PERILS IN CONSOLIDATING FINANCIAL STATEMENTS OF EXEMPT ORGANIZATIONS

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When both entities are tax exempt, and one is a 501(c)(3) charity, accountants should think twice before consolidating.

The accounting standards that govern consolidation, set by the Financial Accounting Standards Board (FASB) in its Codification of Standards ("the Codification"), provide that when two entities are sufficiently related, their financial statements should be consolidated into a single statement presenting the combined financial picture of the two entities as if they were one entity. When both entities are tax exempt, and only one is a 501(c)(3) charity, accountants should think twice before consolidating, however.

Section 501(c) allows many different types of nonprofit organizations to be generally exempt from paying federal income tax. Each type has a different core function that forms the basis for its exemption, and is subject to different rules and restrictions on its operations in order to qualify for exemption. As a result, engaging in a range of activities on the most tax-advantaged basis often requires using nonprofits with different tax statuses operating in tandem.

For example, public charities exempt under Section 501(c)(3) are by far the most common type of exempt organization, and receive the most favorable tax treatment, but sometimes find that the vigorous pursuit of their charitable missions demands that they participate in the development of public policy affecting their constituents. Federal tax law, however, restricts the amount of lobbying that a charity may conduct, and prohibits charities from conducting any partisan political activity.[1] To address these limits, many charities create an affiliate entity with a different tax-exempt status (specifically under Section 501(c)(4)).

Similarly, organizations exempt under other Code sections, such as social welfare organizations exempt under Section 501(c)(4), labor unions exempt under Section 501(c)(5), and business leagues or trade associations exempt under Section 501(c)(6), are subject to less restrictive limitations on their activities than charities are, but also receive less favorable tax treatment. In particular, even if they conduct charitable activities, their contributors cannot take a deduction for their gifts. To gain access to charitable funding sources, a non-charity may therefore form a Section 501(c)(3) affiliate to engage in activities consistent with both charity status and the interests of the non-charity.

Such affiliation arrangements can take a wide variety of forms, but in a typical tandem exempt organization relationship, one entity ("Parent") exercises strategic control over the

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other ("Affiliate") through the authority, set forth in the Affiliate's governing documents, to select and remove at least a majority of the Affiliate's directors. Such high-level control ensures that the two organizations continue to work in a complementary way (within their respective tax statuses, of course), even though they operate, on a day-to-day basis, as independent legal entities.[2]

The effective separation of entities, which is essential to the preservation of the tax status of the charity (whether Parent or Affiliate), will be unnecessarily undermined if the financial statements of affiliated exempt organizations are consolidated in circumstances where the Codification does not require, nor in some cases even permit, consolidation. This can be problematic for both Parent and Affiliate. For a charitable Affiliate, improper consolidation may suggest that the non-charity has control over and access to the charity's assets for noncharitable purposes. For a charitable Parent, improper consolidation can mislead the public about the charity's activities, suggesting that the charity engaged in activities inconsistent with its tax status that were actually conducted by its noncharitable affiliate. Such a misimpression may increase the charity's risk of IRS audit, cause unnecessary concern to existing or potential funders, or generate adverse publicity.[3]

Tandem exempt organizations under federal tax law

As noted above, an organization that is recognized as exempt from federal income tax under Section 501(c)(3) may receive deductible contributions but is subject to strict limits on certain types of activities, including lobbying and partisan political activities. The former must be insubstantial or within the limits stated in Section 501(h), while the latter are strictly prohibited. The U.S. Supreme Court, in *Regan v. Taxation with Representation*, 461 U.S. 540, 51 AFTR2d 83-1294 (1983), described both tax-exempt status and the availability of tax-deductible contributions, as "a form of subsidy that is administered through the tax system."[4]

To qualify for recognition under and the benefits of Section 501(c)(3), an organization must be "organized and operated" for charitable purposes.[5] An organization satisfies the "organized" prong only if its organizing document (e.g., articles of incorporation) limits its purposes to one or more charitable purposes and does not expressly empower the organization to conduct substantial activities not in furtherance of charitable purposes.[6] An organization satisfies the "operated" prong only if it engages primarily in activities that accomplish a charitable purpose.[7] An organization that is operated for the benefit of private interests is not operated for charitable purposes.[8]

Organizations exempt under Sections 501(c)(4)-(6)[9] (as well as most other Section 501(c) organizations) are not eligible to receive contributions that donors may deduct as charitable contributions (although contributions may be deductible as business expenses). However, with the reduced public subsidy come looser reins: the activities of non-charity exempt organizations are subject to fewer restrictions than those of charities (though the exact restrictions vary across the different types of organizations).

In *Regan*, the Supreme Court noted that for purposes of determining whether a charity and its 501(c)(4) affiliate are actually distinct under federal tax law, "[t]he IRS apparently requires only that the two groups be separately incorporated and keep records adequate to show that tax-deductible contributions are not used to pay for lobbying."[10] The Court upheld the lobbying limitation imposed by Section 501(c)(3), ruling that "Congress has not violated [the organization's] First Amendment rights by de-

[1] Section 501(c)(3) provides that to qualify for exemption, "no substantial part of the activities" of an organization can constitute lobbying, and the organization may "not participate in, or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office." A more comprehensive discussion of the restricted activities of public charities is beyond the scope of this article. See Section 501(c)(3) and regulations thereunder. See also Fei and Colvin, "How to Set Up and Maintain an Action Fund Affiliated with a Charity," 15 J. Tax'n Exempt Orgs. 184 (Jan/Feb 2004).

[2] For more information about tax issues associated with tandem exempt organization structures, see Fei and Colvin, *supra*, note 1.

