

**Social Enterprises: Tax Implications**

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The movement towards social enterprises that we've seen in the last decade is beginning to reshape both the nonprofit and for-profit sectors—with nonprofit charitable organizations looking more and more like for-profit entities and vice versa, the rise of joint ventures between nonprofits and for-profits, and increasing numbers of for-profit entities creating and controlling affiliated charities. Nonprofit organizations are moving towards social enterprise structures in an effort to increase revenues as they face simultaneous challenges of uncertain philanthropic funding, diminishing governmental funding, unstable fundraising revenues, and increased competition for limited resources. For-profit entities are similarly operating in an increasingly competitive market and are seeking to differentiate themselves and generate goodwill by self-identifying as social enterprises, sustainable businesses, and/or certified B corporations. At the same time, social entrepreneurs are moving towards sector agnosticism and away from the traditional model of pursuing charitable goals through standard nonprofit structures.

As the differences in the activities of nonprofit and for-profit organizations continue to blur with the increasing commercialization of charities and the growth of socially-purposed taxable entities, the nonprofit sector will see stronger pushback from regulators and critics. The Internal Revenue Service (“IRS”) will place greater scrutiny on unrelated business taxable income; nonprofits will respond with increased use of taxable subsidiaries; and critics of the “hybrid” entities (such as the benefit corporation) will become increasingly vocal, warning legislators not to give preferential treatment to such entities because of the risks of charity-washing (*i.e.*, developing goodwill by aligning your product with a charity) and encouraging attorney general oversight.

As a result of this shifting regulatory environment, boards of directors of nonprofit organizations seeking to launch social enterprise ventures must ensure thorough compliance with the applicable laws and regulations and should give careful consideration to the legal structure best suited to the goals and needs of the organization prior to initiating any such venture.

**Earned Income and Social Enterprise**

Earned income is clearly central to the success of for-profit entities, but it has also long been an important source of revenues for many nonprofit organizations. As nonprofits move increasingly more towards earned income and social enterprise models, the rules governing

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unrelated business taxable income will become even more central to the decision-making considerations of boards of directors.

### **Nonprofit Organizations**

According to the National Center for Charitable Statistics, in 2011, U.S. public charities reported over \$1.59 trillion in total revenues.<sup>3</sup> Of this, only 22 percent came from contributions, gifts, and government grants, while 72 percent came from program service revenues (including government fees and contracts) and an additional 6 percent came from other sources, including dues, rental income, special event income, and gains or losses from goods sold.<sup>4</sup> The increased attention being paid by nonprofit boards to social enterprise and earned income strategies is in part the result of waning charitable contributions, grants, and government funding, combined with increasing operating costs and demands for charitable services. Although we have started to see an increase in charitable giving as we've seen growth in the U.S. economy, the *Giving USA 2013 Report Highlights* note that, “[w]hile total charitable giving is growing, if it continues to grow at current rates, giving will not reach the high of \$344.48 billion in 2007 for at least six years (adjusted for inflation).”<sup>5</sup> Given the current conditions, it is not surprising that nonprofit boards are looking for untapped revenue sources. Rather than venturing into a completely unknown area, boards are often advised to earn revenues by expanding existing areas of service within the organization. However, in determining whether this is the appropriate course of action for an organization, it is important for a nonprofit board to consider, among other things, whether such activities will generate revenues subject to the unrelated business income tax (“UBIT”).

### ***Related vs. Unrelated Business Income***

From a federal tax perspective, earned income of nonprofits is categorized as either related or unrelated income. Unrelated income (after deducting expenses directly connected to the business producing the unrelated income) may be subject to UBIT, at rates equivalent to for-profit tax rates, which should be factored into the business plan. Moreover, and more fundamentally, under the commerciality doctrine, an exempt organization cannot engage in a substantial amount of unrelated business activity without risking the loss of its 501(c)(3) tax-exempt status. While some advisors use a general rule of thumb that generating less than 20 percent of an organization's gross income from unrelated business activities is likely permissible, there is no exact amount or percentage of business activity that constitutes a “substantial amount.” In determining whether the substantiality limit has been crossed, it is more important to consider the percentage of organizational resources (e.g., assets, staff hours) that are devoted to the unrelated business activity.

