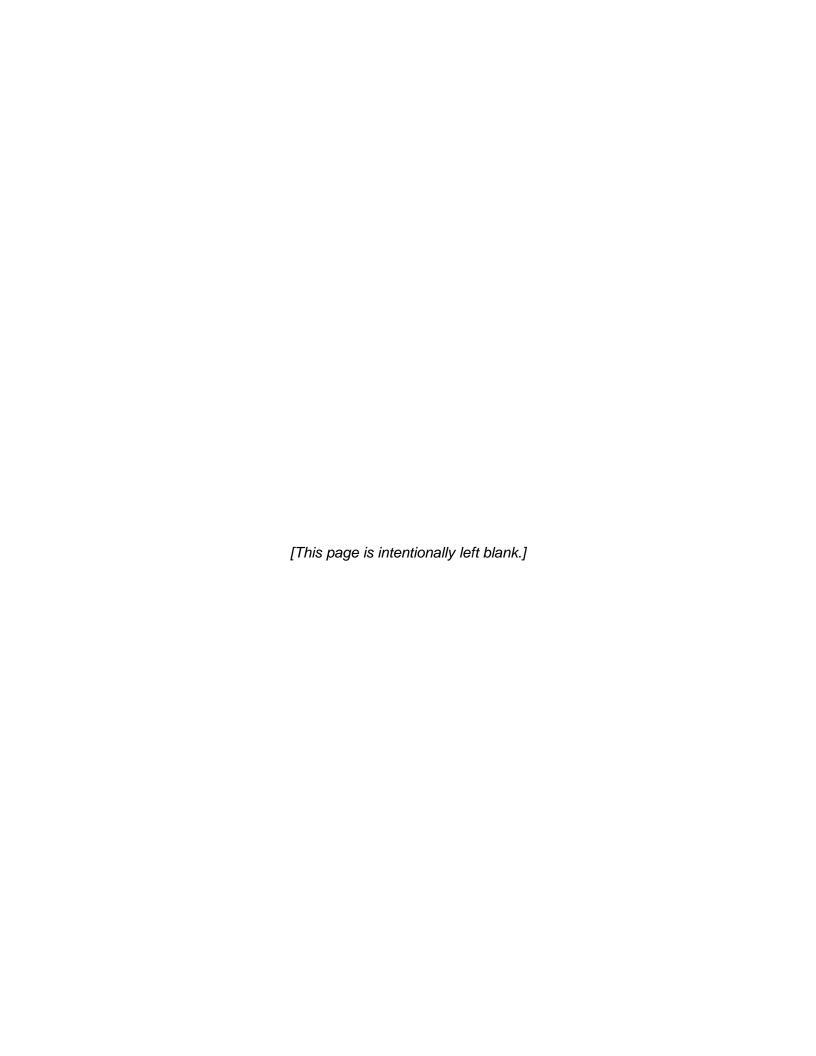


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I. Introduction

A Section 501(c)(3) tax-exempt organization may choose to affiliate itself with another organization through a parent-subsidiary relationship, common control, joint venture, shared ownership, or other affiliation.¹ Such an affiliation could prompt certain unintended legal results, especially in the context of tax or labor and employment law, if a governmental authority or court were to find that the tax-exempt organization was effectively integrated or joined as one entity with the other organization.

For the purposes of this memo, we assume that the tax-exempt entity may form an affiliation with a for-profit entity or another tax-exempt entity.²

In Section II of this memo, we provide a brief overview of the motivating factors and benefits that a tax-exempt entity might consider in forming an affiliation with another entity, as well as an overview of some of the risks of such affiliations. In Section III, we identify guidance from the Internal Revenue Service ("IRS") with respect to how such affiliations could be structured. This discussion will address scenarios (1) where an existing tax-exempt entity wishes to spin off an existing or proposed operation into a newly-formed separate entity, and (2) where two preexisting entities wish to affiliate with each other.

In Section IV, we examine how certain affiliations with tax-exempt entities described in Section 501(c)(3) of the Internal Revenue Code ("IRC") are viewed by the IRS and courts, as well as the tests used to determine such tax-exempt entity's "separate entity" status. For comparison purposes, we will also provide a summary of the IRS' and courts' treatment of relationships between a Section 501(c)(3) tax-exempt entity and its founders, directors/trustees, and officers.

In Sections V and VI, we discuss legal principles from other areas of the law that are similar to the doctrines followed by the IRS. Nonprofits need to be cognizant of these principles

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This memo focuses on issues relating to Section 501(c)(3) tax-exempt organizations affiliating with other business entities. It does **not** address issues related to tax-exempt organizations organized under other sections of the Internal Revenue Code (for a listing see Annex B) affiliating with other business entities.

There are some situations where a tax-exempt entity may not form an affiliation with a for-profit entity or another tax-exempt entity. For example, a Section 501(c)(3) entity is not allowed to control, be affiliated with, or make contributions to a Section 527 political action committee. See INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, FREQUENTLY ASKED QUESTIONS ABOUT THE BAN ON POLITICAL CAMPAIGN INTERVENTION BY 501(c)(3) ORGANIZATIONS: CONTRIBUTIONS TO POLITICAL ORGANIZATIONS (APRIL 20, 2010) ("[A] section 501(c)(3) organization may not make a contribution to a political organization described in section 527 (such as a candidate committee, political party committee or political action committee (PAC)). Nor may such an organization establish and maintain a separate segregated fund under section 527."), available at www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Frequently-Asked-Questions-About-the-Ban-on-Political-Campaign-Intervention-by-501(c)(3)-Organizations:-Contributions-to-Political-Organizations (web page last accessed on May 24, 2011).

when structuring affiliation relationships. In Section V, we identify criteria used to determine when a parent entity may be subject to the liabilities of a subsidiary entity if the complainant is able to "pierce the corporate veil" of the parent entity.

In Section VI, we summarize the different approaches of the National Labor Relations Board ("NLRB") and the courts under the federal employment law concept of a "single employer".

Lastly, the attached Annex A provides a summary compilation of various tests and considerations for your reference. Annex A should be reviewed in light of the analysis set forth in this memo. The attached Annex B provides a listing of different types of tax-exempt organizations under the IRC.

II. <u>Background on Affiliations with Tax-Exempt Entities</u>

A. <u>Benefits of Affiliation</u>

An affiliation between a tax-exempt organization and another entity can be prompted by tax or business reasons. Four primary benefits of forming an affiliation include: (1) preserving the tax-exempt organization's tax-exempt status while potentially allowing more operational freedom through the affiliate; (2) management of unrelated business income tax ("UBIT") exposure; (3) insulating the tax-exempt organization from liability and regulation; and (4) satisfying regulatory requirements. A common scenario is one where the nonprofit wishes to take a certain action not directly related to its primary purpose while maintaining favorable tax treatment.

1. <u>Preserving Tax-Exempt Status</u>

So long as the primary purpose of a tax-exempt entity continues to be conducting its exempt functions, an unrelated trade or business may be allowed within a tax-exempt entity's structure. However, the exempt status may be placed in jeopardy if the nonprofit's unrelated work becomes dominant or even substantial. The tax-exempt entity may secure its tax-exempt status by housing the unrelated activity elsewhere. The entity housing the new activity, whether a subsidiary or an outside affiliate, and whether tax-exempt under a different provision of the IRC or for-profit, should be permitted to conduct the new activity without threatening the transferor's tax exemption.³

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The structure of the new entity will impact whether its activities could overwhelm those of a nonprofit parent without jeopardizing the parent's tax-exempt status. As a general matter, if the subsidiary is a corporation then the magnitude of the for-profit activities will not be an issue. However, if the subsidiary is a partnership or an LLC then the scope of the for-profit activities is more relevant. See Section III *infra* discussing the different ways to structure affiliations.

With respect to affiliations with for-profit entities or entities that are tax-exempt under a more liberal provision of the IRC,⁴ the tax-exempt entity may see advantages to having the new activity conducted without the constraints of its more restrictive tax-exempt status. Exempt entities may prefer or find it more efficient or advantageous to have a for-profit affiliate (or, if applicable, another tax-exempt affiliate under a different provision of the IRC), because such affiliated entity might not be subject to the same restrictive provisions of the IRC; for example such affiliated entity might have greater flexibility in managing (and transferring) assets and liabilities and recruiting and hiring employees.

2. Management of Unrelated Business Income Tax

Even if tax-exempt status would be preserved if the new activity were conducted directly by the tax-exempt entity, the tax-exempt entity may face the imposition of UBIT with respect to the new activity. ⁵ The imposition of UBIT will be determined by the relationship of this new activity to the entity's tax-exempt purpose. Subject to certain limited exceptions, if the new activity is regularly carried on and is not substantially related to the entity's tax-exempt purpose, then it will likely result in the imposition of UBIT with respect to any income generated from that activity if the activity is conducted at the parent level. ⁶

See 26 U.S.C. §§ 501(c)(1)-(28); see also Internal Revenue Service, U.S. Dep't of the Treasury, Pub. No. 557, Tax-Exempt Status for Your Organization 65-66 (Rev. Oct. 2010), available at www.irs.gov/pub/irs-pdf/p557.pdf (web page last accessed May 24, 2011). See Annex B for a list of the different types of Section 501(c) tax-exempt entities.

See 26 U.S.C. § 511. With the exception of certain activities, UBIT is generally assessed on income received from "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501 " 26 U.S.C. § 513(a). See generally INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 598, TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (Rev. March 2010), available at www.irs.gov/pub/irs-pdf/p598.pdf (web page last accessed on May 24, 2011).

Unrelated business income is taxable when it is: (a) generated from a "trade or business"; (b) regularly carried on; **and** (c) the activity is not substantially related to mission. It does not matter that revenue supports the charitable mission—it is the activity that is scrutinized, not what is done with the income. The major exceptions to UBIT include: (a) sale of donated goods (e.g., thrift shops); (b) activities where volunteers perform "substantially all the work"; (c) activities carried on primarily for the convenience of the tax-exempt entity's members; (d) rental income; (e) royalties; and (f) investment income. Note, however, that rents, royalties, and investment income paid by a controlled entity to a tax-exempt controlling entity will be subject to UBIT to the extent the amounts paid reduced the net unrelated income (or increased the net unrelated loss) of the controlled entity. See 26 U.S.C. § 512(b)(13); see generally Internal Revenue Service, U.S. Dep't of the Treasury, Pub. No. 598, Tax on Unrelated Business Income of Exempt Organizations (Rev. Mar. 2010), available at www.irs.gov/pub/irs-pdf/p598.pdf (web page last accessed on May 24, 2011).

If the parent tax-exempt entity and the for-profit subsidiary are both corporations, the same regular corporate tax rates will apply in computing either the parent's UBIT or the subsidiary's income tax. By transferring the activity to the for-profit subsidiary, the parent should be protecting its tax-exempt status, but will be conceding that the activity is taxable.

If the activity is transferred to an entity that is treated as a partnership for tax purposes, the transferor's share of the partnership's income will be taxed based on the partnership's use of the activity, as described further below. If the activity is transferred to an entity that is "disregarded" for tax purposes, the activity will generally be taxed as if no transfer had occurred.

