



Structuring Innovative Revenue Models for Nonprofits: For-Profits, Joint Ventures, and Social Enterprises

Tuesday, April 14, 2015, 12:30 p.m. – 2:00 p.m. ET
Venable LLP, Washington, DC

Moderator

Jeffrey S. Tenenbaum, Esq., Venable LLP

Speakers

Carrie Garber Siegrist, Esq., Associate, Venable LLP
Andrew Schulz, Esq., General Counsel, Arabella Advisors





CAE Credit Information

***Please note that CAE credit is only available to registered participants of the live program.**

As a CAE Approved Provider educational program related to the CAE exam content outline, this program may be applied for **2.5 credits** toward your CAE application or renewal professional development requirements.

Venable LLP is a CAE Approved Provider. This program meets the requirements for fulfilling the professional development requirements to earn or maintain the Certified Association Executive credential. Every program we offer that qualifies for CAE credit will clearly identify the number of CAE credits granted for full, live participation, and we will maintain records of your participation in accordance with CAE policies. For more information about the CAE credential or Approved Provider program, please visit www.whatiscae.org.

Note: This program is not endorsed, accredited, or affiliated with ASAE or the CAE Program. Applicants may use any program that meets eligibility requirements in the specific timeframe towards the exam application or renewal. There are no specific individual courses required as part of the applications—selection of eligible education is up to the applicant based on his/her needs.



Upcoming Venable Nonprofit Events

Register Now

May 13, 2015 – Managing Your Nonprofit's FACEBOOK, TWITTER, and LINKEDIN Presence: Avoiding the Legal Pitfalls

June 4, 2015 – Top Trends and Traps in Nonprofit Executive Compensation

July 15, 2015 – Mental Health Issues in the Nonprofit Workplace: Questions Raised by the Germanwings Air Disaster (*details and registration available soon*)



