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Recent IRS Determination Highlights Importance of Separation Among Affiliates

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A recent action by the Internal Revenue Service highlights the importance of maintaining separateness between an association and its affiliates, particularly with regard to how the entities are portrayed to the public through the Internet.

Background

It has long been understood that related entities could be at risk of a court or the IRS disregarding the separateness between the two entities, even though each entity may have separate corporate and tax statuses, thus creating exposure to potential legal and tax liability to both entities. In such instances, the legal and tax liabilities of a foundation (for example) could become the legal and tax liabilities of its related association, a result which could place the association at greater financial and legal risk. In determining whether to disregard the separateness of two entities, whether with regard to potential corporate or tax liability, courts apply state-based common law (often called "piercing the corporate veil"). [1]

A parent corporation and its subsidiaries generally will be considered separate entities for federal income tax purposes as long as the subsidiary is incorporated for purposes which are the equivalent of business activities or the subsidiary subsequently carries on business activities. Thus, if an entity is organized with a bona fide intention that it will have some "real and substantial business function, its existence may not generally be disregarded for tax purposes." However, if one entity so controls the affairs of a subsidiary that it "is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded." [2]

The general presumption has always been that corporate separateness should be honored, except in extreme circumstances. A determination about whether two organizations' corporate separateness should be disregarded is fact-specific; courts over the years have looked to the following key factors to determine whether two entities are truly separate for tax or liability purposes:

1. Inadequate capitalization of the subsidiary given its business goals and operations;
2. Financial support of the subsidiary's operations by the parent;
3. A joint accounting and payroll system;
4. The subsidiary's lack of substantial business contacts with any except the parent;
5. Commingling of assets;
6. Reference to the subsidiary in financial statements as a division of the parent or to the fact that the subsidiary's obligations are those of the parent;
7. The property of the corporations is used by each entity as if jointly owned;
8. Failure to follow corporate organizational requirements:

    A. No meetings of directors;
    B. Failure to elect officers;
    C. Failure to file annual reports or other required governmental reports;
    D. Failure of the directors or management to approve and control corporate activities;
    E. Failure to maintain minutes of meetings; and
    F. Inadequate allocation of costs and expenses.

As a practical matter, the IRS and courts are very hesitant to attribute the activities of an affiliate to a parent organization or vice versa. [3] In general, the IRS has taken the position that the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide "clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent." [4]

In short, the current state of the law demonstrates that certain common-sense steps can and should be taken to preserve the separateness between an association and its related foundation or taxable subsidiary, and after doing so the risks of having the separateness disregarded can be managed adequately. For instance, while it is generally understood that a majority or all of the directors of the affiliate may be named or appointed by the parent, many organizations will seek to avoid substantial (i.e., majority) overlap of individuals serving on both entities' boards of directors. [5] Also, associations should establish written agreements among affiliates to properly allocate expenses for any shared equipment and services, as well as to address use of trademarks and other intellectual property. Further, it is important that associations properly manage the manner in which communications and activities are attributed, so that it can be clearly understood which entity is responsible for the communication or activity.

Recent Technical Advice Memorandum

A recent IRS Technical Advice Memorandum ("TAM"),[6] highlights the importance of remaining vigilant about maintaining separateness among affiliates. The TAM involved a website shared by an organization exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code ("IRC") and its subsidiary affiliate exempt under IRC Section 501(c)(4). Pursuant to federal tax law, a 501(c)(3) organization is strictly prohibited from engaging in political campaign activities; such activities are, however, permissible for 501(c)(4) organizations. At issue in the TAM was whether, due to the affiliates' shared website, the IRS would attribute the political campaign communications of the 501(c)(4) organization to the 501(c)(3) organization, thereby potentially jeopardizing the parent 501(c)(3) organization's tax-exempt status.