3. Insulation from Liability and Regulation

An exempt entity may also prefer to place some of its riskier tax-exempt activities into one or more separate entities to protect itself (and its assets) from direct liability. This protection may apply generally in the corporate context by preventing the piercing of the "corporate veil", and might also be applicable in the labor law context. For example, a tax-exempt entity could own real estate, but not want to expose all of its assets to the liabilities associated with property ownership. Alternatively, a tax-exempt could operate a day care, school, or health care facility, fully in the furtherance of its exempt purpose, but because of the considerable risks and liabilities inherent in those operations, they could be placed in a separate entity to protect the assets of the parent tax-exempt entity.

Aside from liability concerns, certain activities can result in greater regulatory oversight or specific requirements of state law. For example, if a nonprofit sought to involve itself in providing insurance to low income individuals, it would likely be subject to both state and federal insurance regulations. If the tax-exempt entity would not otherwise be subject to this level of oversight and regulation but for its involvement in a particular activity—i.e., the provision of insurance—outsourcing the activity to a subsidiary might place only the subsidiary within the purview of the oversight and regulations. Conversely, if the tax-exempt entity is subject to regulatory oversight, but the new activity, if housed elsewhere, would not be, such tax-exempt entity may find it more efficient to place such activity in a subsidiary or joint venture.

4. Satisfying Regulatory Requirements

In some instances, either lenders or federal, state, or local regulation may require that the activity be housed in a separately formed "single purpose entity". The rationale behind the formation of the new entity is often influenced by the other benefits discussed above, including protecting the original entity's tax-exempt status and limiting the liability of the original entity in complex transactions.

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An important caveat to this entire discussion regarding avoidance of liability is that one cannot create a separate entity for the sole purpose of evading the law and certain liabilities. As discussed in Section V *infra*, courts will pierce the corporate veil in situations where the subsidiary is merely a sham or was created to perpetrate a fraud. Likewise, as discussed further in Section VI *infra*, separate entity status will be disregarded if the court concludes that the subsidiary was created for the purpose of evading federal antidiscrimination laws.

The affordable housing context is an example of where the formation of a single purpose entity is legally required. Depending on the specific jurisdiction and applicable regulation, this entity may take the form of a corporation, limited partnership, or limited liability company ("LLC") and may be either for-profit or nonprofit. Due to the complex nature of many of these transactions, particularly in the area of affordable housing, and the variety of regulatory structures that can be implicated, it is important to consult with experts and legal counsel who specialize in this area before embarking on such a venture.⁸

B. Risks of Affiliation

While there can be significant benefits to affiliating with another entity, there can also be significant risks. The most significant of these risks can arise when a court or other governmental authority collapses the affiliates together and does not recognize them as separate entities. This could result in exposure to liability for the activities of the affiliate, and possibly lead to the revocation of an entity's tax-exempt status or even civil or criminal penalties. These risks are discussed in greater detail in the remaining sections of this memo.

III. Form and Structure of Affiliations

The types of affiliations addressed in this memo fall into two general categories. The first involves the tax-exempt entity creating a wholly-owned entity for a specific purpose. The second involves the tax-exempt entity forming an affiliation through joint venture, partnership, or otherwise with one or more preexisting entities in order to create a new jointly-owned entity. As explained below, the determination as to which course is more appropriate for a particular tax-

See, e.g., U.S. DEP'T OF HOUS. AND URB. DEV., POLICY AND PROCEDURES ON MULTIFAMILY MORTGAGE INSURANCE APPLICATIONS INVOLVING MASTER LEASE STRUCTURING TO FACILITATE THE USE OF TAX CREDITS, Mortgagee Letter 2009-40 (Oct. 19, 2009) (illustrating the complexity and requirements of HUD programs), available at www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-40ml.doc (web page last accessed May 24, 2011).

It should be noted that while this memo addresses the most common federal tax law and labor and employment consequences associated with the creation of new entities and affiliation with existing entities, there may be additional state law consequences that are **not** addressed in this memo. For example, in *International Schools Services Inc. v. West Windsor Township*, 412 N.J. Super. 511, 530, 991 A.2d 848, 859 (App. Div.), certif. granted, 203 N.J. 96, 999 A.2d 464 (2010), the Appellate Division of the New Jersey Superior Court held that International Schools Services Inc. ("ISS"), a Section 501(c)(3) nonprofit was not entitled to an exemption from real property taxes because "a portion of ISS' profit was being used to subsidize the operations of its [two] profit-making affiliates through the provision of professional services that were not 'charged back,' below-market rents, and unsecured loans that do not appear to have been timely repaid. In addition, although ISS has an educational mission, it has lent its name and reputation to promote joint profit-making ventures, as evidenced, in part, by its creation of ISG and ISSFIN, which operate out of the same building as ISS and share officers and staff; the wording of the ISSFIN press release; and the expanded mission statement on ISS' website promoting "ISSFIN['s] . . . money and asset management products."

exempt entity is fact specific and depends heavily on the underlying reasons for forming the affiliation. ¹⁰

A. <u>Creating a Directly Controlled Entity</u>

The first type of situation most commonly arises when a tax-exempt entity wants to engage in an activity in which it has not previously engaged, and prefers to do so without affiliating with an outside partner. This situation can also arise where the entity engaged in an activity that initially was insubstantial but such activity has grown or has potential to grow to a point where the entity's status is being reconsidered. If the entity could benefit from not conducting the activity itself—at the parent level—as discussed above, it could create a subsidiary to conduct the activity.

One of the more common methods of forming such an affiliation is the creation of a for-profit subsidiary by the nonprofit. ¹¹ If properly structured, the parent-subsidiary corporate form provides the advantage of insulating the parent from liability for the subsidiary's actions. ¹² Additionally, a subsidiary corporation is treated as a separate entity for tax purposes and, therefore, is considerably useful when UBIT at the parent level is of particular concern. However, when the subsidiary is a for-profit, it effectively concedes that any income on the part of the subsidiary is taxable, even if it would not have been taxable if earned by the parent. ¹³

Instead of using the corporate form, another option is to create a wholly-owned subsidiary in the form of a single-member limited liability company ("LLC"). The LLC has the advantage of being like a corporation for purposes of liability protection, but it is considered a disregarded pass-through entity for taxation purposes. As a pass-through entity, the LLC's income, taxable or exempt, will pass through to the parent. Accordingly, if there is unrelated business income generated by the LLC, the parent will have to pay UBIT. An LLC is useful when exposure to an activity's risk or liability is of particular concern, but there is minimal concern about the new activity's tax implications.

Lastly, it should be noted that operating an unrelated for-profit activity directly as a sole proprietorship does not protect the nonprofit from either tax exposure or liabilities. A sole proprietorship is merely a part of the organization that owns it.

Another major factor to be considered is state tax law, which is **not** discussed in this memo.

See, e.g., I.R.S. Priv. Ltr. Rul. 9016072, 1990 WL 699152 (Jan. 24, 1990) (where a tax-exempt organization owned a for-profit subsidiary and that subsidiary in turn owned a network of for-profit subsidiaries).

As discussed in Section V *infra*, misuse or abuse of the parent-subsidiary corporate form will undermine this insulation from liability. Additionally, as discussed fully in Sections IV, V, and VI *infra*, there are a number of potential pitfalls that can not only result in a loss of tax-exempt status, but also subject the parent to liability for the subsidiary, or vice versa.

See Frances R. Hill & Douglas M. Mancino, Taxation of Exempt Organizations, ¶ 29.02, at n.3 (2002).

B. Affiliating with a Preexisting Entity

The tax-exempt entity may instead decide to engage in a new type of activity by collaborating with one or more other entities already in existence. The collaborating entity may be tax-exempt under the same or a different provision of the IRC or may be a for-profit entity. A common approach to such a collaboration is to establish a joint venture in the form of a corporation, LLC, or partnership. 15

As with the creation of a subsidiary, the most protective form for the joint venture to take would be creating a jointly-owned corporation to conduct the activities of the venture. The corporation, if properly structured, would be considered a separate entity for tax purposes, and would insulate the tax-exempt entity (and the collaborating entity) from potential liability. However, as discussed in Section IV below, the tax-exempt must be cognizant of maintaining the requisite level of separateness with the corporation or risk jeopardizing its exemption. ¹⁶

The other two common forms of joint ventures, LLCs and partnerships, are considered pass-through entities and share a common concern with regard to how the income from the joint venture is treated. As a general rule, income from an LLC or partnership will not be subject to UBIT in the tax-exempt parent's hands if the trade or business of the venture is substantially related to the exempt purpose of the parent entity.¹⁷ Therefore, the tax-exempt entity must be careful that the LLC or partnership is organized and operated to further its exempt purpose, and that any revenue the tax-exempt entity receives from the LLC or partnership is related to the its exempt purpose.¹⁸ However, if the activity is not substantially related—as determined by

The tax planning objectives of the other partners in the joint venture will influence the formation structure. For example, if the goal is for the joint venture entity to be tax-exempt itself, it will need to adhere to all of the same rules for forming a tax-exempt entity as the affiliating tax-exempt entity. If the joint venture entity is tax-exempt itself, it may alleviate some of the concerns discussed below with regard to the tax treatment of the venture's revenue.

Additionally, a joint venture like arrangement may also be accomplished through vendor or licensing arrangements. However, this would be a contractual relationship as opposed to the more formal creation of a new jointly-owned entity.

¹⁶ See HILL & MANCINO, supra note 13, ¶ 29.08.

See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 1998-1 C.B. 718, 1998 WL 89783 ("A §501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners."); see, e.g., I.R.S. Priv. Ltr. Rul. 9608039, 1996 WL 76473 (Nov. 30, 1995).

See Rev. Rul. 98-15, 1998-12 I.R.B. 6, 1998-1 C.B. 718, 1998 WL 89783 (comparing the organization and operation of two similar joint venture LLCs, each involving a tax-exempt and for-profit partner); see also, Rev. Rul. 2004-51, 2004-22 I.R.B. 974, 2004-1 C.B. 974, 2004 WL 1038122 (holding that the tax-exempt entity participating in an LLC was not subject to UBIT because the "the manner in which [the LLC] conducts the teacher training seminars contributes importantly to the accomplishment

considering if the activity would be considered related if conducted by the tax-exempt partner itself—then it would likely be subject to UBIT, payable by the tax-exempt entity. 19

Three common situations and considerations arise when a tax-exempt entity participates in a joint venture: (1) the joint venture is the tax-exempt entity's primary activity; (2) the joint venture is not the tax-exempt entity's primary activity, but the tax-exempt entity is still a general partner of the joint venture; or (3) the tax-exempt entity is a limited partner or minority member. Because the activities of the joint venture will be attributed to the tax-exempt entity, the negative consequences of this participation can range from the imposition of UBIT on revenue from the joint venture to the revocation of the tax-exempt entity's exempt status.

