Comparing Entity and Tax Status Options for Egalitarian Communities

Presented by Attorney Tiffany Clark, at 2013 Twin Oaks Communities Conference, Labor Day Weekend

About me and disclaimer: In part because I'm licensed to practice law only in California, I can't offer any legal advice, or form any confidential/attorney-client relationships at this conference (or anywhere, without a conflicts of interest check and a written, signed attorney-client agreement). *However*, I can and will offer *general* legal information. But it's only partially researched, and may not be accurate generally, let alone applicable to your area or situation. Given this, I *strongly* urge *each* of you serious about forming a community to do all the research you want to do on your own first, but *ultimately* get *thorough* legal and tax advice from a lawyer licensed in your state, who's expert in at *least* tax, entity formation, and employment law. I have found, through painful personal experience that an ounce of prevention is worth a *ton* of cure when it comes to tax and legal matters. Feel free to pass this handout along to your lawyer or others, in its entirety and at no cost, except to extent a brief, fair use quote – otherwise please ask me first). I also invite you to subscribe to my blog (www.tiffanyclarklaw.com/blog), for updates on this research, in addition to other posts that may be of interest.

What is an egalitarian community? My version: a residential income-labor-property sharing community, which gives every member an equal voice and support, but provides more support for some, if/as need dictates. For more, see list at http://thefec.org/taxonomy/term/3.

Entity and tax status options I've considered – *more* or *less*:

- *More* - **501(d)s**: Typically a mutual benefit corporation, formed at the state level, which then receives tax treatment pursuant IRC Sec. 501(d) (which states, I part, 501(d)s are ". . . [r]eligious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received."). Although I'm disappointed about outside income limitations with 501(d)s, I believe most communities will find they are the easiest, least expensive, least risky option.
- *More* - **Partnerships**: Partnerships can be individuals who came together, but I'm using the term to refer to a legal entity that has opted to be treated as a partnership for tax purposes. The entity is often a Limited Liability Company, formed at the state level, which then opts for tax treatment per IRC Secs. 701-777 and regulations. I researched this option extensively, because there's an egalitarian community out there using this structure. I have many concerns about it though, some of which I'll cover in what follows.
- *Less* - **501(c)(3)s**: A 501(c)(3) is an entity formed at the state level that achieves highly beneficial tax treatment (by satisfying the requirements of IRC Sec. 501(c)(3)), including the ability to solicit donations that are tax deductible for donors. Unfortunately, due to limitations on members and other "interested parties" benefiting personally from 501(c)(3) charitable, educational, or other public benefit contributions (beyond reasonable compensation), I believe this would be a highly risky, if not impossible option, at least without extremely careful, probably undesirable structuring. However, certain associations with 501(c)(3)s might work. See offsetting benefits bullet under 2nd bulleted objection, below.
- *Less* - **Housing cooperatives**: More research needed. But, from what I have done, it appears as though there's too much focus on individual ownership of shares, as well as other potential obstacles to egalitarianism.
- *Less* - **Worker cooperatives**: More research needed. So far, I have similar concerns with worker coops that I do with with partnerships and housing coops, although intriguing element allowing members to split profits based on number of hours worked, versus amount of money invested or amount they're paid.

How I overcame most of my objections to the 501(d) – by discovering more info, that alternatives were the same or "worse," and/or offsetting benefits:

- ***I don't consider myself "religious" or even "spiritual," so I'm not sure about forming a "religious or apostolic" community***
  - Reassurance via more info**:** Both the IRS, and case law I'm aware of thus far, indicates that only beliefs *strongly held* are required, even if they're secular beliefs, such secular humanism. See, e.g., *Twin Oaks v. IRS,* 87 TC 1233 (1986) and IRS Manual 7.25.23.
  - Reassurance with offsetting 501(d) benefits**:** Perhaps coming to agreement on common beliefs might bond community members. Also, I value the deference some courts give to entities with a "religious" purpose.
- ***I'd love my community to have the option of subsisting just off of the land and donations for its non-profit, gift economy work***:
  - The trouble is two-fold. First, the IRS claims a 501(d) must have at least one business or the like. IRS Manual 7.25.23, etc. Second, donations to 501(d)s aren't income or gift tax deductible for donors, as they are for 501(c)(3)s. IRS Manual 7.25.23, etc..
  - Reassurance via more info: However, the "even if" language of section 501(d) itself doesn't seem to support the IRS' claim, although this might be upheld based on legislative history, and there's still the lack-of-tax-deductible donations problem.
  - Reassurance via learning partnerships (and other non-501(c)(3) entities) are worse. There is no doubt in tax law that partnerships *have* to be organized for the primary purpose of engaging in a profit-focused businesses, trade, or investment. Standard Federal Tax Reporter 2013 (SFTR) ¶ 25,041 et seq., etc., and are also not eligible for tax deductible donations.
  - Reassurance via offsetting benefits: A possible silver-lining option, although complex and risky, is the option of trying to have a 501(d) *community* hired to provide a *separately incorporated* 501(c)(3) with goods or services. Careful legal/tax planning would be key. Having the community live indirectly off of doing non-profit work is easier for non-egalitarian communities, like Occidental Arts and Ecology Center's affiliated Sowing Circle community, because they can go the simpler route of having members hired on as *employees* of OAEC, without violating 501(d)s no-substantial-outside-income rule (discussed below).
- ***I'd like my community to have the option of relying exclusively, or at least "substantially" on members' "outside income," without negative consequences, like risk to tax status or extra taxation.***
  - *Intro to the "outside income" issue*

