Corporate Reorganizations for Nonprofit Service Providers

by Kathryn M. Vanden Berk

I first became acquainted with nonprofit restructuring possibilities in the early 1980s. I represented several state-wide health care associations. Hospitals across the U.S. were responding to the new Medicare and Medicaid programs by reorganizing their operations using a parent holding company-subsidiaries model (see diagram). These models did several things that supported the nonprofit mission. Most importantly, they maximized reimbursements from public and private sources, protected charitable contributions, limited risk exposures, and allowed for the development of for-profit businesses where they were feasible and appropriate.

When I joined the board of directors of Sunburst Youth Homes (in Neillsville, Wisconsin), I saw that restructuring would be useful for Sunburst for two main reasons. First, because Wisconsin's residential child care reimbursement reduced contract payments for every charitable donation Sunburst received, the more fundraising we did, the less we received from the government. Second, we were not reimbursed for the use of several residential buildings because they were fully depreciated and therefore, under the formula, "cost us nothing to occupy."

Sunburst reorganized in 1983 to create a holding company with three subsidiaries: 1) a tax-exempt residential treatment program, 2) a charitable Foundation, and 3) a for-profit title-holding entity to own and lease-back our buildings and grounds (see page 35 illustration). The arrangement solved our first problem by isolating donations from the operational entity,[1] and the second one by placing all real estate in the for-profit subsidiary and executing leases that required market-rate rents.[2]

All governance, administrative, financial, and personnel functions were centralized in Sunburst Inc. of Wisconsin, the parent holding company. The residential operation in Sunburst Youth Homes, Inc. was headed by a program director. The Sunburst Foundation was headed by a development director. The for-profit Sunburst Facilities, Inc. passively held title to all properties and leased them back to the residential program.

Eventually, Sunburst incorporated a new subsidiary, Sunburst Family Services, Inc., to operate outpatient programs in Madison. A program director headed such areas as group home and foster care, independent living, in-home family therapy, and outpatient counseling. The two operational subsidiaries were protected from liabilities that might arise within the other, and overhead costs were allocated according to contractual requirements, contribution capacity, and cash flow needs.

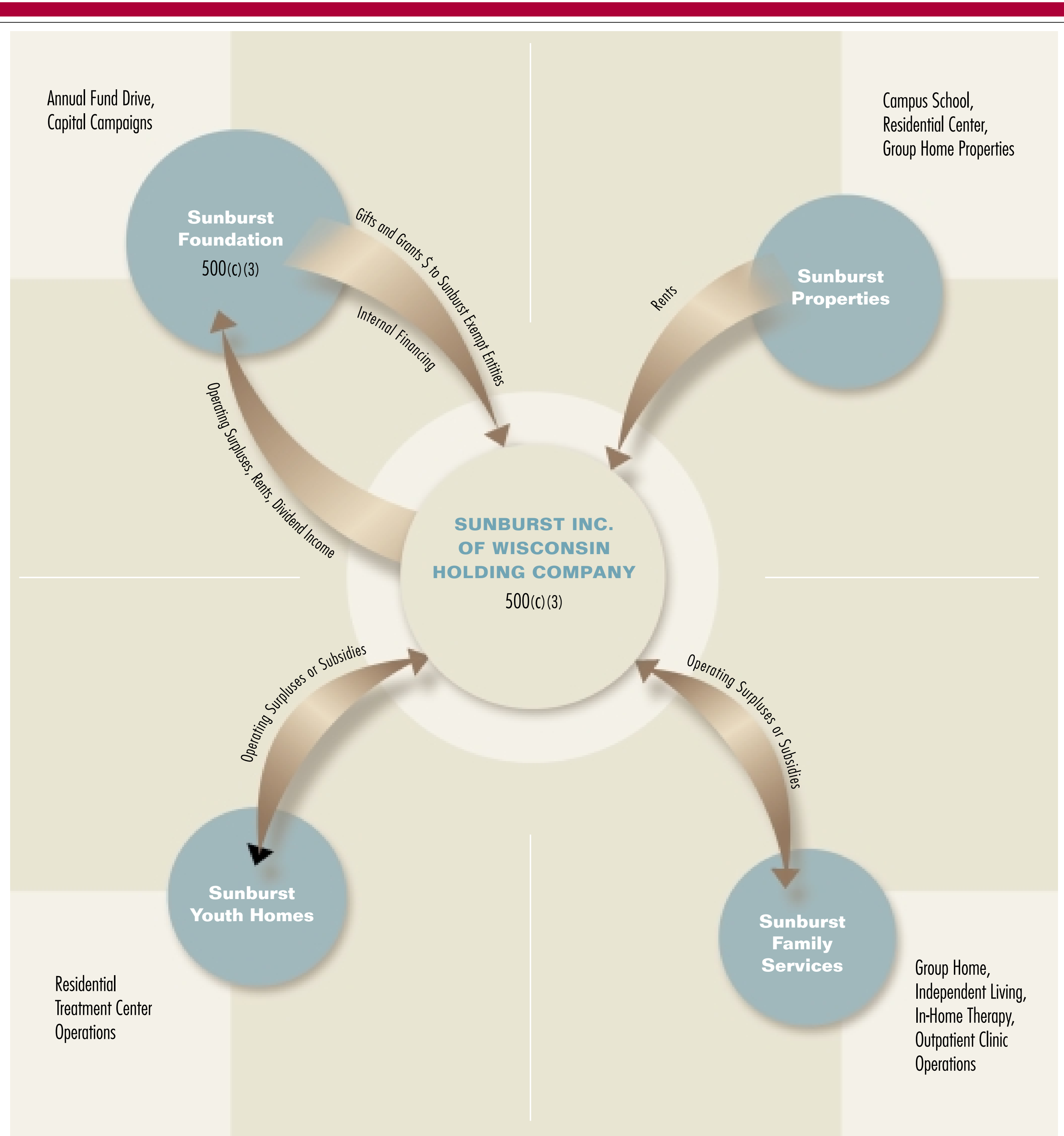
While there is a certain amount of complexity that this added to the overall Sunburst organization, I never found the structure to be cumbersome, confusing, or expensive to administer. I eventually became Sunburst's President and CEO, and felt entirely comfortable with the corporate structure.[3]