When the joint venture is the tax-exempt entity's primary activity, the joint venture must be operated to further tax-exempt entity's exempt purpose. A significant factor in whether the joint venture is considered to be operated to further the tax-exempt entity's exempt purpose is the degree of control the exempt entity has over the joint venture. Revenue Ruling 98-15 provides that:

[A tax-exempt] organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes.²⁰

Accordingly, it is important that the venture be structured so as to give the exempt organization effective control over the day-to-day activities. Furthermore, in order to ensure control over any assets the tax-exempt entity contributed to the joint venture, it must retain at least 50% voting control over the venture. As such, in the case of LLCs, the exempt organization will generally need to be the managing member of the joint venture.

The IRS historically has scrutinized tax-exempt organizations acting as the general partner in a limited partnership when the activity of the partnership is not the exempt entity's

of [the tax-exempt entity]'s educational purposes, and the activities of [the LLC] are substantially related to [the tax-exempt entity]'s educational purposes").

¹⁹ See HILL & MANCINO, supra note 13, ¶ 29.05.

²⁰ Rev. Rul. 98-15, 1998-12 I.R.B. 6, 1998-1 C.B. 718, 1998 WL 89783 (internal citations omitted).

See Redlands Surgical Servs. v. Comm'r, 113 T.C. 47 (1999), aff'd per curiam 242 F.3d 904 (9th Cir. 2001).

primary activity. Peing a general partner exposes all of the tax-exempt's assets to the liabilities of the partnership. Additionally, there is risk of private inurement by a limited partner receiving a disproportionate share of partnership benefits or by the general partner not being adequately compensated for its services or the risks it assumes. As such, the IRS imposes a three part test to determine whether tax-exempt status will be revoked if a tax-exempt entity serves as a general partner. The IRS will first look at whether the tax-exempt organization, as the general partner, is serving a tax-exempt purpose by means of the partnership. If it is, the next consideration is whether the partnership agreement allows the exempt organization to act primarily in furtherance of its exempt purpose. Lastly, the partnership cannot cause the exempt organization to convey undue economic benefit to the limited partners.

In both of the aforementioned situations, including provisions in the formation documents of the limited partnership or the LLC that provide that the organization is to be operated for the specified exempt purpose and that any conflicts should be resolved in favor of operating the organization in a manner consistent with such exempt purpose, even at the expense of maximizing the profits of the limited partners or other members, strengthen the exempt general partner's position and significantly reduce the risks to its exempt status. Similarly, the partnership or LLC can adopt a conflict of interest policy similar to those adopted by most exempt organizations that provides a procedure for when the organization is considering entering into a transaction with an interested party. Doing so will help to limit the risk of undue economic benefit or private inurement.

As long as the joint venture is not the exempt organization's primary activity then it can be a limited or minority partner. This occurs most often when the exempt organization wants to enter into a joint venture for the purposes of investment or other activities not directly related to its exempt purpose. This has the advantage of protecting the nonprofits assets from exposure to unlimited liability. However, acting as a limited partner or non-managing member increases the likelihood of having UBIT liability because the activities of the limited partnership are often unrelated to the exempt entity's exempt purpose. ²⁶

See Bruce Hopkins, The Law of Tax Exempt Organizations Ch. 30 and §20.11 (10th ed. 2011). See generally Michael I. Sanders, Joint Ventures Involving Tax-Exempt Organizations (3rd ed. 2007).

See I.R.S. Gen. Couns. Mem. 39862, 1991 WL 776308 (Nov. 21, 1991) ("The [IRS] no longer contends that participation as a general partner in a partnership is per se inconsistent with exemption. However, when such activities involve private, taxable parties, they must be scrutinized for private inurement or more than incidental private benefit. The [IRS] weighs all the facts and circumstances in each case, applying a "careful scrutiny" standard of review."); HILL & MANCINO, supra note 13, ¶ 29.04[4].

²⁴ See HOPKINS, supra note 22, at §30.2(b)(ii) at 920.

²⁵ See, e.g., I.R.S. Priv. Ltr. Rul. 9207033, 1992 WL 801058 (Nov. 20, 1991)

See Note 5, supra for a discussion of UBIT.

C. Affiliating with a Preexisting Entity through a Subsidiary—A Hybrid Approach

Another situation can arise when there is a genuine concern about the relevance of the activity to the tax-exempt's purpose or a more serious risk of exposure of the tax-exempt's assets to liability. In such a situation, the tax-exempt entity could create a subsidiary in much the way discussed in Section III.A above, and then have the subsidiary enter into the joint venture with the third-party entity in the way discussed in Section III.B above.

The IRS has permitted this route of allowing a tax-exempt organization to form a wholly-owned organization (usually a for-profit corporation) that would serve as the affiliating entity (instead of the tax-exempt parent). However, while this approach remedies concerns regarding jeopardizing the parent's tax-exempt status and maintaining insulation from liability, when the subsidiary is a for-profit, it effectively concedes that any income on the part of the subsidiary is taxable, even if it would not have been taxable if earned by the parent. ²⁸

IV. Separate Entity Status Under Tax Law

A. Tax-Exempt Status under the IRC

Tax-exempt status under Section 501(c)(3) of the IRC can be achieved by an entity that is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes. . . ."²⁹ There are two tests utilized to apply this qualification—the "organizational test", requiring that a corporation be organized exclusively for exempt purposes, and the "operational test", requiring that a corporation must be operated exclusively for one or more exempt purpose.³⁰ Both tests must be satisfied in order to qualify for an exemption as a charitable organization under Section 501(c)(3).

1. Organizational Test—Organized Exclusively for Exempt Purposes

The constraints of this first test often lead a tax-exempt organization to form an affiliation (through a parent, subsidiary, or sister relationship) with a nonexempt entity or an entity that is

See, e.g., I.R.S. Priv. Ltr. Rul. 199941051, 1999 WL 821706 (July 22, 1999), available at www.irs.gov/pub/irs-wd/9941051.pdf (web page last accessed May 24, 2011); I.R.S. Priv. Ltr. Rul. 200037050, 2000 WL 33120215 (June 20, 2000), available at www.irs.gov/pub/irs-wd/0037050.pdf (web page last accessed May 24, 2011). It should be noted however, that the nonprofit should still be cognizant of maintaining the requisite level of separateness with the for-profit subsidiary discussed in more detail in Section IV below.

²⁸ See HILL & MANCINO, *supra* note 13, ¶ 29.02, at n.3.

²⁹ 26 U.S.C. § 501(c)(3).

Treas. Reg. § 1.501(c)(3)-1; *Bob Jones Univ. Museum and Gallery, Inc. v. Comm'r*, T.C. Memo. 1996-247, *3, 71 T.C.M. (CCH) 3120, 1996 WL 280900 (U.S. Tax Ct. 1996).

tax-exempt under a different provision of the IRC, as discussed in Part III.³¹ While the affiliate focuses on the nonexempt purpose, the Section 501(c)(3) entity can maintain that it is organized *exclusively* for the stated permitted purpose.³²

In determining whether this test is met, the IRS will generally look at the governing documents (*i.e.*, articles/certificate of incorporation and bylaws). Such documents must limit the entity's purpose to exempt purposes only, and cannot expressly empower the entity to participate in (other than in an insubstantial way) activities that do not further such exempt purposes. That is, the purposes for which the organization is created cannot be broader than the specified exempt purposes set forth in IRC Section 501(c)(3). For example, the following activities are deemed not to be charitable purposes and would cause a failure of the organizational test if the governing documents expressly permitted such activities or purposes: (1) devoting more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; (2) directly or indirectly participating in or intervening in any political campaign on behalf of or in opposition to any candidate; or (3) having objectives and engaging in activities that characterize it as an "action" organization. However, the organizational test does not require the governing documents to expressly prohibit private

There are multiple types of tax-exempt organizations, with IRC Section 501(c)(3) organizations (sometimes referred to as "charitable organizations") comprising the largest subset. See HOPKINS, supra note 22, at §2.1 at 26-27; 26 U.S.C. § 501(c)(1)-(28). See Annex B for a list of the different types of Section 501(c) tax-exempt entities.

It is noteworthy that the term "exclusively" has not been interpreted to mean "solely" but rather to mean "primarily." Treas. Reg. § 1.501(c)(3)-1(c)(1). This means that the presence of a single nonexempt purpose, if substantial in nature, will destroy the exempt status of the entity. However, if the nonexempt activity is insubstantial or merely incidental, then it will not be fatal to the organization's exempt status. See Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945); see also Rev. Rul. 77-366, 1977-2 C.B. 192, 1977 WL 43733. Additionally, the focus is less on the specific activities of the organization, and rather on whether those activities act to achieve the organization's primary purpose. See generally HOPKINS, supra note 22, at §4.4 at 72-74.

The IRS has taken the position that it will only look at a "creating document"—which for a corporation is the articles of incorporation and not the bylaws. As a result, a defect in the articles of incorporation cannot be remedied by a correction in the bylaws, but rather would require amending the articles in accordance with state law. Hopkins, *supra* note 22, at §4.3(a) at 68. The courts, however, have taken a broader approach, performing a factual inquiry that may include a review of bylaws. *Id*.

Treas. Reg. § 1.501(c)(3)-1(b)(3). An organization is an "action" organization if "a substantial part of its activities is attempting to influence legislation by propaganda or otherwise", "it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office", or "it has the following two characteristics: (a) its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public." Treas. Reg. § 1.501(c)(3)-1(c)(3).

inurement, substantial lobbying, and political campaign activities.³⁵ Nonetheless, including such prohibitions in the governing documents of a Section 501(c)(3) organization is a easy way to remind managers of these limitations.

The final requirement of the organizational test is a provision in the organization's governing instrument requiring its assets to be distributed for an exempt purpose or to state or local government upon the dissolution of the organization; the assets cannot be distributed to a charitable corporation's shareholders upon dissolution.³⁶

2. Operational Test—Operated Exclusively for One or More Exempt Purpose

A relationship created to work within the confines of the organizational test may nonetheless violate the operational test. There is no blanket prohibition against such affiliations, but the IRS may revoke Section 501(c)(3) status if it finds that the Section 501(c)(3) organization merely furthers—in a substantial way—a nonexempt purpose and cannot demonstrate that its activities are for an exempt purpose.³⁷

The relevant income tax regulations provide:

[A]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if three requirements are satisfied: (1) the organization engages primarily in activities that accomplish exempt purposes, and no more than an insubstantial part of its activities is in furtherance of a nonexempt purpose; (2) the net earnings of the organization do not inure in whole or in part to the benefit of private shareholders or individuals; and (3) the organization is not an "action" organization that attempts to influence legislation by propaganda or otherwise. 38

It is worth noting that the IRS will find that the purpose of the activities conducted is more important that the type of activities. For example, if the purpose of the activity is deemed to be funneling tax-deductible contributions to another entity that does not have Section 501(c)(3) status, the IRS will likely take a hard stance against the relationship, regardless of what the activity is.

Steven D. Simpson, *Tax-Exempt Organizations: Organizational and Operational Requirements*, 896 TAX MGMT. (BNA), at A-197 (2000).

³⁵ HOPKINS, *supra* note 22, §4.3(a) at 67-68.