- What is "outside income": "Outside income" is income *earned* by a member working as an agent or employee of a *non-501(d)-owned* entity, then *contributed* to the member's 501(d). IMPORTANT NOTE: Per the "assigned claims" or "assignment of income" doctrine, n*o check-writing tricks, labels, or contracts can transform outside income* being earned by members who are in fact acting as agents or employees of *non-501(d)-owned* entities. This long-standing doctrine, prevents high-income-tax-bracket earners from shifting the extra tax burden off themselves, via attempting to do a pre-tax "assignment" of their higher-tax-bracket income, to family members or entities to whom they owe payment. See IRS Rev. Ruling 1980-332 and SFTR ¶ 2150.78, 2200 ("assigned claims") and 6650 ("income and profits after assignment").
- Why might a community wish to *maximize* outside income without penalty? It would be nice to at least have the *option* to rely "substantially" on the outside income of 1) especially high-earning employees of outside entities, who love their jobs, and/or 2) high-earning *licensed professionals* (e.g., lawyers, accountants, general contractors), who are often prohibited by state law from serving clients from within entities not limited exclusively to their profession (e.g., 501(d)s that do more for income than provide that one type of licensed service). *Subsidiary ownership* of outside licensed professional corporations by the 501(d) has not worked, to the extent I've heard. *For example*, the Farm's 501(d), The Second Foundation (TSF), failed to convince the Tennessee Bar Association to go for this idea, with respect to its attorney members.
- Why might a community wish to *minimize* outside income? In addition to the reasons discussed below, some communities might want to have the kind of community bonding they believe could better come through everyone working physically and mentally together, on-site, for community-owned businesses.

o *Problem #1 - Risk to tax status:*
- The trouble is, the IRS claims a 501(d) must not receive "substantial" support from outside income. See IRS Rev. Ruling 1980-332 ("if an organization is substantially dependent on wages earned by some of its members from outside employment, rather than on an internally operated business, it does not qualify for exemption from federal income tax under section 501(d) of the Code. See Rev. Rul. 78-100, 1978-1 C.B. 162," also citing related case *Riker,* 224 F2d 220 (9th cir 1957) (finding net profits of a business taxable income to the *business*, even if all proceeds contributed to another entity, if the receiving entity does not itself *own* the business, even if that entity completely *runs* the business).
- Reassurance via more info:
  - I do not believe this IRS position has been challenged in court. If it was, it might not stand.
  - It may be that 501(d) members *could* contribute to their 501(d)s, in *"substantial"* amounts, outside income specifically designated and used as *"capital contributions*." I believe "substantially dependent" may be interpreted by courts as to mean only substantially dependent for ongoing *income*, where "capital contributions" are not considered "income," but rather investments in 501(d) businesses that might then *produce* ongoing income. See IRC sec. 118; SFTR ¶7200). This would be particularly valuable at the start-up of a 501(d), when investment would be essential to provide initial business infrastructure. More research needed.
    - *However*, the "income" label may be unavoidable, if members are considered customers of the 501(d), because they receive goods and services from it. That said, the exact same issue exists with partnerships. For both, see SFTR relevant ¶s re "capital contributions."
- Partnerships (and even worker coops) may be worse:
  - At least with 501(d)s, the IRS appears to effectively concede that an "*insubstantial*" amount of direct support of 501(d) members can come from outside income, without jeopardizing its tax status. A partnership's tax status, on the other hand, would be at risk I believe, if *any* outside income was being used to just effectively *re-distribute equitably* amongst partners, for non-business-justifiable, egalitarian purposes (rather than business-infrastructure investment or start-up-businesses-justified cash-flow purposes). *This is because*, in contrast to 501(d)s, partnerships (and even worker coops) must have a *primary* purpose of furthering a partnership-owned *trade or business* (or investment, for partnerships), with support to member-partners being provided *only* to the extent of 1) each member's investment-based share of profit generated *by* those profit-focused endeavors (rather than redistribution of the outside income of partners), and 2) what each member "deserves" as *"reasonable* compensation" for their profit-focused services. See SFTR ¶s 25,041 et seq.
- Offsetting benefits: As suggested earlier, it might help bond community members to work *together*, in on-site, 501(d) businesses, to generate most of their income.