To be considered unrelated business income, the income must be generated by an activity that constitutes (1) a trade or business, (2) that is regularly carried on, and (3) is not substantially

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<sup>3</sup> The Urban Institute, National Center for Charitable Statistics, *Quick Facts About Nonprofits*, available at: <http://nccs.urban.org/statistics/quickfacts.cfm>.

<sup>4</sup> See <http://nccs.urban.org/statistics/quickfacts.cfm>.

<sup>5</sup> The Lilly Family School of Philanthropy at Indiana University, *Giving USA 2013: Highlights*.

related to the furtherance of the organization's exempt purpose.<sup>6</sup> Whether an activity is a *trade or business* turns on whether it is carried on for the production of income from selling goods or performing services, and is conducted with a profit motive. An activity is *regularly carried on* if conducted with similar frequency and continuity with which a for-profit conducts the same activity. This means that a one-time fundraising event, such as a car wash or a charity auction, if not regularly carried on, will not generate unrelated business income. Finally, the revenues will only be subject to UBIT if the business activity is *not substantially related* to the organization's exempt purpose. This third factor is often the most difficult factor to analyze and involves a highly fact-sensitive inquiry. To be substantially related, the activity must contribute importantly to accomplishing the organization's exempt purpose other than through the production of income, and whether the generated income is used to fund charitable programs is irrelevant to the determination.<sup>7</sup> This prohibition on looking to the manner in which generated income is spent reinforces the underlying rationale of UBIT—to prevent tax-exempt organizations from having an unfair competitive advantage over for-profit entities engaging in the same business activity.

### ***Exceptions to Unrelated Business Income***

Federal law provides multiple exceptions for activities that may otherwise be considered to generate unrelated business income subject to taxation. Some of the more common of these exceptions include income generated from business activities for which substantially all of the work is performed by volunteers; a business carried on primarily for the convenience of an organization's members, students, patients, officers, or employees; a business selling merchandise if substantially all of the merchandise has been donated to the organization; and the distribution of low-cost items as part of charitable fundraising efforts.<sup>8</sup> Another exception applies to qualified sponsorship payments made to an exempt organization if there is no arrangement or expectation that the payor will receive any return benefit in connection with the payment. Although benefits such as goods or services of an insubstantial value or use of the donor's name or logo are acceptable, sponsorship payments differ from advertising (which is not excepted from UBIT) in that any such acknowledgment of the payor must include only value-neutral descriptions of products or services and the content should be controlled by the organization rather than the payor. There are also exceptions from UBIT that generally apply to certain forms of passive income, including real property rental income; interests, dividends, and annuities; royalty payments; and certain capital gains from the sale of property.<sup>9</sup>

### **For-Profit Entities**

In contrast to nonprofit organizations, for-profit entities may be operated for any legal purpose, including a charitable purpose. They are assessed a federal tax on their net income, but this may be of little consequence if they make no profit. Also in contrast to nonprofit organizations, for-profit entities are not subject to prohibitions on private inurement or private benefit; self-

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<sup>6</sup> Internal Revenue Code ("IRC") Section 513. See also IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, available at: <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

<sup>7</sup> Treas. Reg. 1.513-1(d)(2).

<sup>8</sup> IRC Section 513(a), (h).

<sup>9</sup> IRC Section 512(b).

dealing rules; restrictions on lobbying or political campaign activities; or 501(c)(3)-like public disclosure requirements.

These regulatory differences add up to give for-profits the advantages of increased freedom in their business operations, greater privacy, and the ability to attract equity capital and investors. In the context of operating a social enterprise, however, a for-profit business form may also have disadvantages of lower public trust and a diminished capacity for attracting philanthropic capital.

