FISCAL: SPOTLIGHT ON SOCIAL ENTERPRISE (PART II)

CAPLAW 2009 National Training Conference

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Seattle, WA

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Handouts:

1. LaVerene Woods PowerPoint
2. R. Brian Tipton PowerPoint

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Spotlight on Social Enterprise: Legal Issues

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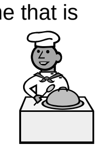
Defining Social Enterprise

- Social Enterprise Alliance: "An organization or venture that advances its social mission through entrepreneurial, earned-income strategies"
- Compare with an enterprise for social good: A venture that generates earned income that is <u>used</u> to further a social mission.



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Distinguish Means v. Ends

- Toy manufacturing operated as training program for chronically unemployed = related
- Grocery store in low-income neighborhood with low margins that uses net proceeds to assist the homeless = not related

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Requirements for Section 501(c)(3) Status

- Must be organized and operated primarily for exempt purposes
- Allows some level of unrelated business activity
- To be related, an activity must directly further exempt purposes
- The fact that net revenues from an activity are used to further a social mission does not make the activity related

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Exempt Purposes

- Relief of the poor and distressed or underprivileged
- Advancement of religion
- Advancement of education or science
- Lessen neighborhood tensions
- Eliminate prejudice and discrimination
- Defend human and civil rights
- Combat community deterioration and juvenile delinquency

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Examples of Social Enterprise Activities that can be Related for Tax Purposes

- Training programs that create earned income
  - FareStart – food industry training
  - Goodwill – retail training and job opportunities
- Certain fee-based services that fulfill the provider's mission
- Child-care when needed for caretakers to pursue gainful employment

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Training Programs: Tax Rules

- Number of non-trainees must be only those necessary for a successful training program
- Once an individual has completed training (unless there is a continuing disability) he/she must be out-placed
- Tension: what's best for mission isn't necessarily best for business

Services to Other Exempt Organizations

- Providing business management consulting services to other Section 501(c)(3) organizations generally is not related if priced at cost or fair market value
- Same analysis for services such as IT, accounting and human resources, and investment management
- Such services are generally related only if priced at "substantially less than cost" (e.g. 70% below cost)

Services to Other Organizations

- Providing services for cost or fair market value can be related if the service is uniquely tied to the specific mission
- Examples:
  - The provision of nurse manager services oversight to another organization's neo-natal intensive care unit
  - Consulting services to a commercial bank to assist it in addressing low-income community needs

Consequences of Unrelated Trade or Business

- Taxable on net income (after deduction of allocable expenses) at graduated corporate rates of 15-35%
- Must file IRS Form 990T, subject to public disclosure
- Potential adverse effect on state property tax exemption
- Potential distraction from mission
- Potential threat to organization's tax exemption, if unrelated activities become substantial

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How Much Unrelated Activity is Too Much?

- No bright line
- Section 501(c)(3) organization must be operated primarily for exempt purposes
- Organization may receive unrelated business taxable income so long as it carries out charitable activities "commensurate in scope" with its financial resources

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Legal Structures for Earned-Income Activities

- Options
  - Division of 501(c)(3)
  - Single-member limited liability company (LLC)
  - Separate 501(c)(3) organization
  - Taxable subsidiary
- Set-up
  - Board consideration and approval
  - Control issues

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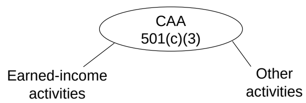
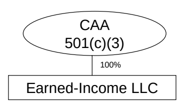
Division

- No new entity created
- Part of existing 501(c)(3); reports activities, income and expense on Form 990
- Appropriate for:
  - Related activities
  - Unrelated activities that are not substantial
- Does <u>not</u> protect other assets of organization from liabilities of earned-income activity



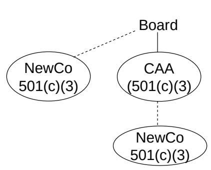
Single-Member LLC

- Requires creation of LLC by filing with state
- Part of 501(c)(3) for federal tax purposes; reports activities, income and expense on Form 990
- If properly structured, protects other assets of organization from risks associated with earned-income activity
- Appropriate for
  - Related activities
  - Unrelated activities that are not substantial
- <u>Not</u> appropriate to protect 501(c)(3) from engaging in substantial unrelated activity