o *Problem #2: Extra Taxation* (for the following, when no citation, see generally See SFTR ¶s 25,041 et seq and citations at definition of "outside income," above):
- The trouble is, outside income is subject to *"double-taxation"* (at least to the extent it's considered "income" and not a "capital contribution" to the 501(d) – see more below). That is, outside income is taxable *first*, to the member who earns it, and then *again*, to the 501(d). And, as noted earlier, *no check-writing tricks, labels, or contracts* can make members who are in *fact* acting as agents or employees of non-501(d)-owned entities can make "outside income" otherwise.
- Partnerships are probably *much* worse:
  - BOTH involve *first*-level taxation on outside income: The *earner* of outside income is almost *always* going to be taxed at the *first* level, because of a long-standing, long upheld prohibition on the "assignment of income."
  - BOTH involve *second*-level taxation (aka, "*double taxation*") on outside income, at least when the IRS considers it *income* to the entity: That is, when outside income is deemed "income" versus a "capital contribution" (see next bullet). So, the entity will likely be taxed (albeit pass through style, meaning each member will pay taxes on their taxable share of that outside income) when outside income: 1) is used directly for the non-profit-focused purpose of egalitarian personal

support of member-partners ongoing personal expenses, v. for investment in entity businesses; or 2) is effectively just a payment by a member-partner-customer for goods and services – big risk, so research more.

- BOTH likely can *limit* double-taxation on outside income when it qualifies as a "capital contribution," at least usually: As noted earlier, "capital contributions" to profit-producing assets of partnership-owned businesses are not usually subject to tax. For reasons discussed earlier, there's reason to think the same could be true for 501(d) corporations as well.
  - HOWEVER, WITH PARTNERSHIPS ONLY, WHICH MAY IMPEDE EGALITARIAN DECISION-MAKING, capital contributions *must* buy more interest/ownership: Double-taxation is avoided *only* when capital contributions, by a contributing partner, *buy* them a larger share of *interest* in the partnership: See See SFTR ¶ 25,240 (re "nonrecognition"). This could lead to undue influence in decision-making, since partners have a *right* to a return of their interest/capital contributions, upon departure or liquidation, with only some caveats/mitigation possible.
- PARTNERSHIPS ONLY have excess taxation problem in that, in *addition* to being taxed on their share of partnership net income like 501(d) members are, partnership members-partners are taxed on *any* cash or in-kind benefits they *actually* receive from partnership (even if that value is *more* than their taxable share of the partnership's net profits),. This difference is a result of differences in both governing statute language and purpose. Section 501(d) makes it clear that, the primary purpose of a 501(d) is to support community members living their religious or apostolic beliefs together. Even *though* 501(d) members are clearly understood to enjoy full, and often relatively unconditional, support by the 501(d), they are explicitly *only* taxed on their equal share of net 501(d) income, not at all on the fair market value of what they *actually, personally* receive. But most businesses, including partnerships, don't work that way. Full and equal support of partners is not contemplated, let alone an acceptable primary purpose. Rather, because their primary purpose is to generate profit, it's assumed that anything given to any worker-partner is either profit or compensation – and so fully taxable. Saying it's a gift won't likely ever fly (see more later).
  - WHY SUCH A PROBLEM FOR PARTNERSHIPS: If a 501(d) grows a million dollars worth of food for its own members' consumption, none of the value of that, freely given to members, would be taxable to them. By contrast, in a partnership, each partner would likely owe income tax on the fair market value of any partnership-produced food, etc., he or she consumed, beyond a very token, fringe benefit level, and beyond value of what already taxed for that partners distributable share of partnership business/investment profits.
  - However, as discussed below, if partners are willing to structure themselves to be considered *employee*-partners, with all the accompanying negatives of that, AND on-site food and housing can be justified as a reasonable profit-producing, business expense, this extra taxation could be offset somewhat, via 1) partnerships being able to deduct, as a business expense, at least the expense it lays out for partner on-site housing and food; 2) partners not having to claim as compensation the fair market value of that food and housing. See more in employment discussion below.
- ANOTHER HUGE, PARTNERSHIP-ONLY NEGATIVE – *triple* taxation possible: Any "unreasonable compensation" received by a partner will be taxable to the partner, as hinted at just above. *But,* to the extent "*unreasonable*," it *won't* be tax deductible to the partnership, meaning each partner will also pay tax on their interest-based *share* of any additional net partnership income resulting from not getting to *deduct* the unreasonable compensation. See See SFTR ¶s 25,041 et seq, ¶ 8640 (re excessive compensation), and case law such as case cited at next bullet.
- MOREOEVER, UNFORTUNATELY, CALLING INCOME A "GIFT" WON'T LIKELY WORK TO REMEDY ANY OF THE ABOVE: The IRS typically only considers money received a valid, gift, non-taxable to the recipient, when there is a family connection, or at least there aren't any arms-length, particularly profit-production-related benefits, going regularly back and forth between donor and donee. SFTR ¶ 5500 et seq, etc.. As the tax court put the last point, ". . . if services have been performed for the payor directly or for him indirectly, as where he reaps substantial benefits from them, it is ordinarily presumed that the amount received is for the services and is not a gift. [citations omitted] Such presumption is particularly strong [but not only existing] where the employer-employee relationship exists. [citations omitted] And this is not overcome merely by showing that the payments were not treated as expenses by the payor. [citations omitted]." *Laurie v. IRS,* 12 TC 86 (1949) (need to cite check this case for more recent holdings).