WHY REORGANIZE? Today, I work with many complex not-for-profit tax exempt entities, and the reasons for their corporate structuring decisions are as varied as their missions and as unique as their traditions. Let me review the advantages and disadvantages as I see them from my own practice and from others.

Central Governance: The parent holding company's Board of Directors governs the entire operation, thus centralizing control and providing for organization-wide accountability. Directors of each subsidiary are typically appointed by the parent board and exercise only limited governance authority.

Administrative Control: Common needs for executive, administrative, financial, facilities management, and personnel leadership are handled centrally, with clear reporting and accountability "up and down" the corporate structure.

Financial Benefits: Operating surpluses and/or subsidies are moved from one entity to another by application of cost-allocation methodologies. This can maximize reimbursement as, for example, when reimbursement formulas would otherwise penalize a subsidiary if it makes a profit on its service contracts. Interagency loans can generate interest income equal to commercial rates, thus obtaining a higher rate of return than



certificates of deposit or other similarly safe investments. Annual audits are conducted separately for each entity and consolidated at the parent level.

Risk Management: Separate corporate entities insulate assets in one program from risks in other parts of the organization. This is useful when one entity conducts an unusually high-risk activity while another holds title to valuable tangible property or real estate. Because insurance contracts are issued in the name of specific corporations, the perception of independence is strengthened by having each entity separately identified in policy documents.

Protect Exempt Status: When an organization's commercial-type activities (activities typically conducted in the for-profit sector) begin to overshadow exempt activities and purposes, isolating them in a subsidiary protects the tax-exempt status of the remaining enterprise.[4]

For-Profit Subsidiary: When an exempt organization seeks to start or spin off a for-profit enterprise, it must create a separate corporate entity for that activity. The holding company model provides for corporate control over the new entity while ensuring that the parent's exempt status is not threatened by the for-profit focus of the new business. Properly structured, the subsidiary's activity will generate non-taxable dividends, rents, and royalties rather than taxable unrelated business income. Contractual arrange-

ments may provide shared staffing, shared facilities, and document the extension of start-up capital.