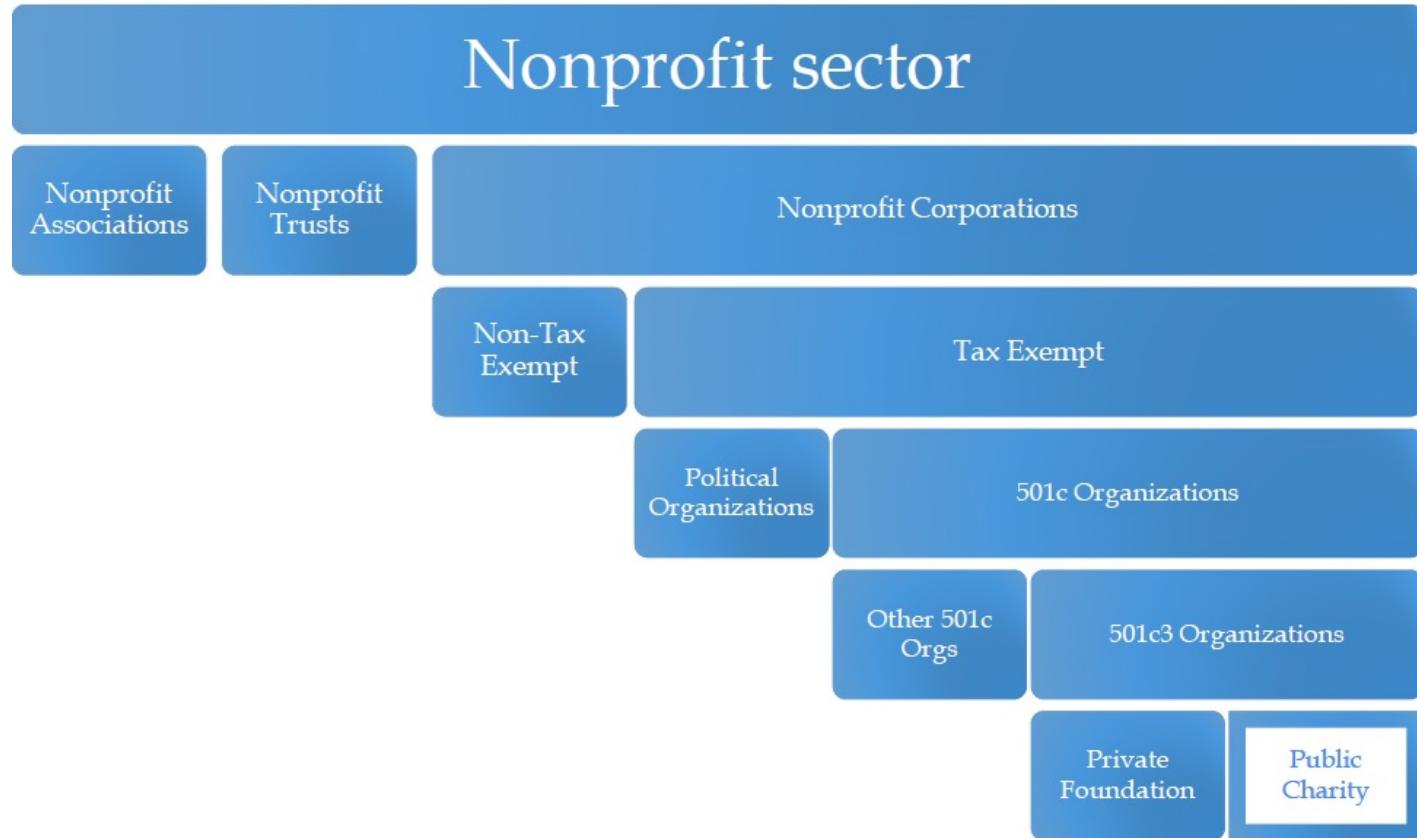
Agenda

- Federal Tax Exemption – A Quick Review
- For-Profit Structure Options
- Joint Ventures – Structuring Considerations
- Social Enterprise Legal Structures
- Questions



Scope of Presentation

■ Public Charities



- For Another Time: Revenue Generating Activities
 - Commercial co-ventures, cause-related marketing, affinity/endorsement programs, etc.





Federal Tax Exemption – A Quick Review

Exempt Organization Purposes

- Section 501(c)(3) tax-exempt organizations must be organized and operated **exclusively** for the exempt purposes described in the Code.
- §501(c)(3):
“...religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals...”



Private Inurement/Private Benefit

- Earnings of an exempt organization may not inure to any private shareholder or individual:
 - Any person having a personal or private interest in the activities of the organization
 - Distinguish between private inurement and private benefit
- Examples:
 - Excessive compensation to insiders, greater-than-fair-market-value goods or services to members or insiders, excessive benefits to anyone
 - Paying personal expenses
 - Rent-free housing
 - Interest-free or no-obligation-to-repay loans



Commerciality – Not More Than an Insubstantial Amount

- Proper for an exempt organization to conduct a commercial trade or business if it is in furtherance of its exempt purposes and the primary purpose is not to engage in an unrelated trade or business
- Generally, the IRS will revoke or deny exempt status to otherwise qualifying organizations where their operation of a commercial trade or business is unrelated to the organization's purposes and it will require substantial attention from the organization



A Brief History

- Prior to 1950, exempt organizations owned and operated unrelated businesses on a tax-free basis
- *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (1951):
 - NYU Law School owned a subsidiary called the Mueller Macaroni Company
 - Paid no income taxes
 - Exempt organizations no longer allowed to conduct tax-free unrelated business activities; unfair competition



Unrelated Business Income Tax

- Unrelated business taxable income tax is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business:
 - Trade or business
 - Not substantially related
 - Regularly carried on



Income Excluded from UBTI

- Income that is specifically excluded from UBIT:
 - Interest income
 - Royalty income
 - Certain research income
 - Conference and trade show revenue
 - Qualified sponsorship income
 - Certain bingo games
 - Debt management plan services
 - Renting mailing list to another charitable organization



Trade or Business

- Not an unrelated trade or business if:
 - Volunteer labor
 - Convenience of members, students, patients, officers, or employees
 - Donated merchandise
 - Low-cost articles



Substantially Related

- Relevant factor here: Is the trade or business related to your exempt organization's purposes?
 - Need to generate revenue is not enough
- Focus: Unfair competitive advantage to exempt organization?





For-Profit Structure Options

Subsidiaries

- Nonprofit organization may isolate profitable non-exempt-purpose activity into a for-profit subsidiary:
 - Preserves exempt status in cases where unrelated activities become excessive in comparison to exempt-purpose activities
- Relatively simple to establish assuming the activity is easily separated from the organization's other activities
- Nonprofit Affiliates? Permissible:
 - A nonprofit may separate some of its activities into one or more nonprofit, tax-exempt, controlled affiliates (for tax, liability protection, and/or other reasons).



Legal Structures

- Traditional for-profit legal structures:
 - S and C Corporations
 - LLC/SMLLC (joint ventures)
 - Co-Op
- Social enterprise legal structures:
 - Benefit corporations, L3Cs, social purpose corporations, etc.