- ***I'd like community members to have the option of enjoying the arguable "benefit" partners can obtain: Being eligible to earn Social Security and Medicare credits for their entity work AND BECOMING so eligible by having members considered self-employed/partner-like and so subject to the appx. 15%* self-employment *tax, NOT by being considered "employees," and so subject to possibly onerous state employment laws (in addition to equivalent total 15% payroll taxes)***
  - The trouble is, state employment laws can be deal-breakers for communities. Workers compensation insurance can be expensive. And imagine settling in CA, and having to pay for most 501(d) hours worked as a *cash* minimum wage? But, at the same time, it also might be nice for members to be *able* to earn eligibility for Social Security and Medicare through their work for 501(d) businesses. Yet, *even if employee-status was desired on balance,* the IRS claims 501(d) members *cannot* be considered employees (however, see what I discovered under reassuring info bullet below). IRS Manual 7.25.23 And both the IRS and cases I have read have confirm that members cannot be considered eligible for the other Social Security and Medicare path: paying *self-employment* tax, because 1) 501(d) members don't act like real partners, since they're not primarily after profit; and 2) they're paid in dividends, which aren't claimable as self-employment income. So, it sounded to me like 501(d)s had no choice, i.e., there was just no way for their members to earn Social Security and Medicare benefits through 501(d) work. HOWEVER, keep reading.
    - BTW, federal law validates this reality about dividends. See SFTR ¶ 32,543, et seq. And, to make matters worse, despite the rumor going around, nothing indicates non-eligible dividend income can be legally "converted" into self-employment income

via any mechanism whatsoever. This is the case, *notwithstanding* the Farm's 501(d)'s practice of encouraging members to claim their dividends as self-employment income. Unfortunately, TSF has been unable to provide me any legal support for this practice, and in my extensive research I found nothing but flat out prohibition of it.