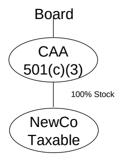
Separate 501(c)(3) Affiliate

- Requires formation of new nonprofit corporation and application to IRS for 501(c)(3) status
- When properly structured, insulates each organization's assets from the liabilities of the other
- Boards can overlap, or board of first organization can appoint the board of second
- Appropriate for:
  - Exempt activities
  - Activities requiring separate mission, staff, regulatory approvals, etc.
- Separate compliance, state and IRS filings for separate 501(c)(3) organizations



Taxable Subsidiary

- Requires creation of separate for-profit corporation
- 501(c)(3) owns 100% of the stock of the for-profit corporation, elects board of for-profit
- When properly structured, protects assets of 501(c)(3) from liabilities of subsidiary <u>and</u> protects 501(c)(3) from substantial unrelated activity
- Appropriate for:
  - Substantial unrelated activities
- Subsidiary files state and federal tax returns, pays corporate tax on net income at 15-35%
- Subsidiary may pay dividends to 501(c)(3); 501(c)(3) not taxable on dividends



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Operating a Taxable Subsidiary

- Must observe separate corporate formalities
  - Separate EINs and bank accounts; no commingling
  - Separate board meetings, minutes
  - Website identities
- Shared Staff: Allocation of time and expense
- Shared Facilities and Equipment: Allocation of expense
- Documentation
  - Written Agreement
  - Time sheets

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WEDNESDAY, JUNE 24, 2009

SOCIAL ENTERPRISE (PART II)

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QUESTIONS TO CONSIDER

- What is social enterprise?
- *Why consider social enterprise?*
- *What will be the impact on the organization's reputation?*
- What is the relationship to the organization's mission or exempt purpose?
- What are the tax and *other fiscal implications of the enterprise?*
- *What other risks are associated with the enterprise?*
- How should the enterprise be structured and *what special aspects of the enterprise must be considered?*

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WHAT IS SOCIAL ENTERPRISE?

- No standard definition
- Generally distinguished from traditional fundraising by application of entrepreneurial or for-profit business principles
- Relationship to organization's mission or purpose depends on definition used
  - Can apply to mission-centered ventures that both generate revenue and help fulfill mission
  - Can also apply to revenue-centered ventures that simply generate funds that are used to support programs and services that fulfill mission

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WHY CONSIDER SOCIAL ENTERPRISE?

- More program funding
  - Additional revenue to expand or enhance existing programs
  - Revenue for new programs or services for which other funding is not available
- Generate unrestricted funds that can be used for other purposes
- Diversify funding streams
  - Decrease dependence on grant and private foundation funding and on donations and traditional fundraising
  - Smooth funding cycles and allow more stable revenue during economic downturns
- Post-stimulus planning
  - Allow agency to maintain increased service and program levels after stimulus funding ends
  - Provide for use of new resources after stimulus funding ends

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IMPACT ON REPUTATION

- Organizations should ask "what will be the impact on the organization's reputation?"
- Should consider impact on reputation and effect on ability to fulfill mission
- Example
  - CAA starts micro-lending program
  - How will it handle borrowers who default?
- Reputational risks may influence structure of enterprise

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RELATIONSHIP TO MISSION

- Organization should ask "what is the relationship to the organization's mission or exempt purpose?"
- Both practical and legal/tax reasons for question
- Practical
  - Is enterprise consistent with mission?
  - Is enterprise inconsistent with mission?
- Legal/tax
  - Relationship of enterprise to exempt purpose affects tax treatment of revenue
  - To maintain federal tax exemption, unrelated business income cannot be a substantial portion of organization's receipts
  - Implications at state and local levels too

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TAX AND FISCAL IMPLICATIONS

- Organization should ask "what are the tax and other fiscal implications of the enterprise?"
- Three related questions
  - What is the financial risk to the organization?
  - How will revenue from the enterprise be treated by taxing authorities?
  - *How will revenue from the enterprise be treated by funding sources?*

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PROGRAM INCOME

- Federal funding sources may treat revenue generated by social enterprise ventures as program income
- "Program income" is defined as all "gross income earned by the recipient that is directly generated by a supported activity or earned as a result of the award." 2 C.F.R. § 215.2(x).
- Program income includes income from fees for services, from the rental or other use of real estate or goods acquired with grant funds, and from interest earned on loans made using grant funds
- Grantees are not accountable for program income generated after end of project

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PROGRAM INCOME

- Program income normally must be used in one of three ways. See 2 C.F.R. §§ 215.24.
  - Added to the grant funds and used to provide additional services (additive alternative)
  - Used to fund the non-federal share (cost-sharing or matching alternative)
  - Or deducted from the total costs used to determine the allowable costs for calculating the federal share (deductive alternative)
- Deductive alternative is default