### **Current Landscape**

It is helpful for any nonprofit board contemplating engaging in a social enterprise venture to have a strong understanding of the current landscapes of both the nonprofit and for-profit sectors.

### **Nonprofit Sector**

The IRS has shown increasing concern that earned income is not being properly reported or allocated by exempt organizations. In May 2013, the IRS released its *Colleges and Universities Compliance Project Final Report*, culminating a multi-year project evaluating tax-exempt colleges and universities for compliance in the areas of unrelated business income and executive compensation.<sup>10</sup> In conducting its evaluation, the IRS found that approximately 90 percent of the 34 colleges and universities it had examined were underreporting their unrelated business income, totaling approximately \$90 million worth of additional unrelated business taxable income. According to the Report, the primary reasons for the underreporting of unrelated business taxable income were (i) reporting losses (and using them to offset unrelated business income) from activities that did not constitute a trade or business because they had been consistently operated at a loss and therefore lacked a profit motive; (ii) misallocating expenses incurred in carrying out both exempt and unrelated business activities by applying an excessive proportion of the expenses to offset unrelated business income; (iii) miscalculating or failing to substantiate net operating losses; and (iv) misclassifying unrelated business activities as related exempt activities and therefore not properly reporting the income from such activities as unrelated business taxable income. The IRS found that majority of the necessary adjustments to unrelated business taxable income for the universities examined related to the following activities: fitness and recreation centers, advertising, facility rentals, arenas, and golf.

The IRS Colleges and Universities Compliance Project is a good indication of the IRS' increasing focus on the area of unrelated business taxable income. With more nonprofits venturing into social enterprises, it is possible that we will see an even greater focus on such income in the coming years and it will become even more essential for nonprofit boards to ensure proper reporting of unrelated business taxable income.

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<sup>10</sup> IRS, *Colleges and Universities Compliance Project Final Report*, available at: [http://www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_042513.pdf](http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf).

### **For-Profit Sector**

The landscape of the for-profit sector is similarly shifting in light of the movement toward social enterprises and various hybrid corporate forms have emerged as a result. These hybrid models typically require additional public transparency and therefore may be able to develop more public trust and, eventually, attract more philanthropic funding than typical for-profit business forms. However, hybrid entities also typically have less freedom and less privacy than traditional for-profit entities do and are often less attractive to pure financial investors.

The current forms of hybrid organizations, which are discussed in greater detail below, include low-profit limited liability companies (“L<sup>3</sup>Cs”), benefit corporations, flexible purpose corporations, social purpose corporations, and Certified B Corporations. The L<sup>3</sup>C business form first became available in Vermont in April 2008 and there are currently more than 934 entities operating as L<sup>3</sup>Cs.<sup>11</sup> Nineteen states and the District of Columbia currently permit business entities to be formed as benefit corporations<sup>12</sup> and, although the data is not comprehensive, as of July 2013, it was estimated that there were more than 250 benefit corporations (including benefit LLCs permitted in Maryland) in existence.<sup>13</sup> Separately, but relatedly, there are also more than 830 corporations, limited liability companies (“LLCs”), and other business entities in 27 countries that have been certified as B Corporations by the nonprofit B Lab.<sup>14</sup> California also permits flexible purpose corporations and, as of July 2013, the California Secretary of State reported that there were 31 such California corporations.<sup>15</sup> Finally, Washington State also permits entities to be organized as social purpose corporations<sup>16</sup> and, as of August 2013, there were 57 such registered entities.<sup>17</sup>