³⁶ Treas. Reg. § 1.501(c)(3)-1(b)(4).

Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo 1996-247 at *3 (interpreting Treas. Reg. § 1.501(c)(3)-1(c)).

B. Implications of the Operational Test

Typically, the IRS will refrain from attributing the activities of a separately-incorporated subsidiary to its parent "unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent."³⁹ Critical issues throughout all of the foregoing analysis are the concepts of control and inurement/private benefit.⁴⁰ If it appears that the subsidiary is merely an extension of the parent, and was not created for some business purpose, other than tax reasons, the IRS may not treat it as a separate entity. Courts tend to cite a similar set of factors.

The founder-organization relationship illustrates how the presence of control and private inurement can threaten tax-exempt status. Under the IRS' view, when the founder of an entity controls all aspects of the organization's operations without being checked by any governing body, there is risk of abuse and private inurement. A court has held that an organization could not qualify for tax-exempt status when the assets and activities of the organization were found to be identical to those of the organization's sole founder, director, and officer. In essence, the organization was operated for the benefit of a private individual, namely the founder. The court wrote that the organization and the individual were "irretrievably intertwined" and, therefore, the "benefits" of the exemption would "inure" to him. While this is an extreme example, it highlights the need for a real, and not just a formulaic, separation between the parent and the subsidiary.

1. Rent

When a Section 501(c)(3) entity pays rent to an entity with a different tax status, the IRS will inquire whether or not the rental arrangements provide private benefit or inurement to the other party. In making such a determination, the primary inquiry is whether the rental payments

³⁹ I.R.S. Priv. Ltr. Rul. 200132040, 2001 WL 899690 (May 15, 2001), available at www.irs.gov/pub/irs-wd/0132040.pdf (web page last accessed May 24, 2011).

See Internal Revenue Service, U.S. Dep't of the Treasury, Inurement/Private Benefit - Charitable Organizations (Nov. 2, 2010) ("A section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual. A private shareholder or individual is a person having a personal and private interest in the activities of the organization."), available at www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Inurement-Private-Benefit-Charitable-Organizations (web page last accessed on May 24, 2011). For an extended discussion of concepts of private inurement, private benefit, and excess benefit transactions, see HILL & MANCINO, supra note 13, Ch. 4.

Salvation Navy, Inc. v. Comm'r, T.C. Memo. 2002-275, 84 T.C.M. (CCH) 506, 2002 WL 31427293 (U.S. Tax Ct. 2002).

⁴² Id.

are excessive.⁴³ Nonprofit organizations will not lose their status for incurring "ordinary and necessary expenditures in the course of [their] operations."⁴⁴

In *Bob Jones University Museum*, the campus museum was incorporated as a nonprofit years after the university had its Section 501(c)(3) status revoked for school policies found to be contrary to public policy (*i.e.*, prohibiting interracial dating and marriage). The museum and the university entered into a three-year lease pursuant to which the museum would rent space, as well as all of the artwork, furniture, and fixtures, from the university, which retained ownership. ⁴⁵ The university charged the museum a rent of \$3 per square foot, which was substantially lower than the fair market value of the space of \$10-12 per square foot.

The IRS contended that the payment of rent by the Section 501(c)(3) entity conferred an impermissible private benefit on the university, but the court disagreed, concluding that the below-market payment was an "ordinary and necessary" expenditure.⁴⁷ Note that the payment of rent for lower than market value was not problematic, though a payment of rent above market value would have been impermissible.

Alternatively, in some cases the Section 501(c)(3) entity is the landlord and is receiving rent. In these cases, the keeping of detailed records and payment of fair rental value for actual usage would indicate that the other party is not receiving an impermissible benefit from the nonprofit by paying less than fair value.⁴⁸

The same principles apply to other affiliations. To the extent sister entities or a tax-exempt entity and a joint venture in which it participates have a landlord-tenant relationship, detailed record keeping and appropriate allocation of fair value costs remain best practices. These best practices apply regardless of whether the Section 501(c)(3) entity is the landlord or the tenant in the relationship.

Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo. 1996-247, at *4; B.H.W. Anesthesia Foundation v. Comm'r, 72 T.C. 681, 686 (U.S. Tax Ct. 1979) (asking "whether comparable services would cost as much if obtained from an outside source in an arm's-length transaction").

Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo. 1996-247, at *4 (quoting Founding Church of Scientology v. United States, 188 Ct. Cl. 490, 496 (1969)).

Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo. 1996-247, at *1-2.

⁴⁶ *Id.* at *2.

⁴⁷ *Id.* at *4.

I.R.S. Priv. Ltr. Rul. 9542045, 1995 WL 614930 (July 28, 1995), supplemented by I.R.S. Priv. Ltr. Rul. 9720036, 1997 WL 254463 (Feb. 20, 1997).

⁴⁹ See I.R.S. Priv. Ltr. Rul. 9308047, 1992 WL 450762 (Dec. 4, 1992).

2. Overlap of Board Members

While completely overlapping boards of directors/trustees between two entities will not per se result in a determination that the entities are not separate, both the IRS and the courts note that when a substantial percentage of the subsidiary's board members are not employees or directors of the parent (or, as otherwise stated, the subsidiary's board members are independent), that factor will weigh heavily in favor of separate entity status. The law is not clear as to the optimum percentage of independent directors; ⁵⁰ in the *Bob Jones University Museum* opinion, the court noted, "[t]here are no bright-line standards that address the effect on exempt status, if any, of overlapping boards of directors."⁵¹

If a tax-exempt entity permits overlapping boards of directors, it should take certain steps to mitigate this factor. Overlapping directors bring an inherent risk of abuse and, as such, a tax-exempt entity should be even more vigilant with respect to other corporate formalities and the appearance of separateness.

3. <u>Day-to-Day Management/Control</u>

The degree of control that one entity has over the daily activities of the other is also examined. For example, in deciding that the earnings of a Section 501(c)(3) entity's wholly-owned for-profit subsidiary would not be attributed to the nonprofit parent, the IRS stated in a private letter ruling, "[y]ou [the Section 501(c)(3) entity] will not be involved in the day-to-day management and operations of your subsidiary [the for-profit corporation]. Transactions between you and your subsidiary will be conducted on an arm's-length basis." ⁵²

See I.R.S. Priv. Ltr. Rul. 9542045, 1995 WL 614930 (July 28, 1995), supplemented by I.R.S. Priv. Ltr. Rul. 9720036, 1997 WL 254463 (Feb. 20, 1997) ("A majority of the Board of Directors of [for-profit corporation] will be independent of [nonprofit]."); I.R.S. Gen. Couns. Mem. 39326, 1985 WL 291903 (Jan. 17, 1985) ("[Nonprofit] will be managed by a Board of Directors, a majority of whom will not be officers, Directors or employees of *** or any of the other exempt subsidiaries."); Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo. 1996-247 at *5 (noting "[o]nly two of [nonprofit's] five directors...are employed by the University" and finding that university did not have excessive control of the nonprofit); I.R.S. Priv. Ltr. Rul. 8625078, 1986 WL 369370 (Mar. 27, 1986) (noting, though not appearing to require, that at least one-third of subsidiary's Board of Directors will not be related to the parent). While there is no set ratio of overlapping to independent directors, and the IRS does not generally require a majority of directors be independent, the IRS as a general rule reacts more favorably to boards with less overlap and more independence.

Bob Jones Univ. Museum and Gallery, Inc., T.C. Memo. 1996-247, at *5.

I.R.S. Priv. Ltr. Rul. 8625078, 1986 WL 369370 (Mar. 27, 1986). Similar language is found in an IRS general counsel memorandum. I.R.S. Gen. Couns. Mem. 39326, 1985 WL 291903 (Jan. 17, 1985) ("Pursuant to the reorganization proposal, * * * will manage the activities of the taxable subsidiaries which will provide management and operations services to both exempt and for-profit hospitals. * * * states that it will not be involved in the day-to-day management of * * * or of its subsidiaries. Transactions between * * * and the for-profit organizations will be conducted on an arm's-length basis."); see also I.R.S. Priv. Ltr. Rul. 9542045, 1995 WL 614930 (July 28, 1995), supplemented by I.R.S. Priv. Ltr. Rul. 9720036, 1997 WL 254463 (Feb. 20, 1997) (In holding parent and subsidiary

4. Capitalization and Distribution of Assets

Another significant consideration in establishing a subsidiary is its level of capitalization. A tax-exempt organization is permitted to invest a portion of its assets in unrelated activities, including a for-profit subsidiary. However, the prohibitions on private inurement and private benefit will limit the tax-exempt entity's ability to transfer assets to the subsidiary if the result is individual private benefit. As a general rule, when determining how much capital to provide a subsidiary, a tax-exempt organization should utilize only "an amount of resources that is reasonable under the circumstances and that can be rationalized in relation to amounts devoted to programs and invested in other fashions." This rule, however, must be balanced with the general prohibition under state corporate law against undercapitalization.

As demonstrated in Section IV.B.1 above, there are many ways that money can be shifted between the parent and its subsidiary or affiliate, including through rent and the leasing of other resources. Any means of shifting of income or loss producing activities from a tax-exempt entity to its affiliate should be done with sufficient planning and preparation, proper documentation with appropriate records, and at market rates (*i.e.*, rental rates, interest rates for loans). It is important also to remember that, unlike dividends, when a tax-exempt parent receives "any interest, annuity, royalty, or rent" from a controlled taxable subsidiary, those revenues will generally be subject to UBIT.⁵⁴

5. Other Factors

While the courts tend to focus on the factors noted above, tax-exempt organizations should also remain focused on following established corporate practices. There are numerous corporate practices that highlight an entity's individual corporate identity, including observing the formalities mandated by governing documents and law (e.g., timing, location, and other details regarding board and shareholder meetings) and conducting business in one's own name and maintaining adequate levels of capital. The entity and its affiliates should also properly maintain separate books and records, accounts, tax and information returns, financial statements, payroll, and other payables. In addition, entities are encouraged to keep all transactions with affiliates at arm's-length, including (1) fair-market "charge backs" for the cost of shared services (e.g., telecommunication and photocopy charges) and (2) avoiding co-mingling of funds, assets, or liabilities, pledging of assets, or making loans without appropriate consideration and authorization. The arm's-length transactions should be documented in written agreements.

Affiliated entities can share some of the same employees, particularly to realize economies of scale, but doing so carries risks. Unless proper formalities are followed, it may not be clear to outsiders which entity such an employee is acting on behalf of—the actions

separate entities, the IRS stated, "[t]he management of X has represented that there is no understanding or agreement, written or unwritten, that X will direct or actively participate in the day-to-day management of Y or Z. X intends to exercise only the normal rights of a shareholder.").

⁵³ HOPKINS, supra note 22, at §29.3(a) at 895.

