

COMPLIANCE AND AFFILIATED ENTITIES AT PRIVATE COLLEGES AND UNIVERSITIES

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A. The Universe of Affiliates¹

A private college or university (“school”) that wishes to manage compliance by various organizations affiliated with it must first identify the organizations it deems affiliated. In the process, many organizations that are, in some sense, related will be deemed too loosely affiliated to be officially sanctioned. Some loose affiliates may be offered an opportunity to comply with key organizational or tax compliance guidelines as a condition of being officially recognized. Others will be disavowed.

1. Organizations Formed by the University

i. The focus of this outline is subsidiary or affiliated organizations which the school forms for a specific programmatic or business purpose. These can take various forms, as discussed below.

ii. Formation, maintenance and management of affiliated organizations is costly and time consuming. Private schools generally form such affiliates only if there is a compelling reason to segregate an activity. Dissolution of entities, particularly those that have not maintained their books, legal existence and tax filings can be a chore.

iii. A policy, whether written or unwritten, regarding affiliated organizations is advisable. Appointing a small group to oversee maintenance of the organizations is helpful. Advice and involvement from the general counsel, controller and risk management team is essential. Annual disclosures required for federal tax purposes gives the controller’s office a special interest in maintaining current, accurate information on the official affiliates disclosed on the school’s annual tax return (Form 990, 990-T).

iv. A spreadsheet can be very useful that identifies the name, directors, officers, members, annual meeting date, stockholders, EIN, and assigns maintenance responsibility to a specific person, if more than one is involved. Annual reporting to the school’s audit committee will inform the board of activities conducted “off balance sheet” and shine welcome light on any activities which could pose legal or reputational risk if attributed to the school.

¹ The author wishes to thank John Karasek, Esq. for his research assistance with this article.

2. Organizations Affiliated by Agreement

i. Some joint affiliations between the school and other organizations are governed by agreements that should be formalized in clear, well-formulated memoranda of understanding signed by both institutions. Cover all relevant dimensions of the relationship including relative responsibilities, tax burdens, insurance requirements, and facilities use.

ii. Such affiliations tend to be either relatively minor (e.g., a research or teaching collaboration of limited duration or scope) or extensive joint ventures between well-established organizations with separate, but related missions (e.g., between a medical school and its teaching hospital).

3. Organizations Affiliated by Accident

i. This category is reserved for organizations that may have initially had a close relationship to the school, but whose missions or boards have become unsympathetic with, or even antithetical, to core values of the institution. Examples may include fraternities and sororities, alumni or student publications, fundraising or even errant commercial enterprises.

ii. Prudence, tax or legal requirements may dictate expressly disavowing a relationship with such an institution, and removing financial or other support, and withdrawing the right to use the school's name. An effective policy on properly managed affiliates will avoid reoccurrence.

B. Separate Purpose

Schools form affiliates to segregate activities that pose business, tax or liability risks to the institution or which require involvement by others. Before forming a separate entity, all of the assumptions for doing so should be tested, and if found insufficient, the activity should either be conducted by the university directly or abandoned as inconsistent with its mission or image. If formation of a separate organization has adequate rationale, the foregoing analysis will dictate the form of entity chosen.

1. Business Premises. Some common business purposes include:

i. Shielding the school's involvement in land assemblies (to lower transaction costs or avoid public opposition) or preventing copycat investments in other certain assets.

ii. Protecting the school from premises-level or other liabilities. Given the reputational sensitivities of most schools, this rationale is of limited utility.

iii. Segregating UBIT-producing activities.

iv. Engaging in transactions, such as acquiring title through foreclosure or distressed asset sales, which might pose intolerable risks to the school.

v. Creating compensation structures which mimic for-profit pay scales that may raise reasonable compensation concerns at a nonprofit.

vi. Forming a vehicle for joint participation by other profit or nonprofit players.

2. False Business Premises

i. Reputational protection. If an activity is too risky to conduct in the school's name, conducting it through a separate organization only heightens the damage caused when the activity is exposed.

ii. Entrepreneurial Spirit. Aside from valid rationales -- for instance, licensing technology to entities in which the school, the faculty member who creates the intellectual property and venture participants combine -- creating separate entities to "act more like a business," often disguise a dangerous disrespect for the school's fundamental values and sensitivities, and should be disfavored.

C. Forms of Entity

The business rationale for the organization will determine what form it takes. The first question is whether the affiliate should itself be exempt or for-profit. To be exempt, it needs an exempt purpose (including to support the school). Exemption will require an extensive application to the IRS. Disregarded entities, such as LLCs and LLPs, can sometimes achieve the segregation free from entity-level taxation, without the need for a separate exemption.

1. Nonprofits. A school may foster a variety of nonprofits, including:

i. Supporting organizations. These are separate nonprofits of three different types that exist to support another exempt organization. Code 509(a)(3).² These are organizations operated, supervised or controlled by the supported charity (Type I), supervised or controlled in connection with the supported charity (Type II), or operated in connection therewith (Type III). The Pension Protection Act of 2006 ("PPA") has rendered Type III organizations much less appealing. See I.R.B 2006-51. Examples include athletic support organizations, fund raising organizations (e.g., School Friends of Cleveland).

ii. Title Holding Companies. These include exempt organizations formed under Section 501 (c)(2) (primarily for use with only one affiliated school) or Section 501 (c)(25) (can have up to 35 beneficial owners). Subsection (c) (25) orgs are restricted to owning real property. In both cases, all net income, after payment of expenses, must be paid to the affiliated

² All Section references here are to the Internal Revenue Code of 1986, as amended ("Code") and to the Treasury regulations ("Regulations") promulgated thereunder.

