


Social Enterprises and Non-Profit Organizations


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THE INSIGHT CENTER FOR COMMUNITY ECONOMIC DEVELOPMENT AND LEGAL ECONOMIC DEVELOPMENT

This presentation was developed for general educational purposes, and is not intended to serve as a source of legal advice or information.




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Introduction: Insight Center

The Insight Center for Community Economic Development (formerly NEDLC) is a national research, consulting, and legal organization that develops and promotes innovative solutions that help people and communities become, and remain, economically secure.

Insight Center Program Areas


- Economic Security
- Savings and Asset Building
- Workforce Development
- Legal Services



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501(c)(3)'s –The Three Major Principles

- Organized and operated exclusively for charitable purposes
- Activities do not benefit any private person or interest
unless the private benefit is incidental to an organization's exercise of its charitable activities
- Assets are irrevocably dedicated to charitable purposes



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Basic Concept - Charitable Purposes

Rule: Organized and operated exclusively for charitable (exempt) purposes

- Every organization has one or more charitable purposes
- Business activity can further charitable purposes if substantially related to accomplishing such purposes
- The organization may engage in activities unrelated to its charitable purpose only if the unrelated activities are insubstantial in relation to its total activities



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Substantially Related

- An activity is related to exempt purposes only when the activity has a substantial, causal relationship to achieving the organization's exempt purposes.
- Activities must contribute importantly to accomplishing the organization's exempt purposes to be substantially related.
- To be exempt, an income-producing activity must be of a size and extent reasonably in proportion to its contribution.



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Social Enterprise Ventures

- Business-like activities that qualify as charitable and tax exempt because they are related to an organization's exempt purpose and conducted in a manner that includes a charitable aspect.



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Identifying Social Enterprise Ventures

Does it operate like and compete with commercial businesses?

Does it have a "donative element"?

- Fees/prices charged to members of charitable class are subsidized
- Primary purpose
 - Job training for disadvantaged vs. income generation
- Scale
 - No larger than reasonably necessary for charitable purpose



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Is This a Social Enterprise Venture?

An organization was formed to operate a low-price grocery store in a low-income neighborhood and to provide job training. The store is operated in a manner similar to commercial stores, but charges lower prices by taking less profit. About 4% of the store's revenues are used to provide job training to 'hard core unemployed' community residents.



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Not Related

The operation of the store, in itself, is not a recognized charitable purpose

The job training activities are charitable, and require the operation of the store

But - the scale of the store's operation is larger than reasonably necessary to carry out the job training program

-Rev. Rul. 73-127



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A Social Enterprise Venture

An exempt organization operates a retail grocery store to carry out the job training portion of its therapeutic program for emotionally disturbed adolescents.

The training program is operated to provide vocational rehabilitation and to help the teens become self-supporting.

All store employees are emotionally disturbed adolescents who participate in the therapeutic program. The adolescents are paid for working in the store.

The grocery store is operated at a level to utilize only the number of adolescents residing at the facility.

-Rev. Rul. 76-94



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Is This a Social Enterprise Venture?

An organization is operating a hot dog stand.



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Is This a Social Enterprise Venture?

- ABC operates a halfway house for recovering alcoholics and a furniture production business.
- The furniture is produced by halfway house residents participating in a transitional program.
- The transitional program is designed to help the residents develop self-discipline and regular work habits.
- Residents participate in the program for a short time, until they develop the skills and confidence needed to secure regular employment.



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Yes, the Activity is Charitable

- The residents produce the furniture as part of a bona fide training program focused on the development of particular skills.
- Participants remain in the program for a limited time to develop the skills, rather than becoming permanent employees.
- The business activities are no more extensive than necessary to carry out the charitable activity.



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Forming a Disregarded Limited Liability Company (LLC)

- Advantage: LLC is separate legal entity, protecting parent from liability for debts of social enterprise
- Advantage: Pass-through tax treatment means LLC can operate under parent's tax exemption if activities are charitable and no other owners



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Substantial Unrelated Activity

What is unrelated?

- Activity that is not charitable
- Charitable activity that does not further the organization's specific exempt purpose

What is substantial?

- IRS has not defined



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What if the Activity is Unrelated?

The organization may engage in unrelated activity, without jeopardizing its tax exemption, as long as the activity is not a substantial part of its overall activities.