In order to avoid certain technical problems and duplicative costs associated with maintaining separate websites, a decision was made to house the 501(c)(4) organization's website within the 501(c)(3) organization's website. The affiliated organizations underwent an expense allocation process to ensure that the 501(c)(4) organization paid for its share of expenses associated with the site. In addition, each web page that was being used by the 501(c)(4) affiliate had a heading that included the 501(c)(4) organization's name. However, there were a number of aspects of the website arrangement that the IRS cited as blurring the line between the two affiliates. Notably:

- Every web page in the 501(c)(3) organization's website, including those pages reserved for use by the 501(c)(4) organization, contained a banner with the 501(c)(3) organization's logo and electronic links along the top, left side, and bottom;
- Every web page in the 501(c)(3) organization's website, including those pages reserved for use by the 501(c)(4) organization, included a disclaimer notice and a copyright notice for the 501(c)(3) organization;
- The only visual distinction between the 501(c)(3) organization's pages and the 501(c)(4) affiliate's pages was the inclusion of the 501(c)(4)'s logo and address on the top banner, below the name and logo of the 501(c)(3) parent.

Based on the IRS's description of the shared website, it appears that the 501(c)(3) organization used a template for all pages, which enabled a consistent layout and graphic design across the site with differing content appearing inside the 501(c)(3) "frame." Given the fact that the 501(c)(4) pages looked "virtually indistinguishable" from the 501(c)(3) pages, the IRS concluded that it would treat the statements and communications on those pages as the communications and statements of the 501(c)(3) organization, with potentially significant adverse tax consequences to the 501(c)(3). In effect, the IRS states in the TAM that appending the 501(c)(4) affiliate's name and logo to the 501(c)(3) frame is not sufficient to separate the 501(c)(4) organization's content from the rest of the 501(c)(3) site.

Lessons Learned

The key point to take away from this TAM is not that the IRS has reworked its position with regard to the separateness of affiliated entities. All of the common sense steps that associations take to manage risks in this regard should continue to be taken. Nonetheless, this decision highlights the importance of remaining vigilant about maintaining separateness among affiliates, particularly when it comes to websites. Very often an association will share its base URL with its affiliates and provide links within its website to its affiliates. When doing so, an association should take care to ensure that those affiliate pages are not substantially similar to the association pages in design and appearance. The casual visitor to the site should be able to easily recognize that the page being viewed is for an organization separate from the association. These lessons can and should be applied across all activities and projects of an association and its affiliate—whether online or not. Clear branding of each entity's programs and activities is a vital component of effectively maintaining affiliated entities' separate legal status.

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[1] *See, e.g., Moline Properties, Inc. v. Comm'r*, 319 U.S. 436, 439 (1943) (holding that, for income tax purposes, a taxpayer cannot ignore the form of the corporation that he creates for a valid business purpose or that subsequently carries on business, unless the corporation is a sham or acts as a mere agent).

[2] IRS Priv. Ltr. Rul. 2002-25-046 (Mar. 28, 2002), citing *Moline Properties*, 319 U.S. at 438; *Britt v. United States*, 431 F. 2d 227, 234 (5th Cir. 1970); and *Krivo Indus. Supply Co. v. National Distillers and Chem. Corp.*, 483 F.2d 1098, 1106 (5th Cir. 1973).

[3] *See* Rev. Rul. 58-293, 1958-1 C.B. 146 (holding that a bar association recognized as exempt under Section 501(c)(6) of the Internal Revenue Code ("IRC") may form a separate and related IRC Section 501(c)(3) fund); *see also*, IRS Priv. Ltr. Rul. 2001-32-040 (Aug. 13, 2001) (holding that the formation and operation by an IRC Section 501(c)(3) organization of a wholly-owned for-profit subsidiary will not give rise to concerns about the separateness of the two entities).

[4] IRS Priv. Ltr. Rul. 2001-32-040 (Aug. 13, 2001).

[5] Note, however, that even where a subsidiary's board is solely comprised of directors from the parent organization, separateness may still be honored. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,776 (Feb. 6, 1989). Furthermore, IRC Section 509(a)(3) specifically contemplates that an IRC Section 501(c)(3) supporting organization to an IRC Section 501(c)(6) parent organization will have at least a majority of its directors appointed by the parent organization.

[6] IRS Tech. Adv. Mem. 2009-08-050 (Feb. 20, 2009).