Making Money for Your Mission: Revenue-Generating Ventures

CAPLAW 2010 National Training Conference

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Savannah, GA

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Handouts:

1. Timothy Phillips PowerPoint
2. R. Brian Tipton PowerPoint

Making Money for Your Mission through Social Enterprise

Legal and Tax Issues

CAPLAW 2010 National Training Conference

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What is Social Enterprise?

- "the use of market-based strategies to solve social problems"
- Can be non-profit or for-profit

EXAMPLES OF SOCIAL ENTERPRISE

Local Initiatives Support Coalition (LISC)

- established by the Ford Foundation
- helps community residents transform distressed neighborhoods into healthy and sustainable communities
- model: assembles public and private resources and directs them to locally-defined priorities

www.lisc.org

EXAMPLES OF SOCIAL ENTERPRISES

GoLoco

- allows friends, neighbors and co-workers to arrange trips together
- matches travelers with destination, time and place
- system itself is free; cost sharing generates a 10% transaction fee
- social outcomes: saves time, energy, stress and $$!

www.goloco.org

choose you™

American Cancer Society®

Live Well Today.
Stay Well Tomorrow.™

Risks and Rewards

Legal Ramifications of Social Enterprise

- Under IRC § 501(c)(3)'s operational test, an organization's activities *must (exclusively)* further its charitable purpose
- Legal consequences for nonprofits engaging in business activity include taxation of unrelated business income and even loss of tax-exempt status

Jeopardizing Your Tax-Exempt Status

- 501(c)(3) organizations cannot engage in unrelated business activities that are substantial in relation to their charitable purpose
  - ✓ What is "unrelated"?
    - "making money for our organization" doesn't count as "related"
  - ✓ What is "substantial"?

Understanding UBIT

General Rule

Income derived from trade or business activities not substantially related to the tax-exempt organization's purposes is taxable as if earned by a comparable for-profit enterprise.

Central Elements

- Unrelated: Is there a substantial causal relationship between the revenue-generating activity and the organization's exempt purpose?

  (the activity must contribute importantly to the accomplishment of the tax-exempt's purposes)

  - ✓ Note: The mere fact that the income produced will be used to carry out the mission is not a sufficient causal relationship. The activity must be related.

Trade or Business

- Trade or business activities typically exhibit an intent to derive a profit from their conduct. In addition, the activities must be regularly carried on.

  - ✓ Tip: When considering whether the activity is "regularly carried on" measure the frequency of the activity against the frequency with which a commercial enterprise would conduct it.

Trade or Business Regularly Carried On

- If

1) the activity is infrequent;
2) the activity is conducted only for a short period during the year; or
3) the activity is not engaged in with a competitive or promotional intent,

- Then

It should not be considered as regularly carried on.

Example

- Exempt organization derives revenue from distribution of holiday cards once a year.

Taxable?

YES

- But why?!
  - ✓ Cards deemed to be sold at "retail" not distributed for "charitable contribution"
  - ✓ Enterprise involved commercial co-venturer who was engaged in the "seasonal" activity for profit.

PLR 8203134

UBIT Exclusions

- For certain types of income producing activities there are exclusions (known as modifications) from the rules which require the income to be taxed.

Exclusions

- Passive Income[1] excepted from UBIT:
  - ✓ Dividends
  - ✓ Interest
  - ✓ Annuities
  - ✓ Royalties[2]

1. Not generated through activities of controlled organizations or through borrowed funds.
2. So long as there is no active business associated

Exclusions

- Rents from Real Property
  - ✓ Note: Rent from personal property is generally taxable and if both involved, more than 50% from personal taints entirety.

Exclusions

- Sale of Property
  - ✓ E.g. Capital gains
    - Note: Does not apply to inventory, or property held in ordinary course of business

Common Activities and What to Watch For

Sponsorships

- Qualified Sponsorships
  - ✓ OK
- Advertising
  - × UBIT ☹

What's the Difference?

- Qualified Sponsorships do not provide the sponsor with any substantial return benefits, which include endorsements or promotional messaging.

  Acknowledging is not Advertising. You can give credit but you can't promote.

Cause Marketing

- Using product promotion to promote mission
  - ✓ A marketing approach to charitable giving
    - Company A does well by doing good for Charity B.
  - ✓ Payments structured as royalties for use of name and logo.