[3] Tandem structures involving a for-profit entity are beyond the scope of this article. In such structures, for example, a company may set up and control a charitable foundation or a charity may create a taxable subsidiary to conduct certain unrelated revenue-generating activities or isolate risky activities (such as owning real estate through a single-member LLC). Some of the issues raised by such arrangements are similar to those raised below, although tandem arrangements involving for-profits typically present several issues not addressed here. Also beyond the scope of this article are tandems in which both entities are charities.

[4] Regan v. Taxation with Representation, 461 U.S. 540, 544, 51 AFTR2d 83-1294 (1983).

[5] Reg. 1.501(c)(3)-1(a).

[6] Reg. 1.501(c)(3)-1(b).

clining to subsidize its First Amendment activities."[11] Justice Blackmun wrote a concurring opinion specifically to point out that the constitutionality of the Code's speech restrictions on Section 501(c)(3) organizations depends on the fact that a 501(c)(3) can establish a non-501(c)(3) affiliate through which to make its views known. As Blackmun wrote, "The constitutional defect that would inhere in § 501(c)(3) alone is avoided by § 501(c)(4).... Should the IRS attempt to limit the control these organizations' exercise over the lobbying of their § 501(c)(4) affiliates, the First Amendment problems would be insurmountable."[12]

Subsequent IRS commentary indicates that the IRS will treat a Section 501(c)(3) organization and its non-501(c)(3) affiliate as separate entities for federal tax purposes if the non-501(c)(3) "observe[s] the formalities of its separate organizational status and deal[s] with the 501(c)(3) at arm's length."[13] The day-to-day operational independence of the two entities, therefore, is fundamental to preserving the distinctions that the Code requires between categories of exempt organizations.

Federal tax law thus forces tandem organizations to operate with a substantial level of independence if they want to realize the tax benefits that the tandem structure is intended to provide. The importance of maintaining sufficient independence for federal tax purposes is heightened when one entity is a Section 501(c)(3) charity because the consequences to the charity of insufficient independence are potentially severe. The question raised by the prospect of consolidating the financial statements of such affiliates, then, is whether the degree of independence required by federal tax law is compatible with the degree of ~~control~~ necessary to trigger consolidation. The authors argue that, in many cases, the answer is "no," and that compliance with tax law precludes consolidation.

Consolidation of financial statements under FASB rules

FASB sets standards for the accounting of transactions and associated disclosures to be contained within financial statements that are to be released to parties outside the organization, including rules governing when the financial statements of separate entities must, should, or may not be consolidated. Consolidation reflects the accounting principle that a financial statement should present

The essential separation of entities will be unnecessarily undermined if financial statements are consolidated in circumstances where the Codification does not even permit consolidation.

"information that portrays the complete financial picture of a group of entities that effectively function as one entity."[14] The goal of consolidation is to prevent the distortion of an entity's financial condition that could result if the organization were to shift assets or liabilities to the books of another entity, even though the first organization actually receives the benefits or bears the risks generated by the activities that the second entity conducts.

As a general rule, financial reporting by nonprofits is intended to provide information "that is useful to ... resource providers ... in making rational decisions about the allocation of resources to those organizations," and that is "about the economic resources, obligations, and net resources of an organization...."[15] More specifically, FASB standards for nonprofit accounting set forth a two-pronged test* under which consolidation is required when one nonprofit entity has *both control over*, and an *economic interest in*, another entity.[16] Importantly,

*This article does not address situations in which one nonprofit entity has a "controlling financial interest" *through direct or indirect ownership of a majority voting interest* or *sole corporate membership* in another nonprofit entity. Consolidation is generally required in such circumstances. See FASB 958-810-25-2.

7 Reg. 1.501(c)(3)-1(c).

8 Reg. 1.501(c)-1(d)(1)(ii).

9 Unlike charities, an organization does not require IRS recognition to qualify for exemption under Section 501(c)(4)-(6). Rather, the organization qualifies for exemption if its activities meet the specific organizational and operational requirements of the appropriate section. Nonetheless, many such organizations do apply to the IRS for recognition, in order to ensure—and to demonstrate to potential donors—that their activities actually do qualify for exemption.

10 Regan v. Taxation with Representation, *supra* note 4 at 461 U.S. 540, 544, note 6.

11 *Id.* at 548. The Court also found the speech restrictions imposed by Section 501(c)(3) did not violate the equal protection clause of the Fifth Amendment, even though another type of exempt organization—veterans groups—are both eligible to receive deductible contributions and not subject to the speech limitations imposed on charities. It found that Congress had a rational basis for favoring veterans organizations. *Id.* at 546-551.

12 *Id.* at 552-53 (Blackmun, J., concurring).

13 Thomas and Kindell, "Affiliations among Political, Lobbying and Educational Organizations," *Exempt Organizations Technical Instruction Program for FY 2000 (1999)* at 260.

14 Gross, McCarthy, and Shelmon, *Financial and Accounting Guide for Not-for-Profit Organizations* (John Wiley & Sons, 2005) at 85.

15 FASB, "Statement of Financial Concepts No. 4," ¶ ¶ 35, 43.

16 FASB Codification 958-810-25-2, -3 (emphasis added).

"the existence of control *or* an economic interest, *but not both, precludes* consolidation."[17]

FASB definition of 'control'

The Codification defines "control" for purposes of consolidation as "the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise."[18] As Justice Blackmun's comment in *Regan* suggests, the purpose of creating an Affiliate typically is to give the Parent the opportunity to accomplish things that it could not accomplish as effectively, or at all, on its own. In most tandem relationships, therefore, the Parent needs strategic control over the Affiliate to ensure that the Affiliate, over time, does not drift away from the Parent and cease to serve the Parent's mission. Although control many not be present in some tandem relationships based on their specific facts, the authors assume, for purposes of this article, that the relationship between the exempt affiliates discussed herein satisfies the "control" prong of the FASB consolidation test.[19]

The central question for such entities then becomes whether the Parent also has an "economic interest" in the Affiliate. If so, then the accounting rules require consolidation. If not, consolidation will be precluded.

