DEALING WITH MULTIPLE MASTERS: PLANNING OPPORTUNITIES

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I. INTRODUCTION

Earlier this year, a religious organization asked me for advice concerning the possible establishment of a new entity to hold $50 million as an endowment that would be contributed by the religious organization's foreign parent. The domestic religious organization was organized as a California nonprofit religious corporation and we concluded that the new entity should be formed as a nonprofit religious corporation that would be classified as a Type I supporting organization for federal income tax purposes.

The discussion concerning the formation of a new religious corporation led to further discussion as to whether various religious facilities owned and operated by the U.S. religious organization throughout the U.S. could be incorporated separately in order to further reduce the U.S. religious organization's and its foreign parent's exposure to uninsured, catastrophic claims such as those made against the Catholic Church in recent years. During the course of that discussion, the Chief Financial Officer inquired whether there were any "Delaware-like" states for nonprofit corporations as there were for for-profit corporations, a question that was unlikely to be raised a few years ago.

As nonprofit organizations increasingly engage active business enterprises, including both related and unrelated trades or businesses, and engage in activities that cross state lines, whether they physically cross those state lines or whether they cross state lines

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electronically via the internet or via conventional telecommunications, the issues concerning choice of form as well as choice of state of formation have become all the more critical.

The previous four papers have focus on jurisdictional and other issues that cross state lines, as well as the increasing convergence and overlap between the federal and state regulation of nonprofit organizations. The purpose of this paper is to identify a number of "bread and butter" issues facing nonprofit organizations as well as some proposed solutions, some of which are relatively simple and others of which are more complex. Inasmuch as I will be the last person to present a paper on Friday, November 3, I will revise or rewrite portions of this paper as appropriate based on the input I receive from the other presenters, the commentators, and the attendees.

II. Choice of Form

For practitioners who represent tax exempt organizations the choices of form typically have been influenced by their practice orientation. Transactional lawyers who represent tax exempt organizations, such as myself, favor the use of nonprofit corporations and to an increasing degree limited liability companies. Estate planners, on the other hand, tend to favor the use of charitable trusts because they are comfortable with using trusts and often are less familiar with the detailed aspects of organizing and operating nonprofit corporations. Practitioners who represent religious organizations are familiar with the various types of legal entities used by them, such as nonprofit religious corporation in California, corporations sole and to a certain degree unincorporated associations.

The choice of form as well as the choice of state of formation are influenced by a number of legal as well as business and operational factors. Today, anyone who represents tax exempt organizations needs to have a comprehensive understanding of the organizational options available in order to effectively represent his or her clients. Accordingly, I have divided this part of the paper into three categories: general considerations, state specific issues, and tax planning considerations. These subjects discussed under each of these three headings is not intended to be comprehensive, although I do hope that I have covered the most important topics. At the conference I hope that the commentators as well as the attendees will provide input to add to three of these lists of these considerations.

A. General Considerations Affecting Choice of Form

1. Purposes and Powers.

The focus of this paper is on organizations that desire to qualify for federal income tax exemption under section 501(c)(3) of the Internal Revenue Code. Consequently, the choice of form as well as state of formation will affect the extent to which the organization's organizational documents contain the restrictions on purpose, prohibition against distributions, and provisions for the distribution of assets upon liquidation.

Nonprofit Corporations. If the planner is desirous of organizing the tax exempt organization as a nonprofit corporation the state of formation will greatly influence the drafting of the organizational documents. States such as New York and California have separate statutes specifically dealing with nonprofit corporations intended to qualify for exemption as charitable organizations described in section 501(c)(3) of the Internal

Revenue Code. In New York, Type B nonprofit corporations are formed for charitable, educational, religious, scientific and other exempt purposes described in section 501(c)(3) while in California the general charitable or educational corporations are formed as nonprofit public benefit corporations and religious corporations are formed as nonprofit religious corporations.

In other states such as Illinois and Ohio, nonprofit corporations are formed under a separate set of laws relating to nonprofit corporations that do not differentiate between charitable and other types of nonprofit corporations that will either not seek exemption or seek exemption under a paragraph other than section 501(c)(3) of the Code. In those states it is often necessary for the drafter to insure that specific language required by the organizational test of section 501(c)(3) is included in the Articles or Certificate of Incorporation.

In Delaware, all corporations are formed under the General Corporation Law and specific provisions are made for nonstock, nonprofit corporations.

Charitable Trusts. Charitable trusts are generally formed pursuant to specific state laws. In California, Division 9 of the Probate Code contains the Trust Law, and that division applies to charitable trusts that are subject to the jurisdiction of the Attorney General to the extent that the application of the provision is not in conflict with the Uniform Supervision of Trustees and Fundraisers for Charitable Purposes Act. See Cal. Prob. Code §§ 15000, 15004.

