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Non-Profit Subsidiary and Affiliated Entity Essentials

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When a for-profit corporation transacts with its non-profit affiliates, maintaining compliance can quickly become far more complicated. This can be especially true when company directors or officers have overlapping duties between for-profit and non-profit entities. However, for many it is still advantageous to create a non-profit subsidiary due to the benefits of attaining tax-exempt status, federal grant eligibility, reduced liability, expanded lobbying opportunities, and greater independence from the parenting organization.

Companies will need to determine whether the benefits of forming a non-profit subsidiary outweigh the time, effort, and cost of establishing one. Before moving forward, entities will need to understand compliance with the Texas Business Organizations Code (TBOC). An affiliated transaction—even if only inadvertently—constitutes unreasonable compensation or bestows a private benefit is a risk that non-profits should avoid. According to TBOC Section § 22.053, non-profits are prohibited from paying dividends or any part of their income to a member, director, or officer.

Legal Precedence and Examples

One of the defining court decisions in *Double Diamond, Inc. v. Saturn* (2011) helped provide critical insight into the kinds of transactions that are prohibited for non-profits. In this case, insufficient evidence justifying the payment of rent and salary to an insider constituted unreasonable compensation. The court cited a particular lack of evidence for charges and services rendered to the affiliate. They also did not sufficiently document the property value increase by the new facility.

Yeckel v. Abbott (2009) provides further insight what qualifies as evidence for reasonable spending. The court analyzed the salaries of the non-profit foundation directors and compared them to the scale of the non-profit's overall finances to determine whether their pay scale was reasonable. These numbers were then also evaluated in relation to other comparable non-profits nationwide. Another factor that was considered was whether such salary amounts would inhibit the foundation from accomplishing its intended purpose of charitable giving which led the court to ultimately deem the salaries to be a private benefit.

Case Findings that Inform Affiliated Transactions

These cases have informed how non-profits that engage in affiliated transactions will need to thoroughly document the evidence of reasonableness for any fund, asset, or disbursement to avoid being interpreted as a private benefit. Additionally, any transaction with an affiliate must not hinder the non-profit from achieving its overall purpose through unrelated spending or misappropriation of funds for private benefit.

Any affiliated transaction with a non-profit will be subject to review for reasonableness and should always be taken into account. Even a transaction that should by all counts be considered reasonable will need to provide adequate documentation as proof of its necessity and that it is aligned with the purpose of the non-profit.

Final Takeaways—Maintain Records and Support Non-Profit Goals

Texas courts have used a variety of factors to inquire and inspect the evidence used to support transactions, the relationship to the entities, the financial impact of the transaction, as well as a comparison to other similar entities. As such, all of these factors need to be considered by any organization preparing to transact with a non-profit. These cases indicate that non-profits need to be aware of the impact of their affiliated transactions, maintain records of those transactions, and monitor the data of similar non-profits as well.

Additional safeguards that non-profits can consider implementing to ensure compliance with TBOC is to use independent directors to avoid the need to evaluate the contributions of an insider altogether. This allows non-profits to more consciously select contracts based on prices that will align with their charitable goals and will prevent them from overpaying above market price when transacting with an affiliate.

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