Use of Separate Entities

- Benefits beyond simply minimizing tax liability:
 - Tort and contract liability
 - Isolate unrelated business income
 - Conduct for-profit or dissimilar nonprofit activities in a separate entity for a variety of reasons
- Must adequately capitalize the subsidiary



Separation of Operations

- Not just separation in corporate formation
- Entity separation requires:
 - Separate governing bodies (including distinct meetings and minutes)
 - Avoid commingling assets/separate bank accounts
 - Arm's length relationship between entities
- Other considerations:
 - Shared resources: employees, office space
 - Intellectual property (fair market value)
- Failure – Attribution of activities to parent (for tax, liability, and other purposes)



Considerations

- Administrative costs/state law compliance
- Prudent investment considerations
- Securities laws
- Exit strategy



Joint Ventures – Structuring Considerations

Joint Ventures

- An arrangement in which two or more entities (for example, an exempt entity and a for-profit entity) come together to jointly undertake an enterprise in which they will share the distribution of profits and losses from the enterprise:
 - Considered a partnership for federal tax purposes
- Why?
 - Raise capital
 - New Services
 - Allocate risk
 - Combine diverse areas of expertise



Structures Available

- Joint venture may take a variety of legal structures:
 - General partnership
 - Limited partnership
 - LLC/SMLLC
 - Business corporation (including new social enterprise structures)
- Alternatively, the joint venture may exist as a contractual relationship:
 - Joint operating agreement
 - Service or management contract
 - Lease arrangements



Key Considerations: Private Benefit

- Private benefit inherently conferred to participating partners:
 - Permits if not an impermissible amount and if the private benefit, both quantitatively and qualitatively, does not outweigh the public benefit of the activity
 - Any amount that is more than incidental may jeopardize exempt status
- Generally, if the exempt organization retains control over the venture's activities, then no jeopardy to the organization's exempt status:
 - Depends on the scope of the activities conducted



Exercising Control

- Key importance to IRS and courts:
 - Exempt organization must exercise majority control over the tax-exempt functions of the venture
- Evaluating joint venture for private benefit:
 - Furtherance of exempt purposes? On paper, in practice (responsibilities of exempt organization?)
 - Governance of the joint venture
 - Length of agreement
 - Distribution of earnings between parties



Considerations

- Explore other options where exempt organization is operating a profitable business:
 - Is the business furthering an exempt purpose?
 - Providing employment and training opportunities in restaurant
 - Does the organization's role need to be active?
- All transactions with exempt organizations should be:
 - Fair market value
 - Due diligence
 - Properly documented



Unrelated Business Income

- Related or unrelated activities?
 - If yes, no UBTI
 - If excluded under one or more of the UBI exclusions, no UBTI
 - If no, then is the activity substantial?
- Return on investment in joint venture: Will revenue be treated as unrelated business income?
 - Structure venture so that exempt mission is preserved
 - All about control



Social Enterprise Legal Structures

The Social Enterprise Movement

- The idea: Using the power of business to solve societal and environmental problems:
 - Incorporating missions into corporate DNA
 - Social enterprises use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas
- Social entrepreneurs utilize for-profit and nonprofit legal structures:
 - We will outline the types of “hybrid” legal structures that are often described as “social enterprise” structures



A Brief History

- Some argue that social enterprises actually arrived with the operation of organizations like the Hull House (1884) and Goodwill Industries (1895)
- Modern-day versions entered the scene in the 1970s and 1980s:
 - Recent explosion of popularity
- Social enterprise missions – anything:
 - Including workforce development, housing, community and economic development, education, and health



Supporting Social Entrepreneurs

- ACCION
- Ashoka Innovators for the Public
- Echoing Green
- Grameen Foundation
- Mercy Corps
- Omidyar Network
- Schwab Foundation for Social Entrepreneurship
- Social Enterprise Alliance
- The Skoll Foundation



Geographic Scope of Structure Options

SOCIAL ENTERPRISE HYBRIDS ACROSS THE U.S.*



- Light Blue = General Benefit ("Inc.") Corporation [& Dark Blue indicates Benefit LLC ("LLC") too] = 21.
- Blue-Black = Public Benefit ("PBC") Corporation (requires general & specific public benefit) = 2.
- Dark Purple = Two Types: General Benefit ("GBC") or Specific Benefit ("SBC") Corporations = 1.
- Light Purple = Two Types: General Benefit ("Inc.") or Social Purpose ("Inc.") Corporations = 2.
- Burnt Orange = Quasi-Social Purpose ("Inc.") Corporation = 1.
- Dark Red = Social Purpose ("SPC") Corporation Only = 1.
- Gold = Low-Profit Limited Liability Company ("L3C") = 4.
- Green = Benefit Corporation ("Inc.") and L3C = 4.
- Tan = Recently Introduced Into Legislature = 7
- Gray = Enacted and Repealed L3C = 1.