Unincorporated Associations. An unincorporated association is an unincorporated group of two or more persons joined by mutual consent for a common lawful purpose, whether organized for profit or not. The governing document of the unincorporated association generally means a constitution, articles of association, bylaws, or other writing that governs the purpose or operation of an unincorporated association or the rights or obligation of its members. The governing document of an unincorporated association must address all of the specific requirements the organizational test, unless the state law specifically includes those provisions.

Limited Liabilities Companies. The IRS recognizes that charitable organizations may be formed as limited liability companies if they have members that are themselves section 501(c)(3) organizations. If an LLC wishes to qualify for exemption, its articles of organization and/or operating agreement must meet the organizational test.

Restricted Funds. Rev. Rul. 54-243, 1954-1 C.B. 92 allows non-section 501(c)(3) organizations to establish restricted funds whose accounts are segregated that can qualify separately for section 501(c)(3) status as a separate legal entity even though they are merely established by resolution of the governing body of the non-section 501(c)(3) organization. We have used these restricted funds for section 501(c)(6) bar association educational activities as well as for the charitable activities of section 501(c)(7) organizations.

2. Member Liability

Another issue affecting choice of form is the extent to which the governing statute expressly addresses the issue of member liability for organizations with members.

Nonprofit Corporations. State corporation codes typically address member liability specifically. For example, section 517 of the New York Not For Profit Corporation Law provides specifically that members of a corporation shall not be personally liable for the debts, liabilities or obligations of the corporation. It goes on to provide that a member shall be liable to the corporation only to the extent of any unpaid portion of the initiation fees, membership dues or assessments which the corporation may have lawfully imposed upon the member, or for any other indebtedness owed by the member to the corporation. California law (sections 5350-5354 of the Corporations Code) is substantially the same. The Illinois General Not For Profit Corporation Act provides only that the members of a corporation shall not be personally liable for any debt or obligation of the corporation, while the District of Columbia Nonprofit Corporation Act makes no specific provision for the limited liability of members.

Unincorporated Associations. State laws governing unincorporated associations frequently make no provision for limiting the liability of members and leave that issue to be a matter governed by common law of the state. See, e.g., Cal. Corp. Code §§ 18000 et seq.

Limited Liability Companies. The limited liability company laws of all states provide express provision for the limitation of a member's liability.

Reserved Powers. One issue not addressed in any state law or litigated case of which I am aware is the question of when or under what circumstances a member of a nonprofit corporation may be held liable to third parties with respect to matters governed by reserved powers. In many nonprofit health systems, and other types of multi-corporate nonprofit systems, the nonprofit parent corporation will be designated as the sole corporate member of each of the nonprofit subsidiaries. In the absence of complete board overlap, a parent corporation will typically "reserve" certain powers over matters otherwise under the control of the subsidiary's board of directors or management such as approving operating and capital budgets, approving the selection and removal of the CEO, and so forth. I am not aware of any case law imposing liability on a member by reason of its exercise of its reserve powers.

3. Director and Trustee Liability

The choice of form as well as the choice of the state of organization will affect the availability of limitations on liability for directors who are volunteers. For example, California and Illinois have specific statutes that limit the liability of directors, officers and persons who serve without compensation other than reimbursing for actual expenses. If there is no state law authorization or prohibition then the federal Volunteer Protection Act may be available. See 42 U.S.C. § 14501 et seq.

4. Governance Considerations

The choice of form of entity as well as the state of formation are affected by a wide range of governance considerations. This discussion is not intended to be comprehensive.

Size of Governing Body. Charitable trusts can typically be formed with as few as one trustee and the IRS has recognized that a charitable trust would not be precluded from establishing its section 501(c)(3) status "merely because the creator of the organization (if a trust) is the sole or controlling trustee or merely because the organization is controlled by one individual." See Rev. Rul. 66-219, 1966-2 C.B. 208.

Similarly, the many nonprofit corporation laws allow nonprofit corporations to be formed with a single director, such as California. However, others, such as the District of Columbia, require boards comprised of more than one director, three in the case of the District of Columbia. See District of Columbia Nonprofit Corporation Act § 29-301.19(a).

Unincorporated associations require at least two or more members while LLCs can be formed with a single member and can be member-managed.

Fiduciary Duties. Another important issue that needs to be thoroughly researched in selecting the form of organization as well as the state of formation is the nature of the fiduciary duties of the persons serving as the directors or trustees of the organization. Most states appear to have adopted the traditional corporate standards of care and loyalty for nonprofit corporations although there may be states in which the courts have applied a hybrid standard that includes some standards of care that are derived from trust law rather than corporate law.

State charitable trust statutes tend not to be as clear as nonprofit corporation laws with respect to the standards of care applicable to trustees, the ability of trustees to rely on the

advice of experts and others, and similar matters typically addressed in state nonprofit corporation laws. One of the reasons why organizers of nonprofit corporations like Delaware is the fact that Delaware nonprofit, nonstock corporations are covered by the same General Corporation Law that applies to for-profit corporations and there is a well developed body of law that can readily be transferred to nonprofit, nonstock corporations such the duty to shop.