  Note: May be subject to state registration and/or reporting.

- Formats Product Sale/Purchase
  - Product Partnership (save lids to save lives)
  - Product Certification (heart check)
  - Choose You™
  - Cause Branding (Choose You™ Red Dress™) (unique cause brand licensed to partner companies) (drives consumer engagement)

Sales of Property

- Volunteers run the store ☺
- Sales of donated property – “thrift shop-exception” ☺
- Low-cost items (i.e. t-shirts & coffee mugs) ☺

☺ [If incidental to charitable solicitation]

Activities for Convenience of Members

- Restaurants, Gift Shops, Parking Lots, Lunches operated for students, patients, employees
  - ✓ OK ☺
- Open to general public ☹

Activities for Convenience of Members

- BINGO
  - ✓ OK ☺
- BUT: Regulated by the state. Be sure to register and comply.

Joint Ventures

- May be “whole” or “ancillary”, all or part of exempt organization’s assets, activity contributed.
- Must further purposes
- Charity must act exclusively in furtherance of its purposes
- Activities may not jeopardize exempt’s tax status, i.e. no disproportionate risk to charity or excess private benefit to for profit partner.
- Most common structures – limited partnership or LLC.

CAPLAW 2010 NATIONAL TRAINING CONFERENCE
WEDNESDAY, JUNE 16, 2010

MAKING MONEY FOR YOU MISSION: LEGAL CONCERNS FOR GRANTEES

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WHY SOCIAL ENTERPRISE?

- More funding for programs
  - 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 any purpose

WHY SOCIAL ENTERPRISE?

- 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

PRIMARY CONSIDERATIONS

- Considerations
  - Financial considerations
  - Potential effect on organization's reputation
  - Relationship to organization's mission
  - *Tax and legal implications*
  - Structuring the enterprise
  - *Other risks/considerations*
- Overlap to varying degrees

LEGAL IMPLICATIONS

- Program Income (federal grantees)
- Additional grantee legal issues
  - Equipment
  - Facilities
  - Cost allocation
- Other legal risks common to for-profit businesses
  - Contracts
  - Torts
  - Labor and Employment Law

PROGRAM INCOME

- Federal grantees must consider additional legal issues concerning relationship of income generated by social enterprise ventures to federal funding and federal resources
- Federal funding sources may treat revenue generated by social enterprise ventures as program income
- Improper handling of program income may subject grantees to disallowances or other enforcement actions, including termination

PROGRAM INCOME

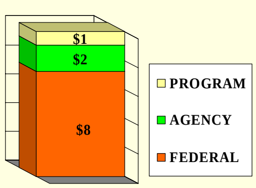
- "Program income" is defined as all "gross income earned by the recipient that is directly generated by a supported activity or earned as a result of the award." 2 C.F.R. § 215.2(x).
- Program income includes income from fees for services, from the rental or other use of real estate or goods acquired 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

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

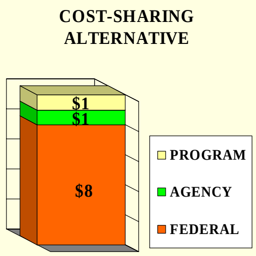
ADDITIVE ALTERNATIVE

ADDITIVE ALTERNATIVE



- Example
  - $10 million budget
  - 20% match required
  - $1 million program income
- Several programs generally allow use of Additive Alternative
  - Weatherization
  - Head Start

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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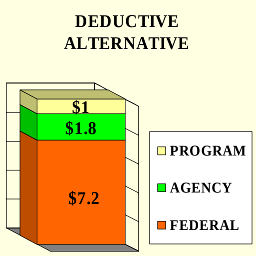
DEDUCTIVE ALTERNATIVE



- 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

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OTHER GRANTEE ISSUES

- 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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OTHER GRANTEE ISSUES

- 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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COMMON LEGAL ISSUES

- Contracts
  - Breach by organization
  - Breach by vendors and subcontractors
  - Breach by clients
- Tort liability
- Labor and Employment Law
  - Shared or "leased" employees
  - Wage and hour issues

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OTHER CONCERNS

- Organizations should also consider what other potential risks are associated with the proposed venture
- Actual concerns/risks will depend on the particular organization and venture
- Possible types of concerns/risks
  - Operational
  - Strategic

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)