⁵⁴ See 26 U.S.C. § 512(b)(13).

clerical employees are less likely to be attributed, whereas managerial and financial personnel will likely raise greater concern.⁵⁵ This is especially important where one of the entities is restricted in engaging in certain activities and the other entity is not. For example, a Section 501(c)(3) nonprofit can engage in a very limited amount of lobbying, whereas a Section 501(c)(4) nonprofit is not limited in the same way. However, issues of private inurement and UBIT are typically more pressing than the risk of attribution from sharing employees. If the entities do share employees, it is important to allocate between the two organizations their fair shares of the employees' salaries and fringe benefits to limit the possibility of private inurement.⁵⁶ Likewise, if the shared employees are involved in providing goods or services unrelated to the exempt entity's exempt purpose, then any revenue generated may be subject to UBIT.⁵⁷

V. <u>Liability Exposure and Piercing the Corporate Veil</u>

Section IV of this memo reviews various rules applied by the IRS and the courts when deciding whether two entities should be treated as one, such that the activities of one entity will be attributed to the other entity. Similar legal doctrines are applied in other areas of the law. These doctrines are the subject of Sections V and VI. Nonprofits need to be cognizant of these principles when structuring their affiliation relationships.

As a general rule, one entity will not be responsible for the liabilities of an affiliated entity. However, a constant concern in the general corporate context is the principle of piercing the corporate veil. Although piercing the corporate veil is typically used as a remedy in actions to hold shareholders—including corporate holders—liable for the acts of a corporation, the law for piercing the corporate veil provides a helpful analogy as it explains what standard a complainant must meet for a court to disregard the corporate form as well as highlights the types of fact sensitive inquiries a court or governmental authority will likely make.

See I.R.S. Priv. Ltr. Rul. 9438041, 1994 WL 516072 (June 29, 1994), supplemented by I.R.S. Riv. Ltr. Rul. 9539014, 1995 WL 572634 (Sept. 29, 1995) (Subsidiary had it its own employees and management, but Parent was permitted, without jeopardy to its tax-exempt status, to "make available to Subsidiary clerical and professional employees of Parent, for which Subsidiary will reimburse Parent on a per diem basis at the employee's standard rate of pay, plus benefits, for each day that a Parent employee works for Subsidiary"); HILL & MANCINO, supra note 13, ¶ 27.03[2][d].

See I.R.S. Priv. Ltr. Rul. 8435162, 1984 WL 267589 (June 4, 1984) ("[T]the sharing of office facilities, equipment, supplies, and participation in a single health plan will not constitute an impermissible inurement of net earnings or otherwise jeopardize [the non-profit's] status under section 501(c)(3) of the Code as long as the relevant costs continue to be allocated between [the non-profit] and [its] subsidiary on the basis of their actual usage."); HILL & MANCINO, supra note 13, ¶ 27.06.

See I.R.S. Priv. Ltr. Rul. 8453078, 1984 WL 271459 (Oct. 8, 1984) (fee for management and accounting services from exempt parent to subsidiary was unrelated business income because the services were unrelated to the parent's exempt purpose).

Courts have held veil-piercing to be appropriate "when the court must prevent fraud, illegality or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability for a crime." Under the common law in New Jersey, a court will pierce the corporate veil when two elements are established: (1) the subsidiary was dominated by the parent corporation and (2) adherence to the corporate form would perpetrate a fraud or injustice, or otherwise circumvent the law. Onnecticut and New York employ similar yet distinct tests for determining whether the corporate veil will be pierced.

The instrumentality test requires the plaintiff to prove three elements: (1) control by the parent of the finances, policies and business practices relating to the transactions at issue to such an extent that the subsidiary "had at the time no separate mind, will or existence of its own"; (2) that the parent used its control over the subsidiary for the purpose of committing a fraudulent, wrongful, or otherwise unlawful act; and (3) that the control and breach of duty alleged caused plaintiff's injury. In order to prevail using the identity test, the plaintiff must demonstrate "that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun...." Hess, 822 F. Supp. at 46 (quoting Angelo Tomasso, 187 Conn. at 553-54).

The identity rule requires a plaintiff to show "that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise." *Angelo Tomasso*, 187 Conn. at 554 (internal quotations omitted).

- Unlike the New Jersey test which requires both elements, the New York test is disjunctive. See Wm. Passalacqua Builders, Inc. v. Resnick Developers South, Inc., 933 F.3d 131, 138 (2d Cir. 1991) ("Liability therefore may be predicated either upon a showing of fraud or upon complete control by the dominating corporation that leads to a wrong against third parties.") (citing Itel Containers Int'l Corp. v. Atlanttrafik Exp. Serv. Ltd., 909 F.2d 698, 703 (2d Cir.1990) ("New York law allows the corporate veil to be pierced either when there is fraud or when the corporation has been used as an alter ego.") (emphasis in original)). In making the determination whether the parent corporation is dominating the subsidiary New York courts are entitled to consider factors such as:
 - (1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping of corporate records and the like, (2) inadequate capitalization, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) overlap in ownership, officers, directors, and personnel, (5) common office space, address and telephone numbers of corporate entities, (6) the amount of business discretion displayed by the allegedly dominated

⁵⁸ Zubik v. Zubik, 384 F.2d 267, 273 (3d Cir. 1967), cert. den., 390 U.S. 988 (1968).

Verni ex rel. Burstein v. Harry M. Stevens, Inc., 387 N.J. Super. 160, 199-200, 903 A.2d 475, 498 (App. Div. 2006), certif. den., 189 N.J. 429, 915 A.2d 1052 (2007).

[&]quot;In Connecticut, a court will disregard the corporate veil 'only under exceptional circumstances.' Connecticut recognizes two separate tests for piercing a corporate veil: (1) the 'instrumentality' test; and (2) the 'identity' test." Hess v. L.G. Balfour Co., Inc., 822 F. Supp. 84, 86 (D. Conn. 1993) (quoting Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc., 187 Conn. 544, 553, 447 A.2d 406 (1982)).

The first element will be met when a party can show that the subsidiary maintains no separate existence because it is dominated by the parent. The inquiry is fact intensive, with factors including: (1) undercapitalization of the subsidiary; (2) the parent's day-to-day involvement in the subsidiary; and (3) whether the subsidiary fails to observe corporate formalities, pays no dividends, is insolvent, lacks corporate records, or is merely a facade. ⁶²

With regard to the second element, the New Jersey courts have stated, "the hallmarks of that abuse are typically the engagement of the subsidiary in no independent business of its own but exclusively the performance of a service for the parent and, even more importantly, the undercapitalization of the subsidiary rendering it judgment-proof." ⁶³⁶⁴

The general concept to be taken away from this analogy is that while the nonprofit and an affiliate may work together on many levels to accomplish a wide variety of goals, each must maintain its own independent identity and purpose, with particular attention on delineating between nonexempt and exempt purposes and activities, to prevent jeopardizing the other. However, a great deal of what is and is not permissible will vary depending on the precise form and structure of the affiliation.

corporation, (7) whether the related corporations deal with the dominated corporation at arms length, (8) whether the corporations are treated as independent profit centers, (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group, and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own.

Wm. Passalacqua Builders, 933 F.3d at 139.

- ⁶² Verni ex rel. Burstein, 387 N.J. Super. at 200, 903 A.2d at 498.
- Werni ex rel. Burstein, 387 N.J. Super. at 203, 903 A.2d at 500 (citing OTR Assocs. v. IBC Services, Inc., 353 N.J. Super. 48, 52, 801 A.2d 407, 409-410 (App. Div.), certif. den., 175 N.J. 78, 812 A.2d 1110 (2002)).
- While not widely used, some jurisdictions have fashioned a "quasi-agency" doctrine to supplement general veil piercing law and provide an alternate route for attribution of liability upon a parent company for the conduct of a subsidiary. Under the doctrine, Delaware courts have found that a subsidiary can act as an agent for a parent company without express consent from the parent, if the parent exercised excessive control over the subsidiary to the point that it represents complete domination and control. The factors that are taken into consideration include stock ownership, officers and directors, financing, responsibility for day-to-day operations, arrangements for payment of salaries and expenses, whether separate corporate books and bank accounts were kept and origin of the subsidiary's business and assets. No one factor is determinative, and the decision is based on the consideration of the facts as a whole. If the facts show that the parent exercised such excessive control over the subsidiary, an agency relationship can be found to exist, under which the parent company can be liable for the actions of the subsidiary. See Elmer v. Tenneco Resins, Inc., 698 F. Supp 535 (D. Delaware 1988); J.E. Rhoads & Sons, Inc. v. Ammeraal, Inc., 1988 WL 32012 (Del. Super. 1988); Phoenix Canada Oil Company Limited v. Texaco, Inc., 658 F.Supp. 1061 (D. Delaware 1987); Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil, Inc., 456 F.Supp. 831 (D. Delaware 1978).

VI. Single Employer Determination under Labor and Employment Laws

The National Labor Relations Board ("NLRB"), other federal agencies, and the federal courts have established varying tests for determining whether two or more entities constitute a "single employer" under the National Labor Relations Act ("NLRA") and other federal employment laws. These tests resemble in some ways the IRS' approach to separate entity status, but maintain their own unique attributes. These tests could be implicated if a tax-exempt entity has formed an affiliation with another entity, whether it be a for-profit or a nonprofit, and a labor or employment dispute arose at either of the entities.

The standards for determining whether two nominally independent entities will be treated as a single employer depend upon the statute that governs a particular dispute. While the tests that have been developed under these various statutes utilize several of the same factors, they are not identical and are each tailored to the role that the single employer doctrine plays under each statute and to the specific purposes of the statute itself. In general, single employer determinations in cases arising under the NLRA will be governed by a four-part "NLRB test." While this test has been applied by some courts under Title VII of the Civil Rights Act of 1964 ("Title VII") and other employment discrimination laws, 66 the federal Third Circuit and a number of other circuits have developed a unique, three-part, "Title VII test". A third, five-factor "DOL test" has been applied to single employer determinations under the Family and Medical Leave Act ("FMLA") and the Worker Adjustment and Retraining Notification Act ("WARN Act").

A. The Single Employer/Integrated Enterprise Test under the NLRA

The National Labor Relations Act ("NLRA")⁶⁸ protects the right of employees to form unions and governs many aspects of an employer's relationship with a union representing its employees. The provisions of the NLRA are enforced exclusively by the NLRB.

1. Test Overview

The consequences of a finding that two or more entities constitute a single employer under the NLRA can be far-reaching. The NLRB's "single employer" test can be used to extend NLRB jurisdiction to an entity that on its own would be too small fall within the agency's regulatory authority. Once such jurisdiction is established, the NLRB will have the power to

⁶⁵ NLRB v. Browning-Ferris Industries, 691 F.2d 1117, 111 LRRM (BNA) 2748 (3d Cir. 1982).

⁶⁶ See, e.g., Parker v. Columbia Pictures Indus., 204 F.3d 326, 341, 24 Employee Benefits Cases (BNA) 1214, 10 A.D. Cases (BNA) 396 (2d Cir. 2000).

Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 85, 92 FEP Cases (BNA) 1249 (3d Cir. 2003), cert. den., 541 U.S. 959 (2004).

⁶⁸ 29 U.S.C. § 151, et seq.