Compensation. Some state nonprofit corporation codes such as California's expressly authorize the payment of reasonable compensation to members of a nonprofit public benefit corporation's board of directors for their services in that capacity.

5. Foreign Entity Registration

If an entity formed in one jurisdiction desires to conduct business in another jurisdiction, state laws will typically require the foreign entity to register or otherwise qualify to do business. In the District of Columbia, for example, a foreign corporation, in order to procure a certificate of authority to conduct affairs in the District of Columbia, must make an application to the mayor. See District of Columbia Nonprofit Corporation Act § 29-301.68. The approach of New York is slightly different. Section 1301(a) of the New York Not For Profit Corporation Law provides that a foreign corporation "shall not conduct activities in the state until it has been authorized to do so as provided in [Article 13]." Importantly, section 1301(b) identifies a number of activities that will not be considered to be conducting activities in New York, including holding meetings of directors or members, maintaining bank accounts, granting funds, and distributing information to members. This of course is in contrast to the position of the California

Attorney General with respect to what constitutes what "doing business" in California for purposes of registering with the Attorney General and complying with the requirements of the Nonprofit Integrity Act.

B. State Specific Issues

There are a number of other matters that require careful review when deciding upon a type of entity and place of organization for a new nonprofit corporation. Some of these are described in the next paragraphs.

1. Composition of Board of Directors

As discussed above, some states permit the formation of charitable corporations with boards of directors comprised of a single person, while others describe a minimum number of directors. However, section 5227(a) of the California Corporations Code provides that not more than 49% of the persons serving on the board of any nonprofit public benefit corporation may be interested persons. For purposes of that section, interested persons mean either (1) any person currently being compensated by the corporation for services rendered to it within the previous twelve months, whether as a full or part-time employee, independent contractor or otherwise, excluding any reasonable compensation paid to a director as a director; or (2) any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law or father-in-law of any such persons. Prior to 1996, there was no remedy for violating section 5227 and it was not uncommon for family foundations organized as public benefit corporations to be in violation of the 49% limitation when family members controlled the board and one or more relatives were employed in executive or other positions with the family foundation.

However, section 5227(c) now provides a remedy that includes permitting any person with standing to bring an action to correct the violation of that section, (e.g., the Attorney General), and authorizing the court to enter any order which will provide an equitable and fair remedy to the corporation, including but not limited to, an order for the election of additional directors, an order to enlarge the size of the board, or an order for the removal of directors.

Many organizations upon learning of this requirement elect to not organize as public benefit corporations but rather as California charitable trusts or they incorporate in another state such as Delaware that does not have such a limitation and then qualify to do business in California.

2. Special Treatment of a Religious Corporation

As mentioned briefly at the outset, California has a separate nonprofit religious corporation law that is specifically drafted to accommodate the diverse types of organizational aspects of religions and related organizations. Thus, the California law can accommodate hierarchical as well as denominational religions as well as non-mainstream structures. Importantly, nonprofit religious corporations formed in California are subject to less supervision by the California Attorney General. Section 9230 of the Corporations Code provides that unless the Attorney General has granted specific enforcement responsibilities, the Attorney General shall have no powers with respect to any corporation incorporated or classified as a religious corporation under or pursuant to this code. Corp. Code § 9238.

This limitation on enforcement authority has, to the best of my knowledge, never been challenged by an attorney general or other charities regulator of another state as it relates to activities of a religious corporation in that state.

3. Nonprofit Integrity Act

The enactment of the Nonprofit Integrity Act by California potentially affects out-of-state corporations and other entities doing business or holding property in California, including the choice of form. Specifically, all forms of charitable entities that have revenues of $2 million or more are required to have a certified audit. Similarly, all organizations are required to disclose the compensation of the president and CFO to its governing body or committee thereof. However, the audit committee requirement only applies to nonprofit corporations.

The Audit Requirement. The audit requirement applies to any charitable corporation, unincorporated association, charitable trust, or any other person holding funds for charitable purposes. The "any other person" language would cover LLCs that qualify for exemption under section 501(c)(3). In addition, the "any other person" language of the Act would apply to separate funds established by section 501(c)(4) social welfare organizations, section 501(c)(6) trade associations, section 501(c)(7) social clubs, and other non-section 501(c)(3) organizations formed to receive or that set aside funds for charitable purposes.

The audit requirement applies to any such organization that (a) is required to file a report with the California Attorney General, and (b) receives or accrues gross receipts of $2

million or more annually from sources other than government grants and service contracts which an accounting is required by the organization. Cal. Govt. Code § 12586(e)(1).