FASB definition of 'economic interest'

As defined by FASB, the Parent in an affiliate relationship has an "economic interest" in its Affiliate if "(a) the [Affiliate] holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the [Parent], either directly or indirectly by producing income or providing services, or (b) the [Parent] is responsible for the liabilities of the [Affiliate]."[20]

The Codification elaborates on this general definition via examples indicating that a Parent has an "economic interest" in an Affiliate in any of the following situations:

- The Affiliate solicits funds in the name of and with the approval of the Parent, and substantially all of the funds solicited are intended by the donor or otherwise required to be transferred to the Parent or used at its direction or discretion.
- The Parent transfers significant resources to the Affiliate, which holds those resources "for the benefit" of the Parent.
- The Parent "assigns certain significant functions" to the Affiliate.
- The Parent provides or is committed to provide funds for the Affiliate or guarantees significant debt of the Affiliate.
- The Parent has a right to or a responsibility for the operating results of the Affiliate, or, upon dissolution of the Affiliate, the Parent is entitled to the net assets, or is responsible for the deficits, of the Affiliate.[21]

Applying FASB's 'economic interest' definition

Tandem relationships involving a Section 501(c)(3) charity and another type of exempt organization are, in most cases, inherently incompatible with the existence of an "economic interest" as defined by FASB. In fact, the primary purpose of such a tandem relationship is to exploit the benefits of the affiliates' differing tax status by *separating* their "economic interests," allowing them to pursue different but complementary goals. That ability would evaporate if the entities were to lose their independent (financial) identities. When one of the entities is a charity, federal tax law imposes rules designed to *limit* the existence of an "economic interest" of one affiliate in the other.

Affiliate holds resources for Parent. The first prong of the FASB definition of an "economic interest" is met when an Affiliate holds or utilizes resources that must be used for the purposes of the Parent. When this occurs, consolidation ensures that current and potential future contributors to each entity understand that certain resources held by the Affiliate actually benefit the Parent. Under conditions described by this prong, the presentation of separate financial statements would understate the Parent's financial resources. Consolidated financial statements showing both the assets held or used by the Affiliate and the benefit received by the Parent avoids such errors, providing more ac-

[17] FASB Codification 958-810-25-5 (emphasis added). The existence of either control or an economic interest—but not both—does, however, require certain disclosures to be made about the relationship between the entities. FASB Codification 958-810-50-3.

[18] FASB Codification 958-810-20.

[19] A complete analysis of the factors that determine the existence of "control" is beyond the scope of this article. For a summary of some relevant factors, see Gross et al., *supra* note 14 at Appendix 7-C.

[20] FASB Codification 958-810-20.

[21] FASB Codification 958-810-55-6.

[22] See Fei and Colvin, *supra* note 1.

[23] See Colvin, "The Section 501(h) Election Allows Many Charities to Become Aggressive Lobbyists," 5 J. Tax'n Exempt Orgs. 38 (Jul/Aug 1993).

curate information about the financial condition of both entities.

However, when the Affiliate is a charity but the Parent is not, federal tax law precludes the Affiliate from holding or using resources for the benefit of the Parent, except to an insubstantial degree.

In the authors' experience, the noncharitable Parent usually is a Section 501(c)(4) social welfare advocacy organization, a Section 501(c)(5) union, a Section 501(c)(6) trade association, or occasionally even a Section 501(c)(7) social club. That Parent usually wishes to access charitable and deductible funding sources in pursuit of charitable activities that complement its primary exempt purposes. Such charitable activities may be relatively modest and passive, such as a scholarship fund, or may involve substantial active programs, such as an ongoing public education campaign or professional services provided to charitable classes.

Satisfying the first prong of the "economic interest" test would cause the Affiliate to fail the "operational" test for exemption under Section 501(c)(3) because its activities would confer an impermissible private benefit on its non-charity Parent. Even if, as often occurs in such circumstances, the non-charity Parent provides support to the charity Affiliate in the form of a grant for overhead and administrative support, the Affiliate must retain sufficient discretion to use the grant funds to accomplish its own charitable purposes, and may not use them for the noncharitable purposes of the Parent.

To take advantage of economies of scale, a Parent and its Affiliate often share resources such as staff, office space, equipment, etc., pursuant to an agreement under which the "using" entity (typically the Affiliate) reimburses the "owning" entity (typically the Parent) for its *pro rata* share of the fair market value of the shared resources. Such an arrangement does not (and cannot, consistent with Section 501(c)(3) status) require the Affiliate to use any of its resources to benefit the Parent. On the contrary, fair market reimbursement reinforces the operational independence of the two entities by ensuring that the charitable Affiliate's resources are used only for its own benefit, rather than for the benefit of the Parent. The presence of such a resource-sharing arrangement indicates that the Affiliate does not hold its assets for the Parent's benefit, and so does not satisfy the first prong of the "economic interest" test.