Generally, the NLRB has jurisdiction over "employers," "employees" and "labor organization" engaged in industries "affecting commerce." 29 U.S.C. §§ 152, 158.

enforce the provisions of the NLRA against the tax-exempt entity by, among other things, ordering and conducting elections to determine whether the entity's employees will be represented by a union, ordering that the entity recognize and bargain with the employees' union, and awarding damages and imposing injunctive relief for the commission of unfair labor practices under the NLRA.⁷⁰

A finding that that two entities are a single employer can also lead to the imposition of a collective bargaining obligation and an obligation to comply with the terms of an existing collective bargaining agreement upon an otherwise non-union affiliate of a unionized entity. Where one or more of the entities of a "double breasted" organization (*i.e.*, an organization that includes both union and non-union entities) are found to constitute a single employer, each of those entities may be required to bargain collectively with the union and to abide by the terms of any collective bargaining agreements already in place.⁷¹ Further, each entity that is found to be a part of an organization that is a single employer will be jointly and severally liable for any unfair labor practices committed by the other entities within the organization.⁷²

Whether two entities constitute a single employer also impacts whether an entity's conduct constitutes unlawful secondary activity. In such cases, however, that the entities constitute a single employer is a defense to liability. See, e.g., Employing Lithographers of Greater Miami, Fla. v. NLRB, 301 F.2d 20, 29, 49 LRRM (BNA) 2869 (5th Cir. 1962) (noting "single employer exception" to NLRA's secondary boycott prohibition).

See, e.g., South Prairie Construction Co. v. Local No. 627, 425 U.S. 800, 92 LRRM (BNA) 2507 (1976) (per curiam); Fuchs v. Cristal Concrete Corp., 2006 WL 2548169, 180 LRRM 2426 (E.D.N.Y. 2006); Herbert Indus. Insulation Corp., 319 NLRB 510, 153 LRRM (BNA) 1047 (1995). However, "the determination that separate companies are a 'single employer' is not enough to bind all the separate companies to the collective bargaining agreements of any one of the companies." Lihli Fashions Corp., Inc. v. NLRB, 80 F.3d 743, 747, 151 LRRM (BNA) 2941 (2d Cir. 1996). Rather, when two entities are found to be a single employer, "for one company to be bound by a collective bargaining agreement made by another company, it must be shown not only that they are a 'single employer,' but, additionally, that together they represent an appropriate employee bargaining unit." Id. at 747 (citing South Prairie Construction Co., 425 U.S. at 804-05).

NLRB v. Bolivar-Tees, Inc., 551 F.3d 722, 184 LRRM (BNA) 2257 (8th Cir. 2008). Unfair labor practice liability as a single employer is distinct from liability based on a finding that two entities are "joint employers." Such a situation arises when two separate entities that do not constitute a single employer are each an "employer" of a particular employee or group of employees within the meaning of the NLRA. Capitol-EMI Music, 311 NLRB 997, 999, 143 LRRM (BNA) 1331 (1993), enf'd, 23 F.3d 399, 146 LRRM (BNA) 2448 (4th Cir. 1994) ("Joint employers are businesses that are entirely separate legal entities except that they both 'take part in determining essential terms and conditions' of a group of employees.") (quoting Manpower, Inc., 164 NLRB 287, 288, 65 LRRM (BNA) 1059 (1967)). In such a situation, one joint employer is liable for the unfair labor practices of the other only where the first employer: (1) knew or should have known that the other employer acted for unlawful reasons; and (2) acquiesced in the unlawful activity by failing to protest and exercise what power it had to prevent the unlawful activity. Id. A joint employer relationship is frequently found in the case of temporary or "leased" employees, but can potentially exist whenever an employee provides services for or is controlled by more than one entity.

Under the NLRB's test, two or more nominally separate business entities are regarded as a single employer when they are so structurally and operationally integrated that they constitute a single, integrated enterprise. "Single employer' status ultimately depends on all the circumstances of the case and is characterized as an absence of an 'arm's length relationship found among unintegrated companies."

Courts and the NLRB have relied on four principal factors when analyzing whether two entities are sufficiently integrated to constitute a single employer under the NLRA: (1) interrelation of operations; (2) control over labor relations; (3) common management; and (4) common ownership.⁷⁵ The determination of whether two entities are a single employer is based on consideration of the totality of the circumstances and no single factor is dispositive.⁷⁶ However, the emphasis is generally on the first three factors, with the question of whether there is centralized control of labor relations among the business entities being the primary consideration.⁷⁷

2. <u>Application of Specific Factors</u>

(a) Functional Integration of Operations

Under the functional integration of operations prong, courts tend to focus on the level of day-to-day control of the business operations exercised by the second entity over the first. In *Gerace Construction*, the NLRB concluded that two construction companies were separate legal entities.⁷⁸ In examining the companies' operations, the NLRB looked at whether the companies maintained separate bank and payroll accounts, filed separate tax returns, and kept separate corporate records. Moreover, the fact that one of the companies charged the other to rent equipment and tools demonstrated a sufficiently arm's-length operating system to preclude a finding that the two companies constituted a single employer.⁷⁹

Radio & Television Broadcast Technicians Local Union 1264 v. Broadcast Service of Mobile, Inc., 380 U.S. 255, 256, 58 LRRM (BNA) 2545, (1965) (per curiam) (expressing the test in terms of the NLRB's jurisdiction); NLRB v. Browning-Ferris Indus., 691 F.2d at 1121.

⁷⁴ NLRB v. Browning-Ferris Indus., 691 F.2d at 1122; NLRB v. Bolivar-Tees, Inc., 551 F.3d at 728-30.

Parklane Hosiery Co., Inc., 203 NLRB 597, 612, 83 LRRM (BNA) 1630 (1973), order amended, 207 NLRB 991, 85 LRRM (BNA) 1039 (1973).

⁷⁶ NLRB v. Browning-Ferris Indus., 691 F.2d at 1122.

⁷⁷ *Id.*

⁷⁸ Gerace Construction, Inc., 193 NLRB 645, 648, 78 LRRM (BNA) 1367 (1971).

⁷⁹ *Id.*; see also Frank N. Smith Associates, Inc., 194 NLRB 212, 219, 78 LRRM (BNA) 1603 (1971).

(b) Centralized Control of Labor Relations

Control of a company's labor relations is the most important factor under the NLRB test. To satisfy this prong, "control must be 'actual' or 'active' rather than merely potential control." When analyzing whether a corporation is a separate and independent entity, the NLRB focuses on factors such as whether the business entities: (1) share employees; (2) provide separate health insurance benefits; and (3) maintain separate federal and state unemployment compensation accounts. Furthermore, the NLRB looks at whether each entity is responsible for the hiring and firing of its own employees along with setting wages, bonuses, hours, and vacation time. Therefore, the more direct control an entity has over another entity's basic employment affairs, the more likely the NLRB will treat the entities as a single employer.

(c) Common Management

Under the common management prong, the NLRB looks at whether two or more entities share the same directors, officers, and/or managers. Common management alone, however, is typically not sufficient to satisfy the single employer status. Rather, the NLRB looks at whether the common management is accompanied by the requisite common control. ⁸³ For example, in *Frank N. Smith Associates*, the NLRB concluded the evidence presented failed to support a finding of single employer status between two New York corporations. ⁸⁴ Although the two corporations had the same corporate president and common stockholders, the responsibility for the day-to-day operations and employees of the companies were vested in separate individuals for each corporation who were not part of the common management.

(d) Common Ownership or Financial Control

Similar to the common management prong, common ownership alone cannot establish an integrated enterprise. In *Mercy Hospital of Buffalo*, the NLRB stated that common ownership, "while significant, is not determinative in the absence of centralized control over labor relations." Therefore, a single employer relationship will only be found if an entity exercises actual or active control (as opposed to potential control) over the day-to-day operations or labor relations of the other entity.

AG Communication Sys. Corp., 350 NLRB 168, 182 LRRM (BNA) 1155 (2007), rev. den., 563 F.3d 418, 186 LRRM (BNA) 2363 (9th Cir. 2009); Parklane Hosiery Co., 203 NLRB at 613.

⁸¹ Gerace Construction, 193 NLRB at 645-46; Parklane Hosiery Co., 203 NLRB at 613-14.

Frank N. Smith Associates, 194 NLRB at 218.

Gerace Construction, 193 NLRB at 645.

⁸⁴ Frank N. Smith Associates, 194 NLRB at 213.

⁸⁵ In re Mercy Hospital of Buffalo, 336 NLRB 1282, 1284, 171 LRRM (BNA) 1339 (2001).

B. The Single Employer Test under Title VII

Title VII of the Civil Rights Act of 1964 ("Title VII")⁸⁶ prohibits discrimination on the basis of race, color, religion, sex, or national origin in the employment context. The standards that have been adopted by courts under Title VII have been extended to a number of other federal anti-discrimination statutes, such as the Age Discrimination in Employment Act ("ADEA")⁸⁷ and the Americans with Disabilities Act ("ADA").⁸⁸ All three laws are administered by the U.S. Equal Employment Opportunity Commission ("EEOC").

The "single employer" test under Title VII is used primarily for the purpose of determining whether an entity satisfies the statute's 15-employee coverage threshold.⁸⁹ In other words, Title VII applies only to employers with 15 or more employees. The single employer test under Title VII is used to determine whether an entity that would not be subject to Title VII due to its size if looked at independently should be deemed to be covered by the statute because of its relationship with another entity. Additionally, although the law is less clear with respect to this

⁸⁶ 42 U.S.C. § 2000e, et seq.

⁸⁷ 29 U.S.C. § 621, et seg. See Section VI.C, infra.

⁴² U.S.C. § 12101, et seq. See, e.g., Crosby v. UPMC, 2009 WL 735868, at *9 (W.D. Pa. Mar. 20, 2009); see also Pearson v. Component Technology Corp., 247 F.3d 471, 486, 17 IER Cases 769 (3d Cir.), cert. den., 534 U.S. 950 (2001).