It is important to note that religious corporations sole, other religious corporations, organizations that hold property for religious purposes, educational institutions, hospitals, and health care service plans are not subject to filing requirements and thus are not subject to the audit requirement of the Nonprofit Integrity Act. In many cases, other licensing requirements or financial realities may require such organizations to have audited financial statements.

Separate organizations affiliated with organizations exempt from the filing requirement are not covered by these exceptions unless they fall into one of the categories of the exceptions.

The annual financial statements must be prepared in accordance with generally accepted accounting principles, and must be audited by an independent certified public accountant in conformity with generally accepted auditing standards. If the firm conducting the audit performs non-audit services, the firm and its individual auditors must adhere to the standards for auditor independence set forth in the latest edition of the Government Auditing Standards issued by the U.S. Comptroller General (know as the "Yellow Book"). The Government Auditing Standards are available at *www.gao.gov*.

The audited financial statements must be available for inspection by the Attorney General and members of the public no later than nine months (without extension) after the close of the fiscal year to which the statements relate. The charitable organization must make its

audited financial statements available to the public in the same manner that it makes its Form 990 or Form 990-PF available under section 6104(d) of the Internal Revenue Code. It should be noted that the California disclosure requirement does not apply to Forms 990-T as does federal law for Forms 990-T filed after the effective date of the Pension Protection Act of 2006, August 17, 2006.

Charitable organizations that have gross receipts of less than $2 million and have audited financial statements also must make their financial statements available for inspection by the California Attorney General and available to the public in the same manner. Cal. Govt. Code § 12586(f). Thus, for example, a Pennsylvania charity with $500,000 or more of gross receipts that has registered in Pennsylvania to solicit charitable contributions would be required to have a certified auditor under Pennsylvania law and, if subject to the NPA, would have to make its financial statements available to the California Attorney General as well as the general public, even though its gross receipts are less than $2 million.

The Audit Committee Requirement. Charitable corporations (but not charitable trusts, unincorporated associations, or other forms of unincorporated charities) that are required to file reports with the Attorney General and have gross revenues of $2 million or more also are required to have an audit committee comprised exclusively of independent members appointed by the board of directors. Cal. Govt. Code § 12586(e)(2). The audit committee may be composed of directors as well as non-directors, but all members of the committee must satisfy the independence standards. Even if a person holding the title of

President, CEO, Treasurer, or CFO is a volunteer and otherwise satisfies the independence standards, that person is also prohibited from serving on the audit committee.

The audit committee must be responsible for recommending to the board of directors their retention and termination of the independent auditor and may be empowered by the board to negotiate the independent auditor's compensation. It must confer with the auditor to satisfy its members that the financial affairs of the corporation are in order. In order to be charged with reviewing and determining whether to accept the audit and assuring that any non-audit services performed by the auditing firm conform with the standards of auditor independence. The audit committee also is required to approve the performance of non-audit services by the auditing firm.

If the charitable corporation has a finance committee, finance committee members must make up less than 50% of the audit committee, and the chair of the audit committee may not serve on the finance committee.

The Compensation Disclosure Requirement. The third requirement imposed by the NPA applies to all charitable organizations that are subject to the jurisdiction of the California Attorney General. Cal. Govt. Code § 12586(g). Thus, for example, religious organizations, educational institutions and hospitals must comply with this requirement even though they are not required to register or file reports with the Attorney General. Cal. Govt. Code § 12586(g). It should be noted that because the Attorney General's jurisdiction over religious corporations is limited, it is unclear whether the California Attorney General would take the position that this portion of the NPA applies to religious

corporations and thus constitutes an independent basis to assert jurisdiction. See Cal. Corp. Code § 9230.

Under this requirement, the board or an authorized committee of the board, and the trustee or trustees of the charitable trust, are required to review and approve the compensation and benefits of the President or CEO and the Treasurer or CFO to assure that the compensation and benefits are "just and reasonable." It is unclear, however, what "just" means in this context. It appears, however, that compensation, even if "reasonable" may not be considered "just" under some circumstances. For example, one could argue that the ratio of CEO compensation to the lowest paid employee is 200 to 1, rather than 25 to 1, the compensation, even if reasonable, may not be "just."

This review and approval must occur initially upon the hiring of the officer, whenever the term of employment of the officer is renewed or extended, and whenever the officer's compensation is modified. This requirement obviously is intended to prevent secret deals between a key executive and a single board member, as allegedly occurred between the former board chairman and the former president of American University.

4. Loans to Directors and Officers

If an organization desires to make loans to directors or officers, careful consideration needs to be given to the state of organization. Delaware provides broad authorization for the making of loans and loan guaranties to officers and employees, including any officer or employee who is a director of the corporation or its subsidiary. See Delaware General Corporation Law § 143. New York prohibits the making of loans to directors or officers,

"other than through the purchase of bonds, debentures, or similar obligations of the type customarily sold in public offerings, or through ordinary deposit of funds in a bank," or to another organization in which one or more of its directors or officers are directors or officers or who hold a substantial financial interest, except a loan by one Type B corporation to another Type B corporation. New York Not For Profit Corporation Law § 716.