Create a Title-Holding Subsidiary: The IRS allows exempt entities to create title-holding subsidiaries to own real property that generates rental income to the corporate parent.[5] So long as the investment remains passive under IRS laws and rules, the parent may receive rent proceeds without incurring taxable income.[6]

Flexibility: While tax law recognizes the wholly-owned C corporation as an appropriate vehicle for a for-profit subsidiary, you may now organize a limited liability company (LLC) as the taxable operating entity.[7] LLCs are favored by some organizations for their flexibility, because most state LLC statutes are much more wide open in how the company may be operated.[8]

Fundraising: A supporting foundation may develop its own independent board of directors with persons selected for their long-standing service to the organization and/or their access to financial resources. This can be an excellent opportunity for using valued individuals no longer eligible for active duty on the governing board, but who remain committed to your organization and want to continue to work for it. It is also an excellent place to position persons of influence and access who cannot spare the time to be on your governing board.

ISSUES IN CORPORATE REORGANIZATIONS. *Change in Mission:* Each element of the corporate structure must ultimately support the exempt purpose and mission of the parent corporation. To the extent that they do not support it, or that they are perceived as being off-task, your organization may lose its stature in the community, credibility with funders, or even its exempt status with the IRS.

Complexity: Increased complexity may be confusing to volunteers, staff, and donors. You must be clear with all stakeholders about what you are doing, why it is important to the organization's future, and how it works.

Finances and Contracts: Lenders, vendors, and contractors must agree to accept changes in loan collateral, contractual responsibility, or funding streams. The reorganization plan must therefore develop a long-term strategy so that eventually each entity will have its own credit history, balance sheet, and creditworthiness.

Loss of Focus on Core Programs: New initiatives may hold the promise of big rewards, but they can also divert organizational resources. If leadership gets enamored of its new for-profit focus to the detriment of the organization's overall well-being, the cost may be too high a price to pay.

Market Forces: Nonprofits getting into the for-profit arena must understand the market they enter and set aside sufficient funds to understand the initial start-up costs. Nonprofits underestimate the costs due to unfamiliarity with business forces or their too rosy search of the "pot of gold at the end of the rainbow."

CONCLUSION. Corporate restructuring may offer your organization a number of advantages in organizational control, efficiency, and accountability. The holding company-subsidiary model can be adapted to a number of needs that might include for-profit and/or commercial activities, title-holding rental-income activities, and fundraising activities. Skillful use of this model is required to ensure that your organization does not lose its essential mission or confuse its employees, volunteers, contractors and vendors, or donors.

I once saw a saying: "Never start a vast project with half-vast ideas." That bit of advice is very wise in this arena. The reorganization of a child welfare agency should never be undertaken without considerable thought and planning. Corporate restructuring may be wonderfully useful for you, or it may unleash all the woes of Pandora's Box. Be certain that you are getting good advice when you decide to look at this option. ■

Endnotes

1. *This required a fully independent foundation, a somewhat risky arrangement. However, we started it with former Sunburst directors who were loyal to the Sunburst mission. Later, when the state's short-sighted reimbursement limitation was lifted, the Sunburst Foundation moved into a closer relationship by requiring that all its board members be appointed by the parent.*
2. *See discussion of title-holding subsidiaries, below. Again, when a number of Wisconsin residential centers followed suit and the reimbursement limitation became meaningless, the Department of Health and Human Services rescinded it and the properties were returned to the residential operations.*
3. *To my great sorrow, Sunburst was closed earlier this year. The reasons for its closure had nothing to do with its corporate structure. However, because the Madison-based Sunburst Family Services had operated as a separately incorporated entity, we were able to save its operations by incorporating a new, unrelated 501(c)(3) organization, licensing it, and transferring operations with a relatively simple sale transaction.*
4. *Even if the activities are initially exempt, they may eventually be declared non-exempt under the principle of "commerciality." See, for example,* Scripture Press Foundation v. U.S., *152 Ct. Cl. 463 (1961).*
5. *The Internal Revenue Code provides two such title-holding entities: 501(c)(2) for single owner entities, and 501(c)(25) for multiple owner entities.*
6. *The assets may not be debt-financed, Sec. 512(b)(3), and the title-holding organization must provide no more than ordinary maintenance on the property. Rev. Rul 69-178 holds that rent from real property is excluded in determining unrelated business taxable income (UBTI) so long as only utilities and janitorial services are provided.*
7. *The IRS now recognizes a single-member limited liability company (LLC) as an exempt organization when its single member is a 501(c)(3) entity, unless the LLC elects to be treated as an association taxable as a corporation under IRC Reg. §301.7701-3(b)(1)(ii).*
8. *Compare, for example, Illinois' General Not- For-Profit Corporation Act of 1986 (805 ILCS 105) and its Limited Liability Company Act (805 ILCS 180).*

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