Nesbit, 347 F.3d at 83-85. Some courts have suggested that the test articulated in Nesbit applies only to coverage determinations and should not be used to determine whether a plaintiff is an employee of a particular entity. See Crosby, 2009 WL 735868, at *9 ("Nesbit involved the situation where the individual corporate entities had less than the threshold amount of employees for purposes of being considered an employer within the meaning of Title VII, and as such Nesbit may arguably not be a relevant consideration in this case [involving a determination of whether a plaintiff was an "employee" of the defendant]."); Daniel v. City of Harrisburg, 2006 WL 543044, at *3-4 (M.D. Pa. Mar. 6, 2006) ("Nesbit did not address the issue of co-employment per se, but rather announced the factors courts should look to before substantively consolidating two or more entities for statutory purposes Because there appears to be no dispute in this case that the Museum employed the statutorily required number of employees, the Court questions the relevance of Nesbit."). It should also be noted that, as suggested by the court in Daniel, the issue of whether two entities are a single employer is distinct from whether they are "joint employers" or "co-employers". A joint or coemployment relationship exists where two or more entities (that are not a single employer) each exercise sufficient control over an employee to be considered an "employer" of that employee. Several courts have held that the fact that two entities are joint employers does not automatically render each entity liable for the acts of the other or provide a basis for finding that Title VII applies to an entity that is not independently large enough to be covered by the statute. See, e.g., Arculeo v. On-Site Sales & Marketing, LLC, 321 F. Supp. 2d 604, 93 FEP Cases (BNA) 1847 (S.D.N.Y. 2004), aff'd on other grounds, 425 F.3d 193, 96 FEP Cases (BNA) 966 (2nd Cir. 2005) (employees of joint employers cannot be aggregated in determining coverage of each entity under Title VII).

issue, each entity within a larger enterprise that is found to constitute a single employer may be jointly and severally liable for violations of Title VII other entities within the enterprise.⁹⁰

The EEOC follows the NLRB test discussed above, as does the Second Circuit. However, some courts apply a different test, referred to herein as the "Title VII test". Under the Title VII test, two nominally distinct entities will be considered a single enterprise when: (1) the company has split itself into entities with less than fifteen employees intending to evade Title VII's reach; (2) a parent company has directed a subsidiary's discriminatory act; or (3) two or more entities are so interconnected that they collectively caused the alleged discriminatory employment practice. It is important to note that unlike the NLRB test, which considers each of the factors together, the Title VII test is disjunctive, so a court can find that two entities are acting as a single employer if it determines that any one factor is satisfied.

Splitting a Company to Evade Title VII

Under this prong, a court will consider "(1) [whether there is a] lack of a reasonable business justification, (2) whether the business split was one that, as an operational matter, would more sensibly be contained within a single business entity . . . , and (3) statements from those familiar with the industry suggesting that the company was split into multiple entities to evade Title VII."⁹⁴

2. Parent Directing Subsidiary's Discriminatory Actions

If the entities are not in a parent-subsidiary relationship, this factor does not apply. When this prong is implicated, courts have focused on the amount of control the parent exercises over the discriminatory conduct.⁹⁵

See Cook v. Arrowsmith Shelburne, Inc., 69 F.3d 1235, 69 FEP Cases (BNA) 392 (2d Cir. 1995). For its part, the Third Circuit has not explicitly decided whether the single employer doctrine it articulated in Nesbit can be applied to impose vicarious liability upon each entity comprising a single enterprise. A number of district courts within the Third Circuit, however, have so held. See Sgrignoli v. Schneider Training Academy, Inc., 2009 WL 1069163, at *1, 21 A.D. Cases (BNA) 1595 (M.D. Pa. Apr. 21, 2009); Whelan v. Teledyne Metalworkers Products, 2005 WL 2240078, at *12 (W.D. Pa. Sep. 14, 2005).

See U.S. EQUAL OPPORTUNITY COMMISSION, COMPLIANCE MANUAL, Section 2-III-B-1-a-iii-(a) (May 12, 2000), available at www.eeoc.gov/policy/docs/threshold.html (web page last accessed May 24, 2011); Parker v. Columbia Pictures Indus., 204 F.3d at 341.

⁹² Nesbit, 347 F.3d at 86.

⁹³ *Id.* at 85-88.

⁹⁴ *Id.* at 86.

⁹⁵ *Id.*

3. <u>Interconnection Among Two Entities Affairs</u>

According to the federal Third Circuit, the focus under this prong should be on the degree of operational entanglement—"whether the operations of the companies are so united that nominal employees of one company are treated interchangeably with those of another." Specifically, the relevant operational factors include:

(1) the degree of unity between the entities with respect to ownership, management (both directors and officers), and business functions (i.e., hiring and personnel matters), (2) whether they present themselves as a single company such that third parties dealt with them as one unit, (3) whether a parent company covers the salaries, expenses, or losses of its subsidiary, and (4) whether one entity does business exclusively with the other. ⁹⁷

Additionally, while not typically a factor in a Title VII case, the court can consider if there is excessive financial entanglement between the two companies.⁹⁸

In *Nesbit v. Gears Unlimited*, the two companies at issue did not hold themselves out to be a single company, did not do business exclusively with each other, and had separate department for human resources, payroll, and finance. Accordingly, the court held that the entities were not a single employer: "In the absence of more significant operational entanglement, common ownership and *de minimis* coordination in hiring are insufficient bases to disregard the separate corporate forms of Gears and Winters." Similarly, in *Cheskawich v. Three Rivers Mortgage Co.*, the court declined to find two companies to be one integrated employer because the companies maintained separate payroll systems, paid their employees from separate accounts, and did not hold themselves out as a single entity or one that did business exclusively with the other. 101

C. The Single Employer Test under the ADEA

Id. at 87.

The Age Discrimination in Employment Act ("ADEA")¹⁰² is an antidiscrimination statute that prohibits an employer from discriminating on the basis of age. As noted above however, it applies only to employers who have twenty or more employees. In the context of ADEA cases,

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    Id.
    Id. at 87-88.
    Id. at 89.
    Id. at 89.
    Id.
    Id.
    Id.
    Id.
    29 U.S.C. § 621, et seg.
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courts in the Third Circuit have historically applied the NLRB test when determining whether to treat two related companies as a single employer in order to satisfy the minimum employee threshold. However, the majority of these cases are applying the pre-*Nesbit* case law. In light of repeated holdings that the same standard applies to ADEA cases as to Title VII, ¹⁰³ and that "Title VII and the ADEA are similar in structure and purpose," ¹⁰⁴ there will likely be a shift from applying the NLRB test to applying the Title VII test to ADEA cases and across the fuller range of employment discrimination cases. ¹⁰⁵ However, until there is a clear precedent from the U.S. Supreme Court applying the Title VII test to an ADEA case, companies would be well advised to be conscientious of both the NLRB and the Title VII standards in order to prevent liability under the ADEA.

For its part, the Second Circuit has held that single employer determinations under the ADEA are governed by that four-factor test. ¹⁰⁶ As explained above, the EEOC follows the NLRB test.

D. The Single Employer Test Under the Family and Medical Leave Act and the WARN Act.

The U.S. Department of Labor ("DOL") has promulgated regulations under the Family and Medical Leave Act ("FMLA") ¹⁰⁷ and the Worker Adjustment and Retraining Notification Act ("WARN Act") ¹⁰⁸ that specifically address when two or more entities should be considered a single employer under the statute. ¹⁰⁹ According to the DOL, "a determination of whether or not separate entities are an integrated employer is not determined by the application of any single criterion, but rather the entire relationship is to be reviewed in its totality. Factors considered in determining whether two or more entities are an integrated employer include: (1) common ownership, (2) common directors and/or officers, (3) de facto exercise of control, (4) unity of personnel policies emanating from a common source, and (5) the dependency of operations." ¹¹⁰

¹⁰³ See, e.g., Fantazzi v. Temple Univ. Hosp., Inc., 2002 WL 32348277, at *3 (E.D. Pa. Aug. 22, 2002).

¹⁰⁴ Carr v. Borough of Elizabeth, 121 Fed. Appx. 459, 460 (3d Cir. 2005).

See, e.g., Crosby, 2009 WL 735868, at *9 (noting that the *Nesbit* test is "the standard for determining when a conglomeration of entities can be considered a 'single employer' in the employment discrimination context").

See Dewey v. PTT Telecom Netherlands, U.S., Inc., No. 95-7838, 1996 WL 364531, at *2 (2d Cir. July 02, 1996); Levine v. Reader's Digest Ass'n, Inc., 347 Fed. Appx. 602, 603 (2d. Cir. 2009).

¹⁰⁷ 29 U.S.C. § 2601, et seg.

¹⁰⁸ 29 U.S.C. § 2101 *et seq. See generally* Ethan Lipsig, Mary C. Dollarhide & Brit K. Seifert, Reductions in force in employment law, ¶ 29.02, Ch. 10.II.B (2007).

The FMLA applies only to employers with 50 or more employees. 29 U.S.C. § 2611(4).

¹¹⁰ 29 C.F.R. § 825.104(c)(2) (FMLA regulation); accord 20 C.F.R. § 629.3(a)(2) (WARN Act regulation).

In *Pearson v. Component Technology Corp.*, the Third Circuit concluded that the test articulated by the DOL should govern single employer determinations under the WARN Act. While the Second Circuit has yet to address the proper standard for assessing single employer status under the WARN Act, a number of New York district courts have applied the DOL test in such cases. The WARN Act applies only to entities that employ 100 or more full-time employees and generally requires a covered employer to provide affected workers with 60 calendar days' advance notice prior of a plant closing or mass layoff. Single employer determinations under the statute can be particularly important since WARN Act claims often arise in connection with an organization's financial demise and workers impacted by such an event frequently try to bring suit against an affiliated entity. 113

The "common directors and/or officers" prong of the DOL's analysis considers at whether the separate corporations: (1) actually have the same people occupying officer and/or director positions at both companies; (2) repeatedly transfer management between the companies; or (3) have officers and directors of one company occupying a formal management position with the second company. 114

Under the "de facto exercise of control" prong, a court may consider whether the parent specifically directed the allegedly illegal employment practice. For purposes of the "unity of personnel policies" prong, courts focus on whether the companies actually functioned as a single enterprise with respect to relationships with employees. Finally, under the "dependency of operations" prong, a court will consider whether the companies maintained separate bank accounts, filed separate tax returns, kept separate corporate records, and shared various resources including equipment, facilities, and administrative services. Mere exercise of a parent corporation's ordinary powers of ownership, however, is not enough to satisfy the "dependency of operations" or "de facto exercise of control" factor.

It is important to note, however, that the factors listed are non-exhaustive and the DOL or a court may consider evidence that otherwise falls outside the listed factors when determining

Pearson v. Component Technology Corp., 247 F.3d 471, 17 IER Cases 769 (3d Cir.), cert. den., 534 U.S. 950 (2001).

See Guippone v. BH S & B Holdings LLC, No. 09 Civ. 1029(CM), 2010 WL 2077189, at *3-4 (S.D.N.Y. May 18, 2010); Vogt v. Greenmarine Holding, LLC, 318 F.Supp.2d 136, 140 (S.D.N.Y.2004).

At least one court has held that the "DOL factors" also apply to single employer determinations under the Fair Labor Standards Act ("FLSA"). See Carstetter v. Adams County Transit Authority, 2008 WL 2704596, at *9 n.11, 15 Wage & Hour Cases 2d (BNA) 1542, 20 A.D. Cases (BNA) 1406 (M.D. Pa. July 8, 2008). But see Bosley v. The Chubb Institute, 516 F. Supp. 2d 479 (E.D. Pa. 2007) (suggesting that NLRB test applies under FLSA).

¹¹⁴ *Pearson*, 247 F.3d at 498.

whether two or more corporations constitute a "single employer" under the FMLA and the WARN Act. 115

VII. Conclusion

The foregoing discussion has provided an overview of the benefits and potential risks of a tax-exempt entity creating an affiliation with another entity. In choosing whether such an affiliation is appropriate, and how to structure such an affiliation, the tax-exempt entity should consider not only its goals in affiliating, but also how the affiliation could expose it to risk.