California adopts a different approach. A public benefit corporation in California is precluded from making any loan of money or property to or guaranty the obligation of any director or officer, unless approved by the Attorney General. However, a corporation may advance money to a director or officer of the corporation or of its parent or subsidiary for expenses reasonably anticipated to be incurred in the performance of duties and the loan prohibition does not apply to a loan for the benefit of an officer in circumstances where the loan is necessary, in the judgment of the board, to provide financing for the purchase of principle residence of the officer in order to secure the services or continued services of the officer and the loan is secured by real property located in the state. Cal. Corp. Code § 5236.

5. Conflicts of Interest

Generally speaking, conflicts of interest are addressed through disclosure and recusal in most nonprofit corporation laws. See, e.g., New York Not For Profit Corporation Law § 715; Delaware General Corporation Law § 144. Again, however, special rules apply to California nonprofit public benefit corporations under section 5233 of the Corporations

Code and affect public benefit corporations formed under California law irrespective of their place of business.

6. Fundamental Transactions

State of formation also dictates the nature of attorney general or charities regulator oversight over fundamental transactions.

Sales of All or Substantially All Assets. A sale, lease, exchange or other disposition of all, or substantially all, the property and assets outside of the ordinary course of business typically requires board approval and then the approval of members. However, the state of formation also dictates the degree of additional oversight or review. For example, nonprofit corporations formed in Illinois simply require the member and board votes and are not required to submit the plan to the attorney general for approval. Illinois General Not For Profit Corporation Act of 1986 § 111.60. In California, a nonprofit public benefit corporation is required to give written notice to the attorney general 20 days before it sells, leases, conveys, exchanges, transfers or otherwise disposes of all or substantially all of its assets outside of the usual and regular course of its activities. Cal. Corp. Code § 5913. In New York, a plan for the dissolution and distribution of assets generally requires the approval of a justice of the Supreme Court in the judicial district in which the office of the corporation is located. New York Not For Profit Corporation Law § 1002(d).

Mergers and Consolidations. In Illinois, two or more nonprofit corporations may merge and no attorney general approval is required, while in California at least 20 days prior to

the consummation of any merger involving a public benefit corporation the attorney general must be provided with a copy of the proposed agreement of merger. Cal. Corp. Code § 6010. In New York, a merger involving a Type B nonprofit corporation requires an order approving the plan of merger or consolidation and authorizing the filing of a certificate by the Supreme Court. New York Not For Profit Corporation Law § 907(a).

Conversions of Status. Some states permit amendments and restatements of a nonprofit organization's articles of incorporation to convert from nonprofit to for-profit status. In other states no express authority for such conversion is authorized and therefore a transaction must be structured in a permitted manner, such as by merging the nonprofit corporation into a for-profit corporation if permitted or by distributing the assets of the nonprofit corporation to the for-profit corporation.

Special Conversion Statutes. When a nonprofit corporation is establishing operations in another state, such as by acquiring a hospital or establishing a new school, its assets and operations in that state may become subject to specific state laws requiring higher levels of review and approval.

C. Tax Planning Considerations

1. Corporation Versus Trust Tax Rates

Tax planning regarding the choice of form involves many issues not least of which is the rate of taxation on unrelated business income. While the existence of unrelated business income is common in nonprofit organizations classified as public charities, private foundations increasingly are having unrelated business income due to their investments in

debt financed real estate, directly or through pass-through entities, or in other forms of alternative investments.

The UBTI of tax exempt organizations that operate in trust form are subject to rates set forth in section 1(e) that are considerably higher than the rates set forth in section 11(a) applicable to organizations taxed as corporations. Accordingly, care should be used in selecting the trust form of doing business for organizations likely to be in receipt of UBTI. In *Sherwin-Williams Co. Employee Health Plan Trust v. United States*, 2002-2 U.S.T.C. ¶50,721 (N.D. Ohio 2002), aff,d, 403 F.3d 793 (Sixth Cir. 2005), the Court of Appeals for the Sixth Circuit affirmed a District Court decision that rejected a section 501(c)(9) voluntary employees' beneficiary association's argument that it should be taxed as a corporation rather than as a trust.

The UBTI of tax exempt organizations of all forms, other than trusts, is subject to tax at the rates generally applicable to corporations, as provided in section 11. Thus tax exempt organizations formed as business corporations, nonprofit corporations, professional corporations,[1] unincorporated associations taxable as corporations, and separate funds are subject to the general corporate tax rates on their UBTI.