The organization may have to pay unrelated business income tax (UBIT), IRC Sections 511-513. Avoids unfair competition with tax-paying businesses.

The organization may decide to establish a for-profit subsidiary to carry out the non-exempt activities.



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UBIT – Three Part Test

Business Activities

- Like a commercial business
- Purpose is the production of income

Regularly carried on

- Frequency or continuity similar to a commercial business

Substantially unrelated to the organization's exempt purpose



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Deductions and Exceptions

Tax applies to net income

- Direct costs of earning income are deductible

Exceptions to UBIT include:

Businesses operated for the convenience of patients, students, etc., such as campus book store

Businesses for the sale of donated goods or that are operated primarily by volunteers

Passive income such as rents and interest
Unless from debt-financed property or controlled entity



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How Much Unrelated Business Can You Do?

An insubstantial amount

How measured:

• Amount of staff time or other resources expended on exempt versus non-exempt activities

- Ex. Textbook publishing by educational institution

- IRS looked at scope of exempt activities and determined exempt activities were commensurate with organization's resources and did not revoke exemption



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Identifying Unrelated Activity

Determine charitable purpose

Review the corporate documents:

- Articles – statements of purpose
- Bylaws – statements of purpose
- Tax exemption application
- Determination letter



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It's Unrelated – Now What?

If charitable:

- Describe on Schedule O of Form 990
 - Non-filers send a letter within 4 ½ months after end of fiscal year

If not charitable:

- Determine if substantial
- Consider establishing a for-profit subsidiary

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For-Profit Subsidiaries: Overview

Why form a for-profit subsidiary?

How does a tax-exempt organization form a for-profit subsidiary?

How does the for-profit subsidiary relate to its tax-exempt parent?

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Why Establish a Subsidiary ?

- Protect organization's tax-exempt status
- Insulate organization from liability associated with the business
- Obtain financing from conventional sources
- Attract staff and board members with business experience

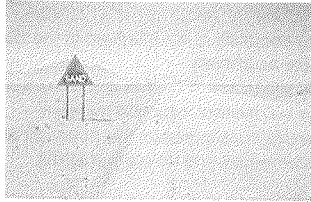
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Forming the Subsidiary: Choice of Entity

Most common choices

- Limited Liability Companies (LLCs)
- Corporations



Forming a For-Profit Subsidiary Corporation

Formation

- Articles of Incorporation filed with Secretary of State
 - Include number and classes of stock authorized
- Parent nonprofit receives ownership interest (stock) in exchange for contribution of money or other assets
- Stockholders appoint directors
- Directors adopt bylaws

Operations

- Directors and officers control the business
- Stockholders elect and can remove directors

Pros and Cons of Corporate Form

- Sophisticated statutory law with ample case law & interpretation reduces uncertainty
 - Established precedent for maintenance of separate identity of parent and sub
- Stock structure facilitates multiple owners with different interests
- Ownership interests easily transferred
 - *But:* may be subject to securities laws
- Flexibility is limited



Limited Liability Companies (LLCs)

Formation

- File with State
- Membership interests exchanged for contribution
- Members negotiate operating agreement

Operations

- Controlled by the operating agreement
- LLC may be managed by members or managers
- Multiple classes of members possible

Pros and Cons of LLCs

- Ease of Formation
- Limited Liability
- Operating Flexibility
- Ease of establishing complex profit distribution schemes
- Flexible taxation
 - May elect to be taxed as a corporation or partnership
- *But* -Relatively New Form of Entity
 - Law of LLCs is relatively undeveloped and many issues remain open
 - May be harder to establish separate identity of parent



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Parent-Subsidiary Relations

The nonprofit and the subsidiary each have their own Boards of Directors and officers, with separate meetings, minutes, accounts, books and records

- There can be overlap but the Boards shouldn't be the same
- Directors and officers have separate duties of loyalty

The nonprofit is not involved in the day to day management of the subsidiary

- As shareholder, it appoints and removes directors
- As LLC member, it appoints managers

Transactions between the nonprofit and subsidiary should be documented and on market terms

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Transfers Between Subsidiary and Parent

Profits are returned to parent as dividends

- Taxed at subsidiary level
- Tax-free to parent

Parent can provide services to subsidiary under market rate contracts

- Agreements for space and services are common
- May be taxable as unrelated business income (UBIT)
- Must be negotiated and priced like arm's-length transactions, but typically are at cost

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Questions



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