Options for Social Enterprise: Using Nonprofit/For-profit Combinations to Drive Mission

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BKD Not-for-Profit Seminar
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Agenda

1. A Changing Landscape: Overview of Social Enterprise
2. Options for Nonprofit/For-profit Combinations
3. Key Considerations for Choices in Structure
4. Case Study: Real Life on a Changing Landscape
A Changing Landscape
What is Social Enterprise?

“A nonprofit venture that combines the passion of a social mission with the discipline, innovation and determination commonly associated with for-profit businesses.”

—Nonprofit and Philanthropy Good Practice Center
What is Social Enterprise?

“Social enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas.”

—Social Enterprise Alliance
What is Social Enterprise?

“At its core, a social enterprise, whatever else it is or is not, is a businesslike activity that is designed, at least in part, to do good, and not simply to generate profits.”

—Robert Wexler
Why Social Enterprise is Gaining Momentum

- Mission-focused organizations
- Results-driven social entrepreneurs
- Adaptation of business tools and techniques
- Association of corporate and social benefits
What’s on the New Landscape?

- Old business structures may be insufficient
- New business structures are still in development
- Creative nonprofit/for-profit combinations allow social enterprise to benefit from both worlds
Opportunities on the Way?

- Internal (e.g., marketing)
- External (e.g., collaborators)
- Opportunities and complications abound!
- Know your options and identify key considerations!
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Nonprofit/For-profit Combinations
Nonprofit/For-profit Combinations

Three Options:

1. Parent-Subsidiary Relationship
2. Brother-Sister Relationship
3. Joint Venture (e.g., partnership)
Parent-Subsidiary Relationship

- Nonprofit parent creates for-profit subsidiary
  - Business corporation
    (taxed as C corporation; avoid S corporations!)
  - Single member LLC
    (taxed as C corporation vs. disregarded entity)
  - Hybrid “benefit corporation”
    (taxed as C corporation; required to consider interests other than profit under state law)
Parent-Subsidiary Relationship

- For-profit parent creates nonprofit subsidiary
  - Traditional “company” foundation
    (classified as “private foundation” for tax purposes)
  - Newer company-affiliated charity
    (classified as “charity” for tax purposes; meets public support test)
Brother-Sister Relationship

- Nonprofit and for-profit entities linked together by:
  - Overlapping directors or management
  - Licensing agreements
  - Resource-sharing agreements
  - Joint operating agreements
  - Other agreements

- Each entity serves active, distinct role in enterprise
- **No** sharing of net profits
Joint Venture

- Nonprofit and for-profit entities enter into joint venture
  - Partnership
  - Multi-member LLC
  - Hybrid “low-profit LLC” (referred to as “L3C”)
  - Other profit-sharing arrangements

- Sharing of net profits
Nonprofit/For-profit Combinations

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Key Considerations
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1. Funding sources
2. 501(c)(3) purpose
3. Intra-enterprise transactions
4. Commercial nature of activities
5. Separate and independent identities
6. Pass-through entities
7. Private foundations
8. Investment of charitable capital
9. Transparency
10. Charitable solicitations
1. What are the funding sources?

- Will funders require a 501(c)(3) recipient?
  - Itemizers who intend to claim 170 charitable deduction
  - Private foundations which prefer to avoid “expenditure responsibility” requirements
  - Some governmental entities and corporate sponsors

- Will funders require a “piece of the pie”?
  - Equity position
  - Stock option or similar security
  - Net profits interest
1. What are the funding sources?

- Will the enterprise rely primarily on program revenues?
  - “Exempt function” income, if conducted directly by charity
  - Taxable income, but operate on break-even basis
  - Taxable income and pay taxes

- Will the enterprise pursue “crowd-funding”?  
  - High volume, small contributions (generally not deducted)
  - Examples: Kickstarter.com, IndieGoGo.com, RocketHub.com, text messaging campaigns
2. Will the enterprise (or certain activities) further a 501(c)(3) purpose?

- If yes, consider brother-sister combination or joint venture, and be prepared to demonstrate:
  - How enterprise (or specific activities) furthers clearly defined 501(c)(3) purpose
  - Separate and distinct identity of charity in enterprise
  - No intent by charity to further either for-profit’s purposes (presumed non-charitable) or joint purposes of enterprise (unless clearly 501(c)(3))
2. Will the enterprise (or certain activities) further a 501(c)(3) purpose?

- If no, consider parent-subsidiary combination, or be prepared to demonstrate:
  - Enterprise activity is “insubstantial” relative to charity’s overall activities
  - Compliance with UBIT rules
3. Are intra-enterprise transactions involved?

IMPORTANT:
Charities may not unduly benefit private interests, especially those of “insiders” (and related persons) who exercise substantial influence over charity

(Known as “private benefit” and “private inurement” doctrines)
3. Are intra-enterprise transactions involved?