2. Tax Disparity Between Corporations and Trusts

The tax disparity between corporations and trusts results from two interrelated factors, the maximum marginal tax rate applicable to each type of entity and the levels of income at which graduated rates apply up to the maximum rate. The following illustrates the

[1] A professional corporation may be classified as a personal service corporation not eligible for graduated rates and its UBI may thus be taxed at 35%. See IRC §§ 11(B)(2) and 448(d)(2).

different effects of the rates based on pre-tax net unrelated business taxable income in the following amounts:

UBTI	TAX EXEMPT ENTITY TAXED AS CORPORATION	TAX EXEMPT ENTITY TAXED AS TRUST	DIFFERENCE
$100,000	$22,250	$38,755	$16, 505
$1,000,000	$340,000	$395,155	$55,155
$10,000,000	$3,500,000	$3,959,155	$459,155

3. Taxable Income Bracket Under Section 1561

Section 1561 limits controlled corporations to one taxable income bracket under section 11. Section 1561 does not define "control" but section 1563 defines "control" in terms of stock ownership, considered in terms of both value and voting rights. Thus, if a tax exempt organization with UBI also "controls" a stock corporation with taxable income, section 1561 would limit those corporations to one taxable income bracket. However, section 1561 makes no reference to control of nonstock corporations. Section 1563(b) provides that an exempt organization is an "excluded member" of a controlled group unless it earns UBI.

In 1994, the Service ruled that the section 512(b)(13) rules for determining control of nonstock corporations apply for purposes of section 1561. Tech. Adv. Mem. 9509002 (Sept. 30, 1994). In this case, a section 501(c)(6) business league controlled, within the meaning of section 512(b)(13), a section 501(c)(3) organization which in turn owned all of the stock of a taxable entity. The Service ruled that the three entities constituted a control

group for purposes of section 1561. The ruling based its finding that the section 501(c)(3) organization controlled the taxable entity on the control rules of section 1563. However, it based its finding that the section 501(c)(6) organization controlled the section 501(c)(3) organization on an expansive interpretation of section 512(b)(13). The Service invoked the concept of control "as a practical matter" to resolve the fact that this case's facts do not fall within the literal requirements of section 512(b)(13) and Reg. Sec. 1.512(b)-1(l)(4), and ruled that "the degree and type of control present in this case is tantamount to a parent-subsidiary relationship" between the section 501(c)(6) organization and the section 501(c)(3) organization.

In this case, the section 501(c)(6) organization did not have the power to remove directors of the section 501(c)(3) organization. Instead, the members of the section 501(c)(3) organization have the power to remove the organization's directors. However, all members of the section 501(c)(3) organization were members of the board of directors of the section 501(c)(6) organization. Based on this fact, the Service asserted practical control over the section 501(c)(3) organization by the section 501(c)(6) organization.

4. State and Local Tax Planning

State and local tax planning will vary from state to state. In some states, franchise or income tax exemptions are based on the federal tax exempt status, while in others such as California an organization must apply for exemption separately. Similarly, each state will have its own sales and use tax regime. In some states, section 501(c)(3) organizations are eligible for sales and use tax exemptions (e.g., New York) while in other there is no tax exemption (e.g., California).

III. Operating Across State Lines

The discussion in Parts II and III are precursors to the various issues that arise when a tax exempt organization operates across state lines.

A. Registration Requirements

1. General Considerations

The typical issue that arises in connection with a nonprofit organization doing business in another state is whether its contacts with the other state are sufficient to give rise to jurisdiction by that state over the activities of the charitable organization. This typically comes up in two contexts. The first is whether the typical state charitable registration requirements will apply. More often than not, the answer to this question will depend on whether the organization is doing business in or doing business with the state, the latter of which should not require any kind of registration. Similarly, the nonprofit corporation must qualify to do business in a state if it wishes to bring actions within that state.

California modified the model Uniform Supervision of Trustees for Charitable Purposes Act (the "Model Act") by adding a definition of charitable corporation that, to my knowledge, does not exist in any other state.

Section 12582.1 of the California Government Code defines the term "charitable corporation" to include out-of-state nonprofit corporations that either are (a) "doing business" in California for "charitable or eleemosynary purposes" or (b) "holding property" in California for such purposes. This definition as it relates to out-of-state charitable corporations is both ambiguous and far reaching.

2. The "Doing Business" Standard

California enacted the Model Act in 1959, and section 12582.1 was not part of the Model Act. Consequently, it is difficult to ascertain exactly what the California legislature meant by the term "doing business" for charitable or eleemosynary purposes. Use of the "doing business" standard for establishing the registration and reporting requirements for charitable corporations, however, was likely to have been modeled on statutory limits for state court jurisdiction over non-resident defendants that were in use at that time by many states as an alternative to long-arm statutes. The doing business standard is to be distinguished from the contemporary "any constitutional basis" statute, which extends the reach of a state court beyond the scope of "doing business" to any organization that has minimum contacts within the state. California, as with most states, has enacted an "any constitutional basis" statute. Cal. Civ. Proc. Code § 410.10.

