Corporate Restructuring—Do You Need It?

How do you know when to restructure? And how do you decide which new structure suits you best?

BY PETER BRINCKERHOFF

One problem that arises with many nonprofits is how to retain their income so that a funder won't come after them. *Sometimes* corporate restructuring is the answer.

Another problem that you may have wrestled with is how to separate business income from your mission income. *Sometimes* corporate restructuring is the answer.

A third problem that may surface is how to appeal to a donor who wants to be sure that your main governmental funder won't use the donation for operations. *Sometimes* corporate restructuring is the answer.

Note that all three of these examples emphasize the word *sometimes.* This is because corporate structures are valuable tools to have in your management tool kit but not ones to apply every day. They are expensive, effective, confusing, and dangerous. For many organizations they prove a real benefit. For just as many they become an albatross.

This article explains how to sort out the differences. Let's begin by examining the most important question:

DO YOU REALLY NEED TO RESTRUCTURE?

Your organization is a corporation under one of the 501(c) parts of the IRS code. You may work for a (c)(3), a (c)(6), or a (c)(9), but if you're like 90% of nonprofit managers, your organization is a standalone corporation. That fact provides you with opportunities to be involved with other corporations if the situation demands it. Thousands of nonprofits have a second, third, or even fourth corporation associated with the "parent" entity, and many are successful in achieving their organizational goals more efficiently as a result.

And many aren't. The first rule of corporate structures is: ***Keep it simple.*** If you can achieve what you want in a simple configuration or, better yet, without an additional corporation, do it.

Why? Because every additional entity is expensive. Managing the finances, governance, accountability, and staffing of more than one corporation is a big investment of time and money.

Therefore, before you develop a new corporation, ask yourself: Is there a compelling reason (or, better, a number of reasons) to start this new entity, or can I do what I want within our existing corporation(s)? Usually, the answer is the latter.

WHAT'S THE BEST STRUCTURE FOR YOU?

Once you're sure you need to restructure, you must choose among a variety of methods. Let's examine the types of corporate structures and the advantages and disadvantages of each.

1. Additional Nonprofit Entity

The most common additional corporation is a second nonprofit entity. These are usually set up as "foundations" to support fundraising or as vehicles to hold property or staff.

Main Uses:

- Foundations for fundraising and development
- Property-holding corporations, designed to maximize rental income from funders, while achieving the benefits of ownership
- Corporations required for funding.

For Example:

A child welfare organization wanted to set up a foundation to harbor its $4.5 million endowment and to be a vehicle from which to attract

Nonprofit World • Volume 19, Number 5 September/October 2001
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (608) 274-9777
www.danenet.org/snpo

larger donations. The rationale for a separate entity was that the main funders of the organization were more and more interested in having the organization spend its own money first, before receiving funds for providing services, and the board and staff feared that their hard-earned endowment would be lost.

Additionally, more and more large donors were aware of this potential conflict. They wanted to make sure that their donations didn't go into the state's general revenue fund.

So the organization set up a foundation as a 501(c)(3). It then donated its endowment to the new entity, with a restriction: The donation could be used only to support the original entity.

Why did it need this restriction? Because the foundation was not fully controlled by the child welfare organization, a condition required by its funders' regulations, and not uncommon throughout the nation.

Advantages:

- A nonprofit is much less likely than a for-profit to raise eyebrows.
- You can have a tax exemption in a nonprofit, if you do things that support your second entity's mission statement. In a for-profit, you pay tax on profit, no matter what you're doing.
- You know how to run a nonprofit.

Disadvantages:

- Second (and third and fourth) entities cost money.
- You will have to keep separate records—*very* carefully.
- You'll have to set up a new board of directors.
- You'll need an audit every year.

Issues to Consider:

- Will you really benefit from all the extra paperwork?
- Is the new entity necessary?
- Does it support your mission?
- Does it enhance your empowerment?

2. For-Profit Subsidiary

In this configuration, a nonprofit establishes a separate corporation that is designed to make a profit. Since for-profit corporations are owned by the stockholders, the stock is held in ownership by the nonprofit (and controlled by the nonprofit's board of directors). The for-profit board is elected by the shareholder (the nonprofit); the for-profit does its business, has income, subtracts expenses, and pays tax on any profit. After-tax profits can be distributed to the nonprofit as stock dividends and aren't taxed again as unrelated income.

Main Uses:

- To attract funds or tax breaks only available to for-profits
- To allow for unusual compensation for staff
- To defuse accusations of unfair competition from competitors.

For Example:

A nonprofit set up a print shop to provide employment for homeless people in an inner city. They found that it was much cheaper, even with the taxes they had to pay, to do it as a for-profit.

Why? The 2% 10-year funding to encourage growth in the "enterprise zone" helped, as did the tax abatement on city taxes for five years, the tax credit for each five jobs created, and other incentives that the city, the Small Business Administration, and the county provided, including $150,000 of printing business in the first six months. None of these would have been available to a nonprofit.

Advantages:

- It's a very common format for a business—understandable to a lender.
- A great deal of incentive financing and start-up capital is available for new businesses that promise new jobs.
- You have flexibility in attracting others to the venture or in compensating certain staff (using the stock).