*For more information, see Brewer, Minnigh & Wexler, *Social Enterprise by Non-Profits and Hybrid Organizations*, 489 T.M. Portfolio (Bloomberg BNA 2014). See also <http://socentlaw.com/2015/03/yet-another-u-s-hybrids-map-with-hyperlinks-rhode-island-should-be-green/>.

NOTE: Image used with permission from author.



Low-Profit Limited Liability Company (L3C)

- An L3C must be organized and operated as follows:
 - significantly furthers one or more charitable or educational [IRC § 501(c)(3)] exempt purposes;
 - would not have been formed but for its relationship to the accomplishment of such purposes;
 - no significant purpose can be the production of income or the appreciation of property.
- No purpose can be to accomplish one or more political or legislative purposes
- Created to facilitate program-related investments by private foundations



Use of L3Cs

- Regulated as a for-profit, not a nonprofit
- For-profit subsidiaries of a charity (e.g., developing surplus real estate)
- Disregarded or exempt subsidiary of a charity
- Models that combine private, philanthropic and government capital (public-private partnerships)
- Program-related investments (but IRS says no advantage)



Benefit Corporations

- New structure to require directors and officers to consider non-financial interests and to protect directors and officers if they sacrifice shareholder wealth in doing so:
 - Baked-in corporate purpose
 - Fiduciary duty redefinition
 - Annual reports



Purpose of Benefit Corporations

- General “public benefit” is defined as:
 - A material positive impact on society and the environment,
 - taken as a whole,
 - as assessed against a third party standard
- May add a “specific public benefit” (but not in derogation of general benefit) specific to the entity's goals, including:
 - Improving health
 - Promoting economic opportunity
 - Carbon neutral operations
 - 100% local sourcing



B Corp – A Certification

- A “B Corp” is an entity that has received a certification from B Lab:
 - B Lab: “The Non-Profit Behind B Corps”
- A “B Corp” is not (always) a benefit corporation:
 - Multiple reasons to become a certified B Corp
 - Certification Process
- Examples:
 - Local: Arabella Advisors, Raffa, Busboys & Poets
 - National: King Arthur Flour, Patagonia, Greyston Bakery, Klean Kanteen, Ben and Jerry’s, Dansko, The Honest Company



Benefit Corporations - Variation

- Earliest adopting states tended to follow the B Lab model Benefit Corporation Act
- 2013: Delaware and Colorado adopted a slightly different approach:
 - Specific benefit
 - Third-party standard
 - Annual benefit report



Social Purpose Corporations

- Social Purpose Corporations exist in:
 - California (Formerly called Flexible Purpose Corporation)
 - Washington
 - Florida
 - Minnesota (although called a “specific benefit corporation” or “SBC”)
- The social purpose can be broadly or narrowly defined, and/or could be a general benefit purpose



Using Social Enterprise Structures

- For profit subsidiaries of 501(c)(3) organizations:
 - Service based nonprofit that provides no-cost services to its nonprofit clients and under the benefit corporation provides at-cost services
- Social enterprises financed by mission-oriented investors/founders:
 - Product companies with founders who merge mission and business
- For-profit with nonprofit mission:
 - Service provider with a triple bottom line (people, planet, profit) serving companies and nonprofits that themselves have a social mission



Considerations

- Investor Confusion
- Additional corporate documentation required
- Conversion of a large entity
- Marketing strategy
- Management ability to consider all stakeholders
- Legal risks:
 - No case law
 - Unnecessary addition to corporate statutes?
- No IRS tax-exemption recognition for these structures



Questions

Jeffrey S. Tenenbaum, Esq., Venable LLP
jstenenbaum@Venable.com
t 202.344.8138

Carrie Garber Siegrist, Esq., Associate, Venable LLP
CGSiegrist@Venable.com
t 202.344.4249

Andrew Schulz, Esq., General Counsel, Arabella Advisors
Andrew.Schulz@arabellaadvisors.com
t 202.759.5744

To view an index of Venable's articles and presentations or upcoming seminars on nonprofit legal topics, see www.Venable.com/nonprofits/publications or www.Venable.com/nonprofits/events

To view recordings of Venable's nonprofit programs on our YouTube channel, see
www.YouTube.com/user/VenableNonprofits