Such reimbursements are often dispensed with entirely when the Parent is not a charity but the Affiliate is, and the Parent may just absorb the Affiliate's overhead and administrative expenses as a form of philanthropic support in addition to any actual donations that may flow from the Parent to the Affiliate. Alternatively, the charity's reimbursements may reflect a discount from full fair market value, again representing the Parent's philanthropic support of its charitable Affiliate. Neither of these arrangements implicates the first prong of the FASB definition because the Affiliate does not hold resources *for the Parent.*

Turning to the reverse situation, it is much less common for the Parent to be a charity and the nonprofit Affiliate a non-charity. Unions, trade associations, and social clubs often find their purposes include purposes that are charitable. This charitable activity could be contained within the Parent consistent with its tax status, but using a charitable Affiliate brings access to the fundraising advantages of Section 501(c)(3) status. In contrast, a charity cannot have any substantial noncharitable purpose. In their practice, the authors have almost never seen a charity Parent with a labor organization, trade association, or social club Affiliate. Accordingly, such tandems are not addressed further here.

The one exception that the authors do encounter regularly arises when a charity Parent forms a Section 501(c)(4) social welfare Affiliate to conduct lobbying and perhaps limited partisan political activity.[22] As discussed above, the Parent's ability to lobby in these situations is limited by Section 501(c)(3)'s requirement that "no substantial part" of its overall activities may constitute lobbying, (except as permitted by Section 501(h)).[23] Similarly, Section 501(c)(3) prohibits any partisan political activity by the Parent. Section 501(c)(4) does not impose the lobbying restriction and the regulations under that section limit partisan political activity only by prohibiting it from being the "primary" activity of the Affiliate. Thus, the Affiliate can lobby without limit, effectively increasing the amount of lobbying the Parent can cause to occur, and can engage in limited partisan political activity. However, the arrangement accomplishes this goal only if the excess lobbying (or partisan political activity) is conducted by the Affiliate on its own behalf. If the IRS attributes the excess lobbying or partisan political activity to the Parent, the Parent will lose the tax advantage of the arrangement, and could put its own tax exemption at risk.

The Affiliate's noncharitable 501(c)(4) status allows it to conduct any activity that a 501(c)(3) organization could conduct. As a result, federal tax law would not prohibit the non-charity Affiliate's resources from being used solely for the purposes of its charitable Parent. However, the charity Parent's purpose in creating a lobbying Affiliate is to expand the repertoire of activities that it may conduct through its Affiliate with non-deductible contributions. Restricting the Affiliate's use of its resources to the charitable purposes of the Parent defeats that purpose by imposing on the Affiliate the same limitations that apply to the Parent. In other words, a charity Parent has no incentive under federal tax law to create a non-charity 501(c)(4) Affiliate under conditions that would satisfy this prong of the "economic interest" test.

Moreover, as noted above, the day-to-day operational independence of tandem entities is a central consideration under federal tax law. If the entities do not operate independently, they will lose the tax advantages sought through the tandem structure. As a result, tandem structures with a charity Parent typically take steps to ensure that each entity conducts its activities on its own behalf and for its own benefit. The Parent may make a grant of charitable funds—within its lobbying limit and earmarked for lobbying—to the Affiliate, but charitable use restrictions will apply only to such granted funds, and it is only these funds that the Affiliate will hold and must expend for the Parent's purposes. The typical lobbying Affiliate will raise substantial noncharitable contributions to support its lobbying work, supplementing the Parent's grant. If the separation of the Parent from the Affiliate has been properly maintained, only the Parent's lobbying grant and not all the lobbying or other activities conducted by the Affiliate will count against the Parent's lobbying limit. (Of course, the Affiliate cannot use the Parent's funds for partisan political activity, and must therefore also raise separate funds for such activity.) The substantiality of funds held by the Affiliate that cannot be used for the Parent's purposes is therefore generally sufficient to defeat application of the first prong of the "economic interest" test in favor of consolidation in this scenario.

If a charity Parent shares resources with its non-charity Affiliate, the resource-sharing agreement with the Affiliate must provide that the Parent will receive at least full fair market value reimbursement for any Affiliate use of the shared resources. Nonetheless, such an agreement does not require the Affiliate to use any of its resources to benefit the Parent so as to trigger consolidation; the Affiliate is merely paying its own way, ensuring that no charitable dollars subsidize its noncharitable activities.

Parent responsible for liabilities of Affiliate. The second prong of the FASB definition of "economic interest" is essentially the converse of the first, requiring consolidation when the Parent undertakes responsibility for the Affiliate's liabilities. In this case, the presentation of separate financial statements in which the Affiliate's liabilities appear on its own books and not those of the Parent would simultaneously present too dismal a picture of the Affiliate's financial condition and too rosy a picture of the Parent's. Consolidated financial statements would correct these errors.

Once again, however, in the typical nonprofit tandem involving a charity, the need for actual operational independence sufficient to preserve the tax-exempt status of both entities usually prevents a Parent from taking general responsibility for the liabilities of its Affiliate.[24]

As a general rule, the corporate form isolates each corporation's liabilities from the other, and precludes the attribution of liabilities to other individuals or entities. This general rule applies unless a purported corporation is actually a mere extension or "alter ego" of another entity or person, rather than a truly independent, if related, entity. Most states honor corporate independence for purposes of isolating liability and reject efforts to "pierce the corporate veil" unless the evidence suggests that honoring the

[24] Although FASB's definition does not explicitly define what it means by "the liabilities of the Affiliate," the authors think that the most fair reading of the phrase is "the liabilities of the Affiliate generally." This interpretation squares with the purposes of the consolidation rules. FASB at least does not intend to require consolidation if the Parent assumes *any* liability of the Affiliate, as such a reading would require consolidation when the amount at issue is not material for accounting purposes.

[25] See, e.g., 9 *Summary of California Law* (10th), Corporations § § 9-15 (Witkin Legal Inst., 2005).

[26] If a non-charity Parent's aggregate contributions to a charity Affiliate are sufficiently large, the Affiliate could risk losing its public charity status and being reclassified as a private foundation. See Section 509. Such a change, however, would have no effect on the question of consolidation.