Disadvantages:

- You *always* pay tax on profits, even if what the for-profit does is related to your mission.
- It's an unusual structure for a nonprofit and often causes political trouble with staff, board, funders, or donors.

Issues to Consider:

- There is often a lot of political fuss over a for-profit subsidiary. Your funders think you have a scam on; your donors assume that since you have a for-profit, you must now be made of money and no longer need their donations, etc.
- Don't even think about selling stock to someone else to raise capital. You must keep control of your for-profit, and that means owning *all* the stock. Stockholders, even minority ones, have rights that you might find surprising, such as the right to see all your books at any time. Check out these rules carefully.

3. Umbrella Corporation

Main Uses:

- To provide a central management and policy entity for multiple corporations that support the umbrella.

For Example:

A multiple-service nonprofit in the South provided a wide variety of services. These included low-income residential sites (through HUD), traditional mental health services, a for-profit subsidiary to employ people with chronic mental illness, and consulting to other providers throughout the state.

To maximize its income through all its funders, and to acquiesce to the various organizational regulations its funders imposed, the nonprofit formed an umbrella corporation. This corporation encompassed the following organizations: a controlled subsidiary 501(c)(3) to provide services, another for each HUD project, a for-profit subsidiary for the employment agency, and a final 501(c)(3) that housed all the employees.

Employee time was then sold at cost to most of the other organizations. The umbrella corporation had the policy board, signed most of the contracts, and purchased employee services as needed.

This admittedly complex arrangement worked very well. Why? *Because there was a specific need for each corporation, and the need was great enough that the cost of running the separate entity was justified by either the savings or the additional income.*

Advantages:

- If set up correctly, this structure allows a lot of flexibility.
- You can place property, people, and profits in separate entities.
- You have the ability to adapt this structure in the future.

Disadvantages:

- These set-ups are complex, costly, and look weird to board, staff, and funders.
- The accountability requirement is high. Paperwork, contracts, invoices, and accounting must be of the highest caliber.
- People will ask questions, and you must be prepared to answer them in a "squeaky clean" manner.

Issues to Consider:

- If you think you're going to be adding corporations at some point to your current configuration, try to plan out the entire configuration now, and fit the pieces in as needed. If you talk now with an advisor about how to establish the various entities, you can save yourself time and money later on. But do this only if there is a *compelling* reason for each entity you establish.

4. Cooperative

Cooperatives are funny animals but surprisingly common. You see them all the time without realizing it. A purchasing co-op for raw materials, a fruit growers' cooperative, a grain elevator—all have the same basic components.

A cooperative is a for-profit venture that has shareholders. Unlike a standard corporation, however, the cooperative board is elected by the shareholders without regard to how many shares they hold; small or large, each shareholder has the same number of votes. But when profits are distributed, they are proportional to ownership.

Main Uses:

- Bringing groups of people or organizations together to do business more efficiently and to purchase expertise, goods, or services that they could not do individually.

For Example:

A group of social service providers on the West Coast needed to reduce the cost of transporting all their varied clientele each day. A committee analyzed where costs could be cut and decided that scheduling, maintenance, and purchasing of vehicles, fuel, and parts were costing too much on an agency-by-agency basis.

A cooperative was established, and each agency invested its vehicles and some cash. Scheduling, maintenance, and purchasing were all centralized. A full-time mechanic was hired, as was a manager. A building that had housed an old tire dealership was purchased and used for maintenance.

The quality of maintenance, done in-house for the first time, went up. Costs went down. All the organizations, whether they had 150 vehicles or five, had an equal say in policy decisions. When profits were distributed after three years, the dividends were not distributed evenly but based on participation in the vehicle pool.

Advantages:

- There is one essential advantage for a cooperative. Organizations that invest in it all have the same representation on the board. Thus it is a very appealing set-up for collaboration and partnership between organizations of different sizes.
- Most funding incentives (low-interest loans, tax breaks) that are available to for-profit corporations are available to cooperatives.
- There is even a specialized bank set up to help cooperatives (the National Cooperative Bank in Washington, D.C.).

Disadvantages:

- If you have the biggest investment, you don't have the most control. At a large organization, this may be a tough sell to a board of directors.
- As with a for-profit corporation, you always pay taxes on any profit.

Issues to Consider:

- If you have a number of organizations that want to get together but the size differences between the smallest and largest is getting in your way, you may want to consider using a cooperative. While not a household word, cooperatives are very common. Some Fortune 500 organizations are cooperatives (Sunkist, Land O' Lakes).

KNOWLEDGE IS POWER

In choosing a corporate structure, keep your mission in mind. Remember, one of the key reasons you want multiple corporations is to empower your organization. Keep focused on the outcomes you want. Get outside help from people who are experts in the issues that are important to you.

Restructuring is not a panacea for keeping what you earn or avoiding irrational funding policies. But restructuring is one tool you need to know about, and to use if necessary.

That's the most important message for any nonprofit: Knowledge is power. Knowledge helps you to be flexible and to use the best tool at the best time to get the most mission out of your decisions.

Corporate structuring is one of those tools. Specialized, expensive, but, in the correct circumstances, incredibly effective. Use it sparingly. ■

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