The "doing business" test, as it applies to nonprofit corporations, can be likened to a state's general jurisdiction statute. Such statutes subject all of an out-of-state corporation's activities to the jurisdiction of the enacting state's courts because the corporation conducts some systematic or ongoing activity within the enacting state – i.e., it is "doing business" within that state. If an out-of-state charitable corporation's conduct does not rise to the level of "doing business" its specific acts within or affecting a state may result in jurisdiction relating to only that specific act or conduct under specific jurisdiction concepts. See, e.g., *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

The leading U.S. Supreme Court case is *Perkins v. Berguet Consolidated Mining Company*, 342 U.S. 437 (1952). In that case, the court concluded that a defendant's contacts were

sufficiently "substantial . . . continuous and systematic," such that personal jurisdiction may exist over the defendant for a cause of action that is unrelated to those contacts the defendant had within the state. *Id.* at 445-446. Thus, the term "doing business" generally requires that a charitable corporation is conducting some systematic or ongoing activity in California before it becomes subjected to the governance requirements of the NPA.

At present, the California Attorney General does not have a particularly nuanced position concerning what constitutes doing business in California. The Attorney General's Frequently Asked Questions ("FAQ") posted on its website concerning the NPA state that making grants to organizations located in California would not constitute doing business in California. However, virtually any other contact with California would constitute doing business. This position is overly broad and likely exceeds constitutional boundaries.

3. The Holding Property Standard

The second basis for subjecting out-of-state nonprofit corporations to California law is the "holding" of "property" in California for charitable eleemosynary purposes. The critical distinction with this particular language is that it should be limited to holding property "for charitable purposes," rather than holding property for investment or other non-charitable purposes – particularly intangible property such as stocks, bonds, partnership interests, and membership interests in an LLC – or in a taxable corporate subsidiary.

For example, suppose a New York based university with its campus in New York State also operates a distance learning program from a physical location in California. In such a situation the organization probably would be "doing business" in California as well as

holding property in California for eleemosynary or charitable purposes. On the other hand, if that same New York based university simply purchases certificates of deposit from a California based bank, or a membership interest in a private equity or hedge fund organized as an LLC that was formed or qualifies to do business in California, it may be holding an intangible asset in a company doing business in California for investment purposes, but it is not holding any property for charitable or eleemosynary purposes.

This is not a distinction that the California Attorney General has acknowledged. In FAQ No. 1 he states that: "[E]xamples of doing business in California . . . include. . . maintaining financial accounts or investments at an office of a financial institution located here."

It simply makes no sense for the California Attorney General to assert jurisdiction over an out-of-state charitable corporation that buys and holds a $5,000 certificate of deposit from a California financial institution or that it invests $10 million in a private equity or hedge fund headquartered in California. In fact, may organizations are not even likely to know whether they hold property for investment purposes in California because they have delegated their investment management decision-making to an investment manager, or have invested in funds of funds.

In the case of charitable organizations formed as trusts, unincorporated associations, LLCs and other non-corporate forms, the reach of the California courts and the California Attorney General is far less clear. The Act by its terms is unhelpfully circular. It states

that it applies if the "state or the Attorney General has enforcement or supervisory power." Until California courts address this issue, the following analysis is suggested.

The corporate governance provisions impose specific requirements on charitable trusts, unincorporated associations and other non-corporate forms of charitable organizations that involve contact that has no clear connection with California, such as the audited financial statement and executive compensation disclosure and approval requirements. Therefore, it is reasonable to assume that those requirements should not apply to an out-of-state, nonprofit non-corporate charity (e.g., family foundations organized in trust form) unless its contacts with California arise at least to the "doing business" level applicable to charitable corporations. It would make little sense to subject charitable corporations to a "doing business" test while subjecting charitable trusts and other forms of non-corporate charities to a broader "on any constitutional basis" (i.e., minimum contacts) test absent specific legislation.

B. Planning Strategies

When a tax exempt organization is formed under the laws of a particular state, and maintains its principal office in that state, the degree to which another state can exercise jurisdiction will depend on the nature of the activities conducted in the other state or directed at the other state. For example, if the organization establishes and operates a permanent office in another state it will typically qualify to do business in that state and, thereby, subject itself to the general jurisdiction of that state. On the other hand, if it conducts activities from its state of formation that have an impact in another state, the issue of whether the other state has general or specific jurisdiction over those activities will

depend on the nature of the activities. As discussed in other papers, state long-arm statutes typically will give jurisdiction in another state for specific activities that rise to the levels of minimum contacts whereas general jurisdiction will arise only if the level of activity is sufficient to justify the extension of general jurisdiction over the organization and its activities and operations outside of the state.

Two basic techniques are typically used to address these issues.

1. Use of Subsidiaries

It is quite common for tax exempt organizations that do business in multiple states to establish new domestic organizations (i.e, organizations formed under the laws of the state in which the activities are being formed) or to form separate subsidiaries under the laws of the state of original organization that qualify to do business in the other state. By using subsidiaries, the foreign parent organization can avoid being subjected to general or specific jurisdiction based on the activities or operations of its subsidiary.