[27] Of course, when the financial viability of the Affiliate depends on voluntary contributions from the Parent, consolidation could be justified even if not required.

[28] See Rev. Rul. 68-489, 1968-2 CB 210.

corporate form would perpetrate an injustice. Such injustice may occur when, for example, an individual has commingled personal assets with those of a corporation he or she controls in order to shield those assets from personal liability, or when one corporation uses another to evade contractual or statutory obligations.[25]

Under this general rule, the mere fact that two entities are affiliated does not, by itself, make the Parent responsible for its Affiliate's liabilities. In the absence of any evidence that injustice would result from honoring the corporate boundaries between the two entities, the Affiliate will remain responsible for its own liabilities.

Although not required to do so as a consequence of affiliation, a non-charity Parent could choose to take responsibility for some or even all of its charity Affiliate's liabilities, in which case the Parent's expenditures on the Affiliate's behalf would constitute a contribution to the Affiliate. Federal tax law permits a non-charity to make contributions to a charity, regardless of affiliation, so a non-charity Parent would not threaten its tax status or that of its charity Affiliate by making such a contribution.[26] However, such a voluntary undertaking, assuming that each entity fully discloses the arrangement on its own financial statements, is not the same as the legal obligation implicit in FASB's test. The Parent has no such legal responsibility, even if it may choose to assist the Affiliate for philanthropic reasons. In the absence of any legal obligation, separate financial reporting does not distort either entity's financial condition. The mere presence of voluntary payments does not meet the second prong of the "economic interest" test, or otherwise implicate any policy basis that would justify consolidation.[27]

Again, if the Parent is a charity, the analysis is different but leads to a similar result. A charity Parent would suffer significant federal tax consequences if it voluntarily assumed the liabilities of its non-charity Affiliate. Such an arrangement would create risk for the Parent because the Parent could be required by the agreement to pay liabilities that the Affiliate incurred in the conduct of noncharitable activities. The IRS would likely interpret such an agreement as unrestricted support by the Parent of the Affiliate, over which the Parent has failed to exercise control and discretion[28] sufficient to ensure that charitable assets are used only for charitable purposes. Consequently, such an obligation would be incompatible with the Parent's tax-exempt status. The second prong of the "economic interest" test should therefore also not be met where the Parent is a charity and its Affiliate is not.

Applying FASB examples

Under the foregoing analysis, applying the two prongs of the FASB test for consolidation to typical nonprofit tandems involving a charity generally will not permit consolidation. The examples set forth in the FASB Codification, however, identify additional circumstances not explicitly addressed in either prong of the test itself that could justify consolidation. As discussed below, the situations described in the examples will rarely occur in tandem structures involving a charity.

Example (a)—Affiliate solicits funds in the name of and with the approval of Parent, and substantially all of the funds solicited are intended by the donor or otherwise required to be transferred to the Parent or used at its direction or discretion. Example (a) calls for consolidation when the Affiliate functions as a fundraising conduit for the Parent. Under such circumstances, consolidation makes sense because the Parent, not the Affiliate, has discretion over the use of the Affiliate's resources. The presentation of separate financial statements would suggest that the Affiliate's revenue is available to the Affiliate, rather than to the Parent, resulting in an overestimate of the Affiliate's resources and an underestimate of those of the Parent. Consolidated financial statements would make clear that the Affiliate's revenue actually benefits the Parent.

The circumstances described in Example (a), however, are unlikely to arise in a tandem arrangement that includes a charity. If the Parent is a charity and the Affiliate a non-charity, the arrangement described in Example (a) raises the tax inefficiency problem discussed earlier. The non-charity Affiliate would be raising non-deductible funds, which are less restricted but harder to raise than deductible funds, then imposing unnecessary restrictions on them by transferring them to the charity Parent. Donors would be better served by giving to the Parent directly, which would make their contributions deductible as charitable contributions. Under the arrangement described in Example (a), the Affiliate's donors would be contributing funds for charitable purposes without the benefit of a charitable deduction, defeating the purpose of the charity Parent having a non-charity Affiliate.

On the other hand, if the Parent is a non-charity and the Affiliate a charity, the arrangement described in Example (a) would cause two major problems under federal tax law. First, the Affiliate's donors would be unable to claim the tax deduction usually available for contributions to a charity. If a donor makes a contribution to a charity, but earmarks the contribution to be transferred to a non-charity, the IRS will treat the charity as a mere conduit, and treat the earmarked transfer as a gift to the non-charity, eliminating any charitable deduction.[29]

Second, and more importantly, the charity Affiliate would fail the "operational" test for exemption under Section 501(c)(3) and would lose its tax exemption. By raising funds specifically for the use of its non-charity Parent, the Affiliate would be using its charitable resources to provide a private benefit to the Parent. Because, by definition, this arrangement encompasses "substantially all" of the funds solicited for the Parent by the charity Affiliate, the arrangement would be likely to constitute a "substantial purpose" of the Affiliate, and would be incompatible with exemption under Section 501(c)(3).

Accordingly, Example (a) should never apply to a tandem system involving a charity.

Example (b)—The Parent transfers significant resources to the Affiliate, which holds those resources "for the benefit" of the Parent. Though not a model of clarity, Example (b) seems to contemplate an arrangement in which the Affiliate acts as a custodian for the Parent's property, housing "significant" assets such as valuable real or intellectual property. The benefits of this property, such as rents or royalties, redound to the Parent. This arrangement gives the Parent an "economic interest" in the Affiliate because the Parent benefits directly from the Affiliate's ownership of the transferred assets. Such circumstances justify consolidation because reporting the transferred assets on the Affiliate's financial statements only would mislead interested parties about the financial condition of the Parent. The Parent could simply transfer assets to the Affiliate to get them off its books, while retaining both control of the assets and the benefits of ownership.