### ***The Philanthropic Facilitation Act***

The Philanthropic Facilitation Act was introduced in the U.S. House of Representatives in July 2013.<sup>18</sup> Although govtrack.us gives the bill only a 2 percent chance of making it out of committee and a zero percent chance of being enacted, the bill is further indication of the rapidly changing landscape of the for-profit sector. The Act would allow for-profit entities with charitable purposes to apply for and obtain a determination from the IRS that would qualify the obtaining entity to receive program-related investments (“PRIs”). PRIs are investments made by private foundations related to the foundations’ charitable purposes and are a little used alternative to foundation grantmaking. PRIs may be in the form of loans, loan guarantees to nonprofit or for-profit entities, or equity investments in for-profit entities.<sup>19</sup> The primary purpose of a PRI must be to accomplish one or more of the foundation’s exempt purposes and

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<sup>11</sup> This number was current as of November 11, 2013. See [http://www.intersectorl3c.com/l3c\\_tally.html](http://www.intersectorl3c.com/l3c_tally.html).

<sup>12</sup> See <http://benefitcorp.net/state-by-state-legislative-status>.

<sup>13</sup> See <http://socentlaw.com/2013/07/how-many-benefit-corporations-have-been-formed/>.

<sup>14</sup> See <http://www.bcorporation.net/>.

<sup>15</sup> Number provided by a representative of the Office of the California Secretary of State at a State Bar of California committee meeting.

<sup>16</sup> See <http://www.sos.wa.gov/assets/corps/SocialPurposeCorp.pdf>.

<sup>17</sup> See [http://www.spcwa.com/we\\_are\\_spc/list-of-spcs/](http://www.spcwa.com/we_are_spc/list-of-spcs/).

<sup>18</sup> See <http://www.govtrack.us/congress/bills/113/hr2832>.

<sup>19</sup> See <http://grantSPACE.org/Tools/Knowledge-Base/Grantmakers/PRIs>.

the production of income or appreciation of property may not be a significant purpose of a PRI. Moreover, the purpose of a PRI may not be to influence legislation or to take part in political campaigns on behalf of or in opposition to a candidate.

The primary benefit of a PRI for the recipient is access to capital at a lower rate than it may otherwise have available to it. For the investor, PRIs provide an opportunity to leverage philanthropic dollars by permitting the foundation to recycle the repaid funds or returned equity for another charitable purpose. Although private foundations are currently able to make PRIs, including in for-profit entities, and despite the benefits, they are very rarely made outside of a few very large foundations. This is largely due to lack of knowledge regarding PRIs by many foundations, the complexities in determining whether an investment qualifies as a PRI, and the risks and penalties associated with mischaracterizing a non-qualifying investment as a PRI. It is typical for a private foundation to obtain a formal legal opinion from an attorney or a private letter ruling from the IRS, both of which can take significant time to obtain and be very costly, as to the validity of an investment as a PRI before making a PRI. The Philanthropic Facilitation Act would permit for-profit entities to obtain an advance determination from the IRS that they are qualified to receive PRIs, thereby eliminating the need for a legal opinion or a private letter ruling and many of the risks associated with making such investments for foundations. Although the Act may never be passed, and the additional administrative burden on the IRS if it were to be passed may be prohibitive, it is an interesting step in a small but growing movement towards shifting philanthropic funds from charities to for-profit enterprises with promising solutions to complex social problems.

### **Starting a Social Enterprise**

So your nonprofit has decided to start a social enterprise. Now what? The initial threshold questions a nonprofit organization's leaders should ask are whether the idea is viable and whether the organization has the capacity to make the venture successful. In evaluating the organization's capacity, the board should look not only at its financial resources, but also its human, systems, technology, time, administrative, and space resources. The board should ask what resources in each of these categories the organization currently has available, what resources it will need in order to successfully operate the social enterprise venture, and what modifications to its operations it may need to make in order to adjust its available capacity. The nonprofit's leaders should also conduct significant research regarding the relevant market, as well as develop a thorough business plan and strong financial projections.