- Identify, evaluate and document each transaction
  - Do charity insiders (or related persons) have an interest?
  - Is the financial consideration reasonable? (comparability data, appraisals, compensation studies, fairness opinions)
  - Are the other material terms fair and reasonable? (length of term, options for early termination, penalties, guaranties, indemnification)
3. Are intra-enterprise transactions involved?

- Consider how each transaction will be approved
  - Independent directors
    (preferably a majority of board)
  - Strong conflict of interest policy
  - IRS process for establishing
    “rebuttable presumption of reasonableness”
    (careful due diligence, approval by disinterested directors, contemporaneous documentation)
4. Are the activities commercial in nature?

IMPORTANT:
Enterprise (or specific activities) will not be considered to further a 501(c)(3) purpose if conducted too similarly to a commercial enterprise

(Known as “doctrine of commerciality”)
4. Are the activities commercial in nature?

- Distinguish 501(c)(3) activities from commercial activities, for example:
  - Reduced fees/sliding scale for low-income users
  - “Customer” base consists of a charitable class (e.g., low-income or distressed individuals)
  - Reliance on “subsidies” to support enterprise (e.g., grants vs. exempt function income)
5. Will the entities maintain their separate and independent identities?

IMPORTANT:
To be treated as separate entities for tax purposes, each entity must (1) be formed with a bona fide intention to have real and substantial function, and (2) not be a mere arm, agent, instrumentality or integral part of the other

(Known as the “alter ego doctrine”)
5. Will the entities maintain their separate and independent identities?

- Avoid 100 percent overlap of directors and officers (aim for majority of independent directors)
- Observe corporate formalities (maintain separate meetings, minutes, bank accounts)
- Interact at arm’s length (document any resource sharing by written agreement)
- Demonstrate separate roles / purposes
6. Is a pass-through entity contemplated?

- Joint ventures involve special concerns
  - Exempt and non-exempt JV activities attributed to partners/members
  - JV must meet special “organizational requirements” for activities to be considered 501(c)(3) (charity control over 501(c)(3) objectives, priority of charitable objectives over profit objectives)
  - Income passes through in its original character (exempt function income vs. taxable income)
6. Is a pass-through entity contemplated?

- S corporations should be avoided!
  - Profit/loss automatically subject to UBIT
  - Gain/loss on stock disposition automatically subject to UBIT
7. Is a private foundation involved?

**IMPORTANT:**
Use of private foundations should be avoided due to severe rules imposed on private foundations and associated penalties

(Known as the “private foundation rules”)
7. Is a private foundation involved?

- Self-dealing rules prohibit many intra-enterprise transactions
  (charities: intermediate sanction rules merely regulate)
- Excess business holding rules prohibit > 20% ownership of for-profit entity
  (charities: no comparable restriction)
- Taxable expenditure rules prohibit all non-charitable expenditures
  (charities: “insubstantial” non-charitable activity permitted)
- And more!
8. Will charitable capital be invested?

- **UPMIFA and fiduciary considerations**
  - Program-related investment: investment made primarily to further 501(c)(3) purpose, with no significant profit motive (below-market terms are appropriate)
  - Mission investment: investment furthers 501(c)(3) purpose, but is not necessarily its primary purpose (consider prudence requirements and fiduciary duties)

- **Tax considerations**
  - Potential private benefit as to for-profit investors
  - Potential impact on ability to carry out 501(c)(3) purposes
9. Is the for-profit prepared for the type of transparency required of a charity?

IMPORTANT:
Form 1023, Form 990 and Form 990-T are public documents!
9. Is the for-profit prepared for the type of transparency required of a charity?

- Form 1023: requires numerous disclosures as to intra-enterprise transactions, including copies of documents
  - Alert for-profit partner
  - Exercise caution in confidentiality covenants
  - Seek IRS protection of confidentiality, if necessary and possible
9. Is the for-profit prepared for the type of transparency required of a charity?

- Form 990: requires numerous disclosures as to affiliated entities and intra-enterprise transactions
  - Schedules L and R mandate disclosure of affiliate relationships and transactions with affiliates and insiders
  - Even more disclosure mandated for controlled entities (> 50% ownership), and no Form 990-EZ allowed
  - Compensation paid by related entity generally reflected
10. Charitable solicitations implications?

- Enterprise involvement may expand charity’s own obligations
- State registration rules may snag for-profit
  - “Charitable organization” definition can encompass non-exempts that make charitable appeals or solicitations
  - Commercial co-ventures and charitable sales promotions rules can apply if goods/services sold with representation it will benefit charity
- 50-state compliance may be necessary
Key Considerations

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Some Other Considerations

- Exit strategy – tax and practical considerations
- Potential application of securities laws
- Potential application of additional unrelated trade or business income tax (if charity controls for-profit entity (> 50% ownership), certain non-taxable passive income becomes taxable)
- Potential loss of postal privileges
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Case Study
Conclusion
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