- o Some reassurance via correcting false info:
  - Despite all the above, 501(d)s *may*, in some regions, in fact *have* a choice of being considered employees and thereby owing 15% tax payments to earn Social Security and Medicare – although it *would* usually mean structuring the 501(d) treatment of members in certain, arguably less egalitarian ways, and arguing *for* employment law status, with *all* the negatives might entail. Despite IRS protest, at least one 501(d) *wanted* employee tax status for its members, all considered, and *succeeded* in arguing for it in federal court. *Stahl v. US,* 861 F.Supp.2 1226 (9th Cir. 2012). And at least one state court has upheld a finding of employee status for 501(d) members as well. *Big Sky Colony, Inc v. Montana Dept of Labor,* 291 P.3d 1231 (2012).
  - The reason the 501(d) community in *Stahl* argued *for* employee status was to achieve the other benefit available by going the employee-status route: on-site food and housing expenditure deductibility from 501(d) income for federal income tax purposes, lowering taxable income share to be claimed by each member (although this may not be a needed benefit, given shares are usually so low to begin with).
- o Reassurance via finding partnerships are better *and* worse (see SFTR ¶s 25,041 et seq and ¶ 32,543 et seq.)
  - When it comes to Social Security and Medicare eligibility partners are better *and* worse. Partners can almost always earn Social Security and Medicare eligibility through their partnership work. So partnerships are "*better*," in that they and/or the partners will *get* to pay appx. 15% in extra taxes and enjoy accompanying benefits. Of course, the offsetting "*negative*" is that they'll *have* to pay those extra taxes, whether the community or partners want that or not. That takes away choice for communities. By contrast, 501(d)s will typically have more control over whether or not they'll be subject to that requirement-eligibility, based on how they structure treatment of members.
  - When it comes to communities wanting to *avoid* employee tax status *partnerships may be worse*. Although partners tend to have a good chance of being considered non-employees generally, technically it *all* depends on how the partnership treats them. By contrast, in *addition* to being able to prove non-employee status based on member treatment, 501(d)s might avoid employee status simply because they're paid in *dividends*, and/or because of typical law/court *deference* to religious entities and/or non-profit mutual benefit corps.
  - When it comes to wanting employee status for the federal deduction of food and housing benefit but NOT wanting to pay the 15% tax for Social Security and Medicare credits, partnerships are worse. That's because, unlike with partnerships, federal law allows religious organizations to opt out of the 15% tax based on incompatible beliefs. IRC Sec 1402(e).
- o Putting all this together – what is a 501(d) to do?
  - How to determine if employee status is *worth* it: With expert legal assistance, I recommend communities *carefully* research, consider, and compare the mixed factors: 1) the arguably non-egalitarian aspects of some of the member-treatment policies that might be needed to obtain member-*employee* status (see next bullet); 2) state employment laws, and just how onerous they really are in your state (I'm guessing in *Stahl*, the 501(d) decided the federal deductibility benefit was worth taking on employee status for members because employment law in their state wasn't all that onerous); 3) the federal tax law *benefit* of members being deemed employees: business-justified, on-site food and housing costs for members deductible from 501(d) income for federal income tax purposes; 4) the option of striving for *employee* status for the food/housing deductibility, but then opting *out* of the 15% tax towards Social Security and Medicare option per IRC Sec 1402(e); 5) ideas about what else might be done with 15% of income, to create an old-age safety net, created, run by, and/or invested in by co-members you *trust* instead; 6) Benefits of such a community-provided old-age care system, in terms of security and emotional bonding of members; and 7) the security for members of knowing they can change their *mind*s, decades into community life and not then be without any care in their old age, if Social Security and Medicare has been earned.
  - How to obtain employee status for members if desired: Check out the *Stahl* case for ideas about the kinds of factors a community can futz with to achieve employee status for its members, as well as relevant state and other cases, as factors can vary depending on who's determining "employee" status, and for what purpose. For example, at least per *Stahl*, requiring a set amount of work hours increases the likelihood of being assigned the "employee" label. And allowing member expulsion for failure to live up to work expectations also increases the likelihood.

Conclusion: While I believe that the 501(d) option is likely the best one for most egalitarian communities, I am particularly disappointed that no options appear to allow the ease, flexibility, and security of maximizing outside income, without risk to tax status or extra taxation. Still, I am determined to continue my research into how to make egalitarian communities as easy, flexible, and secure as legally possible. Feel free to keep up with my research, on this and like topics, by subscribing to my blog, at www.tiffanyclarklaw.com/blog.

Sources for further research (in additional to retention of expert legal counsel): Public law libraries and Google Scholar are great. Less so Google and Nolo books (sometimes available at public law libraries). While you can get some general info through Google and Nolo, often it's wrong, out-of-date, or not relevant. So, I'd pretty quickly move on to Google Scholar (for law review articles) and the closest public law library to you (for good legal treatise sets, like "SFTR," the *Standard Federal Tax Reporter* - although I recently discovered this is a CA-specific source). You can then follow up on cases, codes, and regulations cited therein, using the law library, Google (sometimes), and/or Google Scholar (note: once in a Google Scholar document, click "How Cited" to find more recent materials, to help you decide if the case or other source you found is still good law. However, please *always* rely on an expert lawyer for the final word on *anything* you find, as there are many *non*-obvious tricks to assessing the validity and applicability of sources found.