As with Example (a), the circumstances described in Example (b) are unlikely to arise in a tandem arrangement that includes a non-charity Parent and a charity Affiliate. As shown above, a charity Affiliate cannot use its resources "for the benefit" of its non-charity Parent. Suppose, for example, that the non-charity Parent transfers the title to a building to its charity Affiliate, and requires that the income generated by renting units in the building to various nonprofit organizations be either transferred to the Parent or used by the Affiliate to benefit the Parent.[30] If this function were a purpose of the Affiliate, or a substantial part of its activities, the Affiliate would fail the "operational" test and no longer qualify for exemption under Section 501(c)(3). The arrangement described in Example (b) is therefore incompatible with federal tax law when the Parent is a non-charity and the Affiliate is a charity, and so should never apply to require consolidation.

Example (b) could arise without violating federal tax law, however, in a tandem arrangement that includes a charity Parent and a non-charity Affiliate (which, as noted above, is virtually always a Section 501(c)(4) social welfare organization.)[31] If a charity Parent transfers resources to its social welfare Affiliate, the Parent must restrict the Affiliate's use of the resources to charitable purposes, so the Affiliate would not be able to use the transferred resources to support any noncharitable activities. Typically, these charitable resources would not represent the majority of an Affiliate's assets because, as noted above, such Affiliates typically raise substantial non-deductible funds from sources other than the Parent. This may not always be

29 See Thomason, 2 TC 441 (1943). Such an arrangement can raise other tax problems for donors as well. For example, a large contribution to a Section 501(c)(4) organization may be subject to gift tax under Section 2501, while the same contribution to a charity is not. See Rhomberg "The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions," 15 J. Tax'n of Exempt Orgs. 62 (Sep/Oct 2003).

30 The authors assume, for the purposes of this discussion, that the property is rented only to nonprofit organizations at below-market rates, that it is not debt-financed, and that neither entity would incur unrelated business taxable income from the property.

31 While a 501(c)(4) may operate solely for charitable purposes, an Affiliate whose activities for the benefit of the Parent constituted the Affiliate's *primary* activities would not qualify for exemption under Sections 501(c)(5), (6), or (7), because those sections describe organizations whose exempt purposes are other than charitable.

32 If the Parent's goal in transferring the property is to isolate liability, it may make more sense to establish a wholly owned subsidiary, which need not be tax exempt or might be disregarded for tax purposes, or even another charity, rather than using the Affiliate. Example (b) suggests that consolidation of the financial statements of the Parent and the subsidiary would be appropriate under such circumstances.

33 Specifically, the entity must be organized and operated exclusively for the one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary,

the case, however, especially during a start-up period, when the Section 501(c)(4) Affiliate may have few other resources. Although this situation does not cause the tax-inefficiency problem raised earlier because the resources are similarly restricted in either case, such an arrangement fails to take advantage of the opportunities that the tandem structure presents.[32] Moreover, in some specific circumstances, a Parent could have reasons to create an Affiliate to house the resources, particularly if the resources in question have the potential to generate liability that the Affiliate is in a better position to absorb. Under such circumstances (and assuming that other factors do not undermine the case for consolidation), a charity Parent and its social welfare Affiliate are more likely to be proper candidates for consolidation.

Example (c)—The Parent "assigns certain significant functions" to the Affiliate. Example (c) captures arrangements in which the Affiliate conducts some of the Parent's core operating functions. Such an arrangement warrants consolidation because the activities conducted by the Affiliate are essential to the Parent's ability to accomplish its own purposes, and one cannot evaluate the Parent's financial condition without also understanding that of the Affiliate. Consolidated financial statements would provide the necessary information.

The circumstances described in Example (c) are unlikely to arise in a tandem arrangement that includes a charity. As described above, Section 501(c) sorts exempt entities into categories based on the "exempt purposes" for which each entity is formed and operated. In other words, the distinctions between types of exempt entities result from fundamental differences in the core functions of the respective entities, so that an organization of one type cannot take on the "core functions" of an organization of another type without putting its own tax-exempt status at risk or undermining the goals of the tandem.

For example, to qualify for exemption as a charity under Section 501(c)(3), an entity must be organized and operated "exclusively" for charitable purposes.[33] To qualify for exemption as a social welfare organization under Section 501(c)(4), an entity must be organized and operated for "the promotion of social welfare"[34] (which includes but is broader than charitable purposes). To qualify for exemption as a labor, agricultural, or horticultural organization under Section 501(c)(5), an entity "must have as [its] objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations."[35] To qualify for exemption as a trade association under Section 501(c)(6), an entity's activities "should be directed to the improvement of business conditions of one or more lines of business...."[36] Exemption under Section 501(c)(5) or Section 501(c)(6) permits charitable activity that furthers the required purposes, but does not include charitable purposes.

In the case of a Parent labor organization (the most common Section 501(c)(5) organization) or trade association (exempt under Section 501(c)(6)) with a charity Affiliate (exempt under Section 501(c)(3)), the Parent may not assign any significant labor union or trade association functions to its Affiliate because doing so would cause the Affiliate to impermissibly serve the private interests that the Parent was established to promote. The Parent's core functions are incompatible with the Affiliate's tax-exempt status as a charity, and therefore the circumstances described in Example (c) cannot arise in a tandem relationship of this type without threatening the charity Affiliate's tax exemption.