Once the decision to affiliate has been made, and the corporate form of the affiliation has been determined, consideration needs to be given to the various factors discussed in this memo in order to increase the probability that a court or administrative agency, particularly the IRS, will conclude that (1) two or more affiliated organizations have complied with the formalities required to maintain separate entities and (2) each entity has its own clear and distinct purpose. If this is done, then the risk of courts or other governmental authorities disregarding the separate entity status of the tax-exempt entity will be greatly reduced. However, if business between the entities is not conducted at arm's length, or one entity exercises undue control over the other, the tax-exempt entity not only exposes itself to significant liability, but also risks losing its tax-exempt status altogether.

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¹¹⁵ *Id.* at 491.

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Annex A

Practical Suggestions

1. **Introduction**

There are many considerations facing a tax-exempt organization prior to or in connection with forming an alliance or affiliation with another entity. Certain unintended and damaging consequences could result if the tax-exempt organization were deemed to be a single entity with or otherwise not separate from the affiliate, including:

- Complete loss of tax-exempt status, or loss of tax-exempt status under a particular provision (e.g., Section 501(c)(3)) of the Internal Revenue Code ("IRC");
- Increased liability exposure under general corporate law for the liabilities of the affiliate;
 and
- Increased liability exposure under specific protective laws, such as federal labor and antidiscrimination statutes, including the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, and the Worker Adjustment and Retraining Notification Act.

As a general matter, a tax-exempt entity should be wary of any action or inaction that might be seen as creating an improper relationship or allowing one entity to impermissibly control or dominate another. This holds true regardless of how such an alliance or affiliation is formed or what corporate form the tax-exempt entity has taken.

This article contains a very brief summary of certain legal consequences of certain activities by tax-exempt organizations, including United States federal income tax consequences, and does not present a complete analysis of all consequences, tax or otherwise, that may be relevant to any organization. Legal and/or tax advice should be sought by a tax-exempt entity with respect to its particular situation.

The tax-exempt entity should generally focus on the following areas.

2. Structure and Formation of an Affiliation with a Tax-Exempt Entity

The limited guidance from the Internal Revenue Service ("IRS") indicates that (a) certain organizational forms may be preferable to others with respect to the creation of a tax-exempt entity and (b) certain structures with respect to forming affiliations are treated differently. In determining the best structure and formation, at a minimum the following points should be considered:

• The nonprofit corporation is the most commonly used and widely accepted form for taxexempt entities under Section 501(c)(3) of the Internal Revenue Code ("IRC"). Trusts are often used for private foundations. LLCs are not commonly used for tax-exempt organizations.

- In forming an affiliation with another entity, the tax-exempt entity should try to avoid serving as a general partner in a limited partnership because the IRS generally disfavors such arrangements and requires additional standards to be met in order to maintain tax-exempt status. Sole proprietorships should also generally be avoided for the conduct of a for-profit activity because a sole proprietorship is characterized as part of the parent organization, which would result in the treatment of a for-profit sole proprietorship and its non-profit parent as one entity for tax purposes.
- In forming an affiliation with another entity, the tax-exempt entity should consider the joint venture structure, including the formation of a limited liability company, which has become increasingly popular. In addition, the traditional corporate structure of parent-subsidiary also may be appropriate and would allow each entity to have a distinct tax-exempt or for-profit designation. Treatment of LLCs, partnerships, and corporations under state tax law will also be a consideration.
- As a general matter, all organization documents, including bylaws and formation documents (e.g., articles/certificate of incorporation) should clearly state the tax-exempt entity's permitted purpose and explicitly disallow non-permitted purposes. Further, any affiliation or new entity created by a tax-exempt entity must be created for a bona fide purpose, with a reasonable business justification for doing so, and not merely to avoid certain tax treatment or tax regulation or to avoid possible liability or scrutiny under law (e.g., to avoid the reach of federal anti-discrimination laws).
- The tax-exempt entity must be vigilant to ensure that the affiliation will not result in the diversion of the nonprofit's assets for a private purpose, in order to not violate the doctrines of private inurement and private benefit.

3. <u>Establishing Separate Operations following the Affiliation</u>

The following factors are relevant in determining whether a tax-exempt entity will be recognized as separate from its affiliate. A tax-exempt entity should consider each of these factors in terms of its application to nonprofit's operations and tax-exempt purpose. Where applicable and to the extent reasonably possible, a tax-exempt entity should endeavor to:

- Observe all partnership or corporate formalities of separate existence;
- Maintain separate books and records;
- Keep all assets separate from other entities and avoid any co-mingling of funds;
- Conduct its activities in its own name;
- Pay the salaries of its own employees, provide separate health insurance benefits, maintain separate unemployment and workers' compensation accounts, and generally

avoid centralized control over labor relations (including personnel decisions such as hiring and firing);

- Avoid the perception of interrelated operations and common management;
- Maintain independent management;
- Use its own stationery, invoices, and checks, and not allow other entities to use such items:
- Hold itself out as a separate entity;
- Maintain separate accounts with banking institutions, vendors, customers, etc.;
- Maintain separate financial statements and tax reporting;
- Pay its own liabilities out of its own funds and deposit its own receipts into its own accounts;
- Dedicate all funds of the tax-exempt entity to the exempt purpose, including providing that the organization's assets be distributed for an exempt purpose upon the dissolution of the organization;
- Maintain a sufficient number of employees and operating assets in light of its contemplated business operations;
- Maintain adequate capital in light of its contemplated business operations (particularly with respect to parent-subsidiary relationships);
- Avoid guaranteeing or becoming obligated for the debts of any other entity or holding out the nonprofit's credit as being available to satisfy the obligations of others;
- Avoid acquiring obligations of its partners, members, or shareholders;
- Avoid pledging its assets or making loans or advances for the benefit of any other entity;
 and
- Avoid excessive overlap of board members and corporate officers, and have separate meetings of the respective entities' boards and officers.

Where there are shared assets or liabilities between the entities or where the entities engage in affiliate transactions, a tax-exempt entity should make every effort to:

 Allocate fairly and reasonably any shared expenses, revenues, or cost-savings (e.g., overhead for shared office space) based on actual use and fair market value;

- Ensure any rental payments made are ordinary and necessary expenses and are calculated based on actual use at fair market value (although charging the tax-exempt entity less than fair market value rental may be allowable under certain circumstances);
- Keep detailed records of any payments for shared expenses, revenues, or cost-savings and any payments made between affiliates;
- Maintain an arm's-length relationship with its affiliates;
- Ensure that the tax-exempt entity's assets are not diverted for a private purpose, in order
 to not violate the doctrines of private inurement and private benefit; for example, avoid
 any pass through to the affiliate (or stakeholders) of profits or other benefits that could
 be viewed as excessive or private inurement;
- Correct any known misunderstanding regarding its separate identity; and
- With respect to parent-subsidiary relationships, limit the parent's day-to-day involvement in and control of the subsidiary's operations.

The legal principles governing affiliated organizations are highly technical. If you have any questions about the matters discussed in this article, please contact the Pro Bono Partnership.

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Annex B¹
Listing of Tax-Exempt Organizations Under the Internal Revenue Code

Section of 1986 Code	Description of organization	General nature of activities
501(c)(1)	Corporations Organized under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States
501(c)(2)	Title Holding Corporation For Exempt Organization	Holding title to property of an exempt organization
501(c)(3)	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations	Activities of nature implied by description of class of organization
501(c)(4)	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees	Promotion of community welfare; charitable, educational or recreational
501(c)(5)	Labor, Agricultural, and Horticultural Organizations	Educational or instructive, the purpose being to improve conditions of work, and to improve products or efficiency
501(c)(6)	Business Leagues, Chambers of Commerce, Real Estate Boards, etc.	Improvement of business conditions of one or more lines of business
501(c)(7)	Social and Recreational Clubs	Pleasure, recreation, social activities
501(c)(8)	Fraternal Beneficiary Societies and Associations	Lodge providing for payment of life, sickness, accident or other benefits to members
501(c)(9)	Voluntary Employees Beneficiary Associations	Providing for payment of life, sickness, accident, or other benefits to members

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The following chart is based upon Internal Revenue Service, U.S. Dep't of the Treasury, Pub. No. 557, Tax-Exempt Status for Your Organization 65-66 (Rev. Oct. 2010), available at www.irs.gov/pub/irs-pdf/p557.pdf (website last accessed May 24, 2011).

Section of 1986		
Code	Description of organization	General nature of activities
501(c)(10)	Domestic Fraternal Societies and Associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members
501(c)(11)	Teachers' Retirement Fund Associations	Teachers' association for payment of retirement benefits
501(c)(12)	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, etc.	Activities of a mutually beneficial nature similar to those implied by the description of class of organization
501(c)(13)	Cemetery Companies	Burials and incidental activities
501(c)(14)	State-Chartered Credit Unions, Mutual Reserve Funds	Loans to members
501(c)(15)	Mutual Insurance Companies or Associations	Providing insurance to members substantially at cost
501(c)(16)	Cooperative Organizations to Finance Crop Operations	Financing crop operations in conjunction with activities of a marketing or purchasing association
501(c)(17)	Supplemental Unemployment Benefit Trusts	Provides for payment of supplemental unemployment compensation benefits
501(c)(18)	Employee Funded Pension Trust (created before June 25, 1959)	Payment of benefits under a pension plan funded by employees
501(c)(19)	Post or Organization of Past or Present Members of the Armed Forces	Activities implied by nature of organization
501(c)(21)	Black Lung Benefit Trusts	Funded by coal mine operators to satisfy their liability for disability or death due to black lung diseases
501(c)(22)	Withdrawal Liability Payment Fund	To provide funds to meet the liability of employers withdrawing from a multi-employer pension fund
501(c)(23)	Veterans Organization (created before 1880)	To provide insurance and other benefits to veterans
501(c)(25)	Title Holding Corporations or Trusts with Multiple Parents	Holding title and paying over income from property to 35 or fewer parents or beneficiaries

Section of 1986 Code	Description of organization	General nature of activities
501(c)(26)	State-Sponsored Organization Providing Health Coverage for High- Risk Individuals	Provides health care coverage to high-risk individuals
501(c)(27)	State-Sponsored Workers' Compensation Reinsurance Organization	Reimburses members for losses under workers' compensation acts
501(c)(28)	National Railroad Retirement Investment Trust	Manages and invests the assets of the Railroad Retirement Account
501(d)	Religious and Apostolic Associations	Regular business activities. Communal religious community
501(e)	Cooperative Hospital Service Organizations	Performs cooperative services for hospitals
501(f)	Cooperative Service Organizations of Operating Educational Organizations	Performs collective investment services for educational organizations
501(k)	Child Care Organizations	Provides cares for children
501(n)	Charitable Risk Pools	Pools certain insurance risks of 501(c)(3) organizations
501(q)	Credit Counseling Organization	Credit counseling services
521(a)	Farmers' Cooperative Associations	Cooperative marketing and purchasing for agricultural procedures
527	Political Organizations	A party, committee, fund, association, etc., that directly or indirectly accepts contributions or makes expenditures for political campaigns