Also, it may be necessary to establish a specific type of corporation within a particular state in order to comply with state law-specific requirements. For example, in the health care area, many but not all states have a general corporate practice of medicine prohibition that precludes nonprofit corporations from employing physicians. However, in some states, such as Maryland, the corporate practice of medicine prohibition can be avoided by forming a professional corporation or association that is "captive" in the sense that the physician shareholders have no economic rights to the underlying assets of the professional

corporation or association and they must transfer their share ownership at the direction of the parent organization.

From an administrative standpoint, the parent organization can obtain a group exemption letter if it is eligible and file group information returns. In the alternative, separate exemption determinations can be obtained from each subsidiary and separate information returns can be filed for each subsidiary.

2. Use of Disregarded Entities

In recent years, particularly with the adoption of the check the box entity classification rules, tax exempt organizations are using disregarded entities, namely single member limited liability companies, with increased frequency.

For example, tax exempt organizations that generate intellectual property frequently will set up one or more single member limited liability companies to deal with technology transfer. While the disregarded entity is treated as a division of the tax exempt organization for federal income tax purposes, it is treated as a separate legal entity for state law purposes.

Similarly, many tax exempt organizations form single member limited liability companies to hold and operate real property assets in order to take advantage of the liability protection afforded under state law. However, care is required in planning the use of this structure to insure that the particular state allows property tax exemption to property owned by a single member limited liability company if the real and/or personal property is being used for a charitable or other exempt purpose under state law.

The use of disregarded entities creates some interesting state-federal interface questions.

First, suppose you have a New York-based private foundation organized as a New York Type B nonprofit corporation that wishes to conduct operations in California. Clearly, if the New York tax exempt corporation is doing business or holding property for charitable purposes in California, it will be required to register with the California Attorney General unless it is eligible for any exemption from such registration and once registered it will be required (at least according to the California Attorney General) to comply with all aspects of the Nonprofit Integrity Act, including the requirement for having audited financial statements, maintaining an audit committee independent of a finance committee, and disclosing CEO and CFO compensation. On the other hand, if the New York-based foundation forms a single member limited liability company under the laws of California or under the laws of another state that qualifies it to do business in California, from a state law point of view is the LLC's separate existence disregarded if the organization is treated as a disregarded entity for federal tax purposes?

Generally the answer to this question should depend on how the LLC conducts business in the foreign state, such as California in this example. If the LLC has its own employees, enters into separate leases for facilities, and conducts its business in the state under its name, rather than the name of its parent organization, then it should be treated as a separate legal entity for state law purposes even though it is treated as a disregarded entity for federal law purposes.

Another issue that arises is whether the disregarded status of the LLC for federal tax purposes will have an impact on the liability limitation for state law purposes.

For example, under the New York Limited Liability Company Law (the "Law") section 609(a) provides, in part, as follows:

> Neither a member of a limited liability company, a manager of a limited liability company managed by a manager or managers, nor an agent of a limited liability company . . . is liable for any debts, obligations or liabilities of the limited liability company or each other, whether arising in tort, contract or otherwise, *solely* by reason of being such a member, manager or agent or acting (or omitting to act) in such capacities or participating . . . in the conduct of the business of the limited liability company. (Emphasis supplied.)

Although the use of the word "solely" in section 609 indicates that a member, manager or agent of an LLC will not be liable for the debts, obligations or liabilities of the LLC only by reason of being a member, manger or agent, section 609(a) does not prevent the member of a single member LLC or employees of the member who serve as managers or agents of the LLC from having any liabilities. For example, in a case decided by the Delaware Chancery Court, the court ruled that the phrase "solely by reason of being a member or acting as a manager" in the Delaware statute, which is similar to New York's, implied "that there are situations where LLC members or managers would not be shielded by this provision." *Pepsi-Cola Bottling Company of Salisbury, Maryland v. Hardy*, 2000

Del. Chanc. LEXIS 52 (Del. Ch. March 15, 2000). In fact, that case involved a situation where the defendants were being sued "solely by reason of being a member" of the LLC where the claim was based on fraudulent acts committed by the LLC members before the LLC was formed and took title to the property in dispute.

The language of section 609 of the Law is similar to section 628 of the New York Business Corporation Law that limits the liability of a shareholder of a New York business corporation. None of the decided cases that I reviewed has sought to treat members of an LLC different from shareholders of a business corporation for purposes of exposing members of an LLC to liability greater than that of shareholders of a business corporation. In the case of New York, where the law does not expressly provide for piercing the LLC liability shield, the court should, and are likely to, develop principles for piercing the limited liability veil of LLCs in appropriate circumstances.

Generally speaking from a state taxation point of view, the only drawback of establishing a separate LLC is the annual franchise tax due, which for California is $800 a year.