In the case of a charity Parent (exempt under Section 501(c)(3)) with a social welfare Affiliate (exempt under Section 501(c)(4)), the problem is tax inefficiency, rather than tax incompatibility. Charitable activity falls within the definition of "social welfare," so the Affiliate could undertake the core functions of the Parent without exceeding the boundaries of Sec-

educational, or prevention of cruelty to children or animals. Reg. 1.501(c)(3)-1(d)(1). Although the term "charitable" is included in this list, the regulations clarify that the term "is used in Section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in Section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of 'charity' as developed by judicial decisions." Reg. 1.501(c)(3)-1(d)(2). Thus, the various exempt purposes set forth in the regulations are often referred to collectively as "charitable."

34 Reg. 1.501(c)(4)-1. The regulations further define "social welfare" to include "promoting in some way the common good and general welfare of the people of the community" and "bringing about civic betterments and social improvements." Reg. 1.501(c)(4)-1(a)(2).

35 Reg. 1.501(c)(5)-1.

36 Reg. 1.501(c)(6)-1. Unlike an organization exempt under Section 501(c)(3) or (4), which would be prohibited from engaging in substantial activities that benefit any private interest, an organization exempt under Section 501(c)(6) is specifically created to promote the private business interests of those in the relevant line of business.

tion 501(c)(4). As we have seen, though, doing so defeats the Parent's purpose in creating the Affiliate by constraining the Affiliate's activities to the Parent's more restricted purposes. In addition, shifting the Parent's core functions to the Affiliate would weaken the boundary between the two entities and risk collapse of the tandem structure for federal tax and general liability purposes. Thus, when the Parent is a charity and the Affiliate a social welfare organization, the circumstances described in Example (c) are unlikely to arise.

Similar inefficiency results when the Parent is exempt under Section 501(c)(4) and the Affiliate is a charity. The transferred core functions would be subject to the charitable purpose restrictions of the Affiliate, and the Parent would lose the ability to apply those core functions to its non-charitable goals.

Example (d)—The Parent provides or is committed to providing funds for the Affiliate or guarantees significant debt of the Affiliate. Example (d) contemplates circumstances in which the Parent uses its own resources to sustain the Affiliate. Under such circumstances, weakness in the Affiliate's financial condition would directly affect the Parent's financial condition by requiring or encouraging the Parent to provide additional resources to the Affiliate. Consolidation is justified under these circumstances because the presentation of separate financial statements would provide interested parties with incomplete information about the Parent's finances.

By its terms, Example (d) appears to encompass a tandem relationship in which the Parent transfers *any* funds to its Affiliate. One must remember, however, that the Example simply illustrates the application of the FASB definition of "economic interest," which requires a much closer relationship than a single, or even occasional, transfer of funds. In the context of the definition, Example (d) is best understood to address arrangements in which the Parent indirectly takes responsibility for the liabilities of the Affiliate by providing the Affiliate with the resources it needs to satisfy those liabilities, rather than by assuming, contractually or otherwise, a direct legal obligation for the Affiliate's liabilities, as is contemplated by the second prong of the FASB definition.

Moreover, if a mere grant from a Parent to an Affiliate sufficed to justify consolidation, the resulting financial statements would produce a wildly distorted picture of the economic relationship between the two entities, resulting in confusion rather than clarity. As noted earlier, federal tax law requires affiliated exempt organizations to maintain separation in their day-to-day operations, particularly when one entity is a charity. Accordingly, the Affiliate must make and implement its own, independent decisions about the use of the grant funds for its own purposes.[37] Thus, once the grant is made and the funds become an asset of the Affiliate, the Parent no longer has any financial interest in the funds, and the funds are properly reflected on the Affiliate's separate financial statement.

For example, when a charity Parent makes a grant to its social welfare Affiliate to support the Affiliate's lobbying activities, the charity "provides funds" for the Affiliate. In the authors experience, however, this usually does not happen on a scale or for the purposes contemplated by the FASB definition of "economic interest." Indeed, Section 501(c)(3) provides that lobbying cannot be a "substantial part" of the Parent's overall activities, so the grant to the Affiliate, in combination with any other lobbying expenditures the Parent incurs during the fiscal year, cannot be too large. The social welfare Affiliate, on the other hand, is not subject to any limitation on its lobbying activities. In many cases, the Affiliate exists specifically to conduct more lobbying than the Parent is permitted to conduct. If the grant alone, regardless of its size, were sufficient to trigger consolidation, the consolidated financial statement would blur the distinction between the Parent's lobbying expenditures and those of the Affiliate, creating confusion and risk to the charity Parent, with-

[37] Of course, the Parent may impose some restrictions on the purposes to which the Affiliate may put grant funds, but the Affiliate must maintain discretion and control over how to best to accomplish those purposes.

[38] These donated "back office" services are not the same as the "core functions" discussed under Example (c), above. Their donation by Parent to Affiliate runs in the opposite direction, and should not be interpreted to justify consolidation under Example (c).

[39] The FASB definition of "economic interest" is limited to nonprofit Parents, but allows room for Affiliates that are not nonprofit entities. See FASB Codification 958-810-20. Thus, the FASB definition, and therefore Example (e), could apply to a nonprofit's ownership interest in, for example, a for-profit subsidiary.

[40] Reg. 1.501(c)(3)-1(b)(4).

[41] Although a noncharitable recipient could theoretically be selected to hold the assets for charitable purposes, in practice this rarely occurs.

out providing any material information about the financial condition of either entity.

A similar analysis typically applies when the Parent is a non-charity, such as a trade association exempt under Section 501(c)(6), and the Affiliate is a charity. A grant from the trade association to the charity, without more, does not create any material "economic interest" of the type contemplated by the FASB definition. Consolidation would needlessly obscure the charity's basis for tax exemption by grouping the trade association's other expenditures (which benefit the private interests of its members) with the charity's charitable activities (which cannot benefit private interests).