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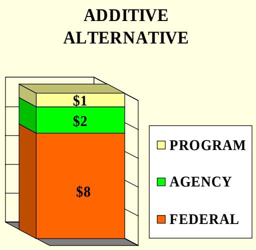
ADDITIVE ALTERNATIVE



- Example
  - $10 million budget
  - 20% match required
  - $1 million program income
- Several programs generally allow use of additive alternative
  - Weatherization
  - Head start

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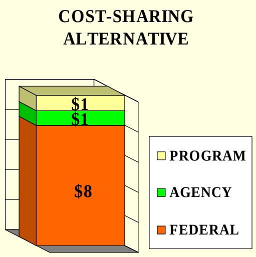
COST-SHARING ALTERNATIVE



- Example
  - $10 million budget
  - 20% match required
  - $1 million program income
- Overall amount needed from agency for match is decreased by amount of program income

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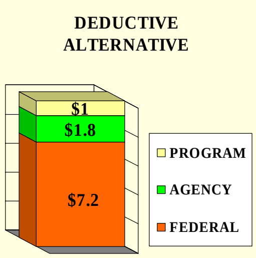
DEDUCTIVE ALTERNATIVE



- Example
  - $10 million budget
  - 20% match required
  - $1 million program income
- Overall allowable costs reduced by amount of program income
- Federal share and agency match reduced in proportion

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PROGRAM INCOME

- Funding sources and individual programs differ in treatment of program income
- Some funding sources may have issued specific guidance
  - Example: head start program instruction ACYF-PI-HS-06-06 (may 10, 2006)
  - Technically about "fund-raising" but application to program income and social enterprise
- Generation of program income should be distinguished from leveraging and "partnering" although may have some overlap

OTHER RISKS

- Organizations should also ask "what other risks are associated with the enterprise?"
- Actual risks depend on the particular organization
- Possible types of risks
  - Legal
  - Operational
  - Strategic

LEGAL RISKS

- Contracts
  - Breach by agency
  - Breach by vendors and subcontractors
  - Breach by clients
- Tort liability
- Human resources
  - Shared or "leased" employees
  - Wage and hour issues
- Additional related legal risks for federal grantees

GRANTEE RISKS

- Use of equipment acquired with federal funds presents special risks
- Grantees "shall not use equipment acquired with federal funds to provide services to non-federal outside organizations for a fee that is less than private companies charge for equivalent services, unless specifically authorized by federal statute, for as long as the federal government retains an interest in the equipment." 2 C.F.R. § 215.34(a).
- While equipment is still used for the project for which it was acquired, "user charges" for equipment use on other projects is treated as program income. See 2 C.F.R. § 215.34(d).

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GRANTEE RISKS

- In addition, grantees must account to the federal government for use of facilities for purposes other than those funded under the grant. See, generally, 2 C.F.R. § 215.32(a); 2 C.F.R. Pt. 230, app. A.
- Fundraising and related costs are not allowable and must be allocated a share of indirect costs. See 2 C.F.R. Pt. 230, app. B, ¶ 17.
- Grantees also must be careful in tracking and allocating salaries and benefits for shared employees. See 2 C.F.R. Pt. 230, app. B, ¶ 8.

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OPERATIONAL AND STRATEGIC RISKS

- Quality of other programs or services may be affected adversely
- May be resources drain
- May create internal conflicts
  - Staff conflicts
  - Revenue sharing
- May lead to mission drift ("tail wagging the dog" syndrome)

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STRUCTURING THE ENTERPRISE

- Organization should ask "how should the enterprise be structured and what special aspects of the enterprise must be considered?"
- Really two related questions
- Both implicate legal and practical concerns

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STRUCTURING THE ENTERPRISE

- Legal concerns
  - What are the possible legal structures?
    - What are the legal requirements?
    - What are the legal implications?
  - What is the potential for legal liability to the original organization?
- Practical
  - Difficulty of creating or operating under particular structure
  - Maintaining control
  - Concerns related to mission, reputation, or "organizational culture"

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STRUCTURING THE ENTERPRISE

- Sometimes the nature of the enterprise will strongly dictate the structure for legal or practical reasons
- Examples
  - Low income housing (Tax Credits)
  - Small business micro-lending
  - Community development financial institution (CDFI)

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