The organization's board of directors will also want to take certain steps to ensure that each director has satisfied her or his duties to the organization. To ensure that the directors have met their duty of care, the board will want to conduct a reasonable investigation to determine that proceeding with the social enterprise venture is in the best interests of the organization. To satisfy the director's duty of loyalty, the board should confirm that it has appropriately identified and managed any potential conflicts of interest that may arise in connection with the venture. And finally, in light of the duty of obedience, the board will want to give thought to how it will ensure compliance with all applicable laws, statutes, and rules, with respect to the organization as a whole and the venture in particular.

Once these initial considerations have been addressed, the organization's leaders will next want to consider whether the intended business is related to the organization's exempt purpose (which is often a complex determination requiring legal advice). If it is, the board of directors should assess whether it is the best investment the organization can make to advance its mission or if it should be considering other alternative investments. It should also analyze the potential risk associated with the social enterprise venture to determine whether it is a worthwhile risk for the organization to take on.

If it is determined that the proposed venture is unrelated to the organization's exempt purpose, in addition to considering whether the business will cause the organization to run afoul of the commerciality doctrine or subject it to UBIT, the board should ask a few additional questions. The board should consider the reasons why the organization is engaging in the social venture and, if it is only to generate revenues to support its other programs, the board should further consider whether the proposed investment in such venture would be a prudent part of a diverse portfolio of investment assets, consistent with applicable prudent investment laws. Finally, before diving into a new social enterprise venture, the board should take a serious look at whether the organization can realistically and effectively compete and make money with the proposed business in light of the landscape in which it will be operating.

### **Form of Entity**

Once an organization has made the decision to move forward with a social enterprise venture, a choice must be made as to the form of the entity to be developed. The form selected may have tax, legal, and operational implications for the venture and the pros and cons of each option should be carefully weighed at the outset. In making such a determination, the board of a nonprofit organization should exercise reasonable care and should take into account a number of both legal and non-legal considerations, including whether the venture significantly furthers the organization's mission or creates risks for mission creep; the tax implications; whether any potential private inurement or private benefit issues exist, particularly through joint ventures with a founder or director or individuals who are compensated by both entities; whether the concept of earned income and the particular activities will fit with the existing nonprofit's organizational culture; and other associated costs of the venture, such as insurance, licenses, and permits.

### **Nonprofit Organizations**

The board of a nonprofit organization considering engaging in business activities aimed at generating earned income will need to determine whether to conduct such activities in-house or through a separate entity, which might be structured as a subsidiary. If the business is related to the organization's exempt purpose, or if it is unrelated, but will constitute a small part of its overall activities, it may be easiest for the organization to conduct the activities within its existing organizational structure. However, if the business is unrelated, it may be subject to UBIT. Moreover, as discussed above, engaging in a substantial amount of unrelated business activity may cause an exempt organization to place at risk its 501(c)(3) tax-exempt status. If the board is concerned about the possibility that the venture's activities are unrelated and

substantial, structuring the social enterprise in a subsidiary or affiliate organization may be an attractive option.

A subsidiary structure may also provide the existing organization with greater protection from a venture with a higher risk profile than that of the organization itself by separating the assets and activities of the organization from those of the venture. Moreover, placing the venture in a subsidiary or affiliate may help to preserve the organizational culture and the built-up reputation and goodwill of the existing nonprofit. If, after reasonable investigation, the board determines it is in the organization's best interest to create a for-profit subsidiary, it has multiple options as to the legal structure of the entity, which are discussed further below.

Another option for a nonprofit board seeking to launch a social enterprise to consider is *fiscal sponsorship*. In the most common form of fiscal sponsorship, the social enterprise may be created as a project to be housed within and legally operated by a fiscal sponsor with a consistent mission and tax-exempt status. Such a comprehensive fiscal sponsorship arrangement may be ideal for incubating and testing a social venture during its initial stages while receiving administrative, governance, and compliance services from the fiscal sponsor. The advantages of such an arrangement, if appropriately structured, include the ability to serve as a vehicle for the collaborative efforts of several parties and the right to transfer the project to another qualified exempt organization. Furthermore, if the venture proves unsuccessful, it can be dissolved with little fanfare or damage to the organization's reputation. As with any fiscal sponsorship relationship, it is essential for an organization's board (or the steering committee of the prospective fiscally sponsored project) to ensure that the right sponsor is selected and that the contract is drafted in a manner that is in the best interests of the project, preferably with the advice of legal counsel.