schools on an annual basis. Both are prohibited from earning more than a minimal amount of revenue from UBIT-related sources.

iii. Trade Organizations. These organizations are formed under Section 501(c)(6) of the Code. An example is a tenant-run merchant organization that conducts marketing activities on behalf of a district in which the school is a significant commercial landlord. The creation of such an organization prevents the collection of funds to support marketing activities of the tenants from tainting the rents of the school/landlord and rendering them taxable. The for-profit tenants enjoy collective use of their marketing dollars without subjecting them to tax. As with all nonprofits, none of the profits from the organization can inure to a private party.

iv. Separate Nonprofits. An activity that has a separate, bona fide nonprofit purpose can obtain a 501(c)(3) (or other) charitable designation. In some cases, it can be useful for the school to form such an organization to “house” a particular exempt activity. If the organization is formed with “members” as opposed to control residing solely in the board, the school can be its sole member and thus have rights, and control, akin to a majority shareholder.

v. Dual Qualified Organizations. For foreign fundraising purposes, it can be useful to consider an organization that is recognized under US and foreign law as exempt.

2. Profitable Organizations

i. Corporations. Despite the advent of LLCs and other entities disregarded for tax purposes, stock corporations remain a viable vehicle to consider. Among other reasons, the law on piercing the corporate veil is much better developed with respect to stock corporations.

ii. LLCs. Pass through tax treatment and minimal state filing and organizational requirements make LLCs appealing. Beware of risk that single-member LLCs may be more casually disregarded or pierced. See, John C. Murray, “ ‘Piercing the Corporate Veil’ of a Limited Liability Company” (2002) <http://www.firstam.com/content.cfm?id=2906>. In many states, LLCs are also attractive title holding vehicles because transfers between the LLC and the school are exempt from conveyance and transfer taxes. Limited disclosure requirements (there are no officers and directors to list in the Secretary of State records) also make these effective shields for investments. A downside, as with most for-profit vehicles, is that the affiliate cannot enjoy the school’s property tax exemption. Also, tax-exempt bond proceeds cannot generally be used to improve properties held by such entities.

iii. Trusts. Grantor trusts can be useful and relatively low cost devices for title holding activities that effectively screen, in most states, the name of the school in public records filings. The trust agreement should allow the school to direct the trustee to retain control.

D. Compliance Issues

1. Preserving Legal Status

In order to preserve legal integrity, all affiliates have to be organized and run independently. Plentiful guidance material is available in the NACUA database on this topic

(maintenance of separate books, observing corporate formalities, treating assets as separate from the school's assets), but the education of the officers and directors asked to serve on such organizations is vital. Training personnel on their duties, including the basic duties of directors, and the need for scrupulous conflict of interest policies, can avoid many pitfalls. Excellent guidance materials are available from the Independent Sector, www.independentsector.org, and other trade organizations focused on nonprofit governance. See, the bibliography that follows and Paul Ward's excellent companion piece for this session.

2. Avoidance of Conflicts, Malfeasance

Conflict of interest policies should either be integrated into the bylaws of corporate organizations or adopted as a freestanding board policy. Consideration should be given in appropriate instances to a whistleblower protection policy (but not needed for most title holding entities).

3. Compensation Issues

In most instances, there will be little or no compensation paid to participants, but where it is paid, attention needs to be given to prevent unreasonable compensation in view of the services rendered, especially with respect to affiliated nonprofits. Ample allowance permits the IRS to aggregate affiliate and school compensation, so there is risk at both levels. Also, even if unpaid by the affiliate, the affiliate officers and directors will likely have their school salaries disclosed on the school's 990 as a result of service on the affiliate. Since the returns are not only placed on the web (www.guidestar.org), but publicly scrutinized, this is often a rude surprise.

4. Tax Management

The risks posed by poorly conceived or managed organizations to the exempt status or tax posture of the school can be very high. Regular consultation and involvement by the school's tax professionals is therefore critical in the formation and operation of affiliates.

E. Risk Management

Effective use of director and officer coverage at the school will often permit coverage for school employees in their capacity as affiliate officers or directors. Counsel should be sure that the organizational documents of corporate entities allow the maximum indemnification of officers and directors permitted by law. State and federal law provide additional volunteer shields.

F. Conclusion

Effective use of affiliates can help the school achieve its programmatic goals or related investment or economic development activities. A policy that encourages clear objectives, transparency, respect for the legal and tax requirements and allows for close supervision (while avoiding attribution) will help further this objective.³

³ In the interests of brevity, I have omitted a bibliography. In addition to those sources cited in Paul's article and in the NACUA database generally, there is an extensive database in my earlier piece: "The Uses of Affiliated Organizations: Education, Economic Activity and Entrepreneurial Activity," June, 2000, available at www.nacua.org.

Biography

James M. Carolan is a principal at Withers Bergman LLP where his practice focuses on advising charities and charitably inclined individuals on real estate development and philanthropic projects. His firm has special expertise in structuring cross-border transactions for charities and individuals. Prior to joining the firm, Mr. Carolan served for fourteen years as in-house counsel at Yale University, where he advised on construction, design, real estate acquisition and development, historic preservation and on a range of tax and business matters. A graduate of Cornell University (A.B.), Stanford University (M.A.) and University of Connecticut (J.D.), he has been a regular lecturer at the Yale Law School, the Yale School of Forestry and Environmental Studies, and the Graduate Program on Planning at Columbia University. He has always been active on public and charitable boards, including The Saint Thomas More Corporation, the Catholic center at Yale University.