Another common source of funds flowing between Parent and Affiliate arises when the two entities seek to realize operational efficiencies by sharing resources such as office space, equipment, and staff.

Much like a grant, this contractual arrangement does not necessarily create the kind of economic interdependence the FASB definition of "economic interest" targets. Each entity spends its own resources for its own purposes, and neither entity is necessarily dependent on the other as a result of the arrangement.

One special case, however, may lead to a different result. Structures described above have included tandem structures in which a Section 501(c)(6) Parent has a charity Affiliate and provides the Affiliate with all of the administrative support the Affiliate requires. Rather than seeking reimbursement through a resource-sharing agreement, the Parent essentially donates the value of these administrative services such as reception, payroll, clerical support, etc., which are necessary to the Affiliate's ability to operate. Under such an arrangement, the Parent's support is qualitatively different from a grant, because the Parent actually controls some essential functions of the Affiliate. This greater degree of involvement by the Parent may be sufficient to establish an "economic interest" in the Affiliate, and therefore justify consolidation under Example (d).[38] (Federal tax law prohibits this type of arrangement if the Parent is a charity, because the contribution of services to a non-charity Affiliate would constitute unrestricted support for the Affiliate's non-charitable activities, in violation of the "operational" test's requirements.)

Finally, Example (d) indicates that consolidation is required when the Parent indirectly supports the Affiliate by guaranteeing its "significant" liabilities, as opposed to providing it with the funds necessary to satisfy those liabilities. This part of Example (d) thus contemplates an application of the second prong of the FASB definition of "economic interest," under which the Parent accepts a legal obligation to pay the "significant" debts of its Affiliate. As noted in the discussion of the second prong of the definition, federal tax law prohibits a charity Parent of the definition sundertaking such an obligation to benefit its non-charity Affiliate. However, a non-charity Parent could take on such an obligation to benefit its charity Affiliate without violating federal tax law, and doing so could justify consolidation under Example (d).

Example (e)—The Parent has a right to or a responsibility for the operating results of the Affiliate or, upon dissolution of the Affiliate, the Parent is entitled to the net assets, or is responsible for any deficit, of the Affiliate. Example (e) seems to contemplate an arrangement in which the Parent has an equity interest or its equivalent in the Affiliate, such that the Parent is entitled to the Affiliate's net revenue or responsible for its net loss. Such an arrangement may arise if, for example, the Affiliate is a limited liability corporation of which the Parent is a member.[39] The equity interest concept, however, does not apply to an interest in a nonprofit entity because, by definition, a nonprofit entity is not owned by anyone, and no person or entity has a right to or responsibility for its operating results, at least as that concept is applied in the context of business relationships.

Example (e) also requires consolidation if, upon dissolution of the Affiliate, the Parent is entitled to the Affiliate's net assets or responsible for its net liabilities. If the Parent is a non-charity and the Affiliate a charity, the Affiliate's governing documents must provide that its assets are irrevocably dedicated to charitable purposes and that, upon dissolution, the Affiliate's net assets will be distributed for charitable purposes.[40] Such a provision is necessary to satisfy the "organizational" part of the test for exemption under Section 501(c)(3), and typically requires that the net assets be distributed to a charity. If the Affiliate's articles of incorporation include such a provision, the non-charity Parent will be barred from receiving the Affiliate's net assets upon dissolution, and the dissolution element of Example (e) will not apply.[41]

If the Affiliate is a non-charity and the Parent a charity, the now-familiar tax efficiency problem resurfaces. If the Affiliate's articles of incorporation required the distribution of the Affiliate's noncharitable assets to the charity Parent, those assets would lose their less-restricted, noncharitable character, and become subject to the more restrictive rules governing assets held by a charity. It would be much more efficient for federal tax purposes for a social welfare Affiliate to have the flexibility to transfer its net assets upon dissolution to another non-charity with a similar mission, so they can be used to continue the Affiliate's noncharitable work in support of the Parent's goals. Trade associations, unions, and social clubs typically transfer their assets on dissolution to their members, not to a charity. In any event, these entities are not, in practice, structured as Affiliates of charity Parents.

Conclusion

Superficially, tandem relationships involving a charity and a noncharitable nonprofit may appear to be appropriate candidates for consolidated financial statements. Affiliated non-profit entities often have some directors in common or operate under common control, and may share staff, office space, and other resources. Their missions are typically tightly intertwined, and their activities are often complementary. This close relationship is often preserved through governance structures that satisfy the "control" prong of the FASB test for consolidation. That is why, for purposes of this article, the authors have assumed that the tandem relationship satisfies the "control" prong.[42]

As shown above, in many cases the federal tax rules governing exempt organizations ensure that a charity Parent and its non-charity Affiliate, or a non-charity Parent and its charity Affiliate, will operate with a degree of independence that is incompatible with the "economic interest" prong. Consequently, most such tandem arrangements do not present the requisite "economic interest," and therefore fail the FASB test for consolidation.

The consequences of unnecessary or inappropriate consolidation can be severe, particularly for the charity. Consolidated financial statements can mislead donors, supporters, the IRS, and others about the nature and extent of the charity's activities.

Therefore, before presenting consolidated financial statements, managers of such affiliated organizations and their accountants should thoroughly consider whether the relationship between the entities actually satisfies both prongs of the FASB test for consolidation. In many cases, the facts required to satisfy the "economic interest" prong will conflict with the charity's continued exemption under Section 501(c)(3). In other cases, facts meeting the test for consolidation would eliminate the benefits of having a tandem arrangement. In either situation, in the authors' experience, a close examination often reveals that the affiliated relationship does not trigger, or even permit, consolidation under the FASB standards. ■

[42] Of course, the specific facts and circumstances of a given arrangement may *not* satisfy the "control" prong.