### **For-Profit Entities**

When forming a for-profit subsidiary, a nonprofit board or social entrepreneur may choose from among traditional business forms such as a corporation or a limited liability company ("LLC"). An LLC offers fewer formalities than a corporation, but is typically set up as a pass-through tax entity and therefore may not be an appropriate vehicle for a nonprofit board to house a substantial unrelated income-generating business in. If a board elects one of these traditional business forms, the corporation or LLC may seek to become a *Certified B Corporation* by the nonprofit B Lab, which may make the entity more trustworthy to certain stakeholders and supporters based on the independently derived criteria the entity must meet and the applicable external audit standards.

Alternatively, a subsidiary may be structured in one of the newer "hybrid" forms, which currently include the L<sup>3</sup>C, the benefit corporation, the flexible purpose corporation, and the social purpose corporation. The L<sup>3</sup>C is a form of LLC, but is governed by statutory limitations that are harmonized with the PRI regulations and therefore may be more attractive to some private foundation funders, though that has yet to be evidenced on a widespread scale. An L<sup>3</sup>C is legally required to have a primary purpose that is charitable or educational. Profit may not be

a significant purpose and the L<sup>3</sup>C may not engage in electioneering or lobbying.<sup>20</sup> Additionally, a tiered equity structure for an L<sup>3</sup>C may allow for first-tier investors (such as private foundations) primarily looking for social return and only incidental financial return on their investment, and subsequent tier investors receiving closer to market rate returns on a successful venture.

A corporate entity may also be formed as a benefit corporation, which must pursue the general public benefit in its corporate activities. A benefit corporation's board of directors also must consider the impact of its business decisions on the entity's employees, its suppliers, the environment, and the community at large. The benefit corporation form is generally viewed as a means of protecting a board of directors from being forced to sell the corporation to the highest bidder or face a shareholder lawsuit, thereby allowing the directors to preserve the social goals of the entity. There is also a movement, although not yet a widespread one, towards providing local tax benefits and contracting preferences to benefit corporations.

The flexible purpose corporation form requires the entity to pursue a stated specific public benefit that has a positive effect on any of its employees, suppliers, customers, or creditors; the community or society at large; or the environment. Generally, flexible purpose corporations tend to be less restrictive and subject to fewer reporting requirements than are benefit corporations. The flexibility offered by a flexible purpose corporation may make it an attractive option for nonprofit boards seeking to launch a California for-profit social enterprise.

A social purpose corporation, which is currently permitted in Washington State, must be organized to promote positive effects (or minimize negative effects) on the corporation's employees, suppliers, or customers; the broader community; or the environment. In contrast to a flexible purpose corporation, however, a social purpose corporation may, but need not, specify a specific social purpose for which it is organized.

### **Closing Thoughts**

In making any determinations regarding the launch of a social enterprise venture and the legal form of an entity, the most important thing for a nonprofit board of directors to bear in mind is that form should always follow function. The board should ensure that it is making informed decisions through every step of the process, and it would be prudent in many instances for the board to be informed by legal counsel or other experienced and reputable experts. It is also important for the board to invest the time necessary to fully understand the pros and cons of each of the hybrid forms and to determine whether being a pioneer in the hybrid space, which has potential costs due to the lack of guidance and legal precedence, will serve to advance the nonprofit organization's mission or will really serve some other purpose. In making these determinations, a director should be cognizant of her or his duty to act in the best interests of the nonprofit organization and to put those interests above any other interests he or she may have.

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<sup>20</sup> More information can be found at <http://www.americansforcommunitydevelopment.org>.