Effective Social Enterprise — A Menu of Legal Structures

by Robert A. Wexler

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Robert A. Wexler

The new client, comfortably seated at the conference room table, asks: “What is the definitive legal form for a new social enterprise — a nonprofit corporation that is tax exempt as an organization described in IRC section 501(c)(3); a nonprofit corporation that is tax exempt as an organization described in section 501(c)(4); a nonprofit corporation that is not tax exempt; a for-profit corporation; a for-profit S corporation; a B corporation; a low-profit limited liability company, also known as an L3C; a combination of the above; or other?” The seasoned attorney, not the least bit intimidated by this complex question, replies with the often used, lawyerly, and in this case quite accurate, response, “It depends.”

In December 2006 I wrote an article titled, “Social Enterprise: A Legal Framework” (The Exempt Organization Tax Review, December 2006, p. 233). That article was an overview of the legal issues facing the social enterprise movement in the United States. In the two-plus years since writing that article, I have had an opportunity to advise more and more social entrepreneurs, some who wish to form a new tax-exempt entity, others who lead established exempt organizations and are seeking to expand their revenue-generating activities, and some who have business plans in various stages of development and are not sure whether they should form a for-profit entity, a nonprofit entity, or both. Those seeking to use both a for-profit and a nonprofit sometimes refer to the new entities as a hybrid social enterprise.

Those of us who work with social enterprises recognize by now that there is no legal definition of social enterprise, and there is not even a uniformly recognized nonlegal definition, although there have been many valiant attempts. The Social Enterprise Alliance (http://www.se-alliance.org) defines a social enterprise as “an organization or venture that achieves its primary social or environmental mission using business methods.” The Skoll Foundation (http://www.skollfoundation.org) defines social entrepreneur, one who forms and leads a social enterprise, as “society’s change agent: a pioneer of innovations that benefit humanity.”

To me, the word “enterprise” implies that there is a businesslike activity. More often than not a businesslike activity will seek to generate revenue. The word “social” implies that some good is coming from the enterprise, other than merely the generation of profits. What makes a particular endeavor socially beneficial is, of course, somewhat subjective. At its core, a social enterprise, whatever else it is or is not, is a businesslike activity that is designed, at least in part, to do good, and not simply to generate profits.

Beyond this basic concept, I am not concerned here with definitions, nor do I care to debate, as exempt organization lawyers sometimes do, whether the concept of social enterprise is good, truly differs from traditional philanthropy, or is just a logical extension of traditional philanthropy. It may well be all of the above. Personally, I believe that identifying socially motivated revenue-generating activity as social enterprise is more helpful than not, that social enterprise does differ, at least in some important ways, from traditional philanthropy, but that social enterprise is not an entirely new construct. It has evolved from at least two sources: (1) the traditional revenue-generating nonprofit models, including hospitals, schools, and low-income housing organizations; and (2) the significant increase in for-profit venture activity during the past 20 or more years.

Some social enterprises succeed, some fail. Our job as counsel is to provide social entrepreneurs and social enterprises with the best possible legal framework to help them try to succeed.

The purpose of this article, my second on social enterprise, is to provide guidance to the social entrepreneur about how to decide whether a new social enterprise should be structured within a tax-exempt or taxable legal entity, or whether a hybrid structure using both a taxable and an exempt entity is more appropriate. The first section presents the menu of legal structures potentially available to the social enterprise, eliminating those that are hardly ever practical. Next, I pose a series of questions that the attorney should consider with the

1 All section references, unless otherwise stated, are to the Internal Revenue Code of 1986, as amended.
<table>
<thead>
<tr>
<th>Meat Type</th>
<th>Tax Factors</th>
<th>Management and Control</th>
<th>Capital and Loans</th>
<th>Distributions of Funds Not Used for Programs</th>
<th>Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit corporation</td>
<td>Taxed on net income.</td>
<td>Shareholders elect board of directors, which delegates to committees and staff.</td>
<td>Shareholders make contributions. The entity may be able to accept program related investments (PRIs) from foundations in the form of loans or equity.</td>
<td>Dividends to shareholders. Can make charitable contributions, but deductibility limited to 10 percent of net income.</td>
<td>Net assets to shareholders, after paying creditors.</td>
</tr>
<tr>
<td>Limited liability company (LLC) taxed as a partnership</td>
<td>Items of income and expense passed through to members. Tax-exempt members treat their share of income as exempt or subject to unrelated business taxable income (UBTI), depending on the character of the income</td>
<td>The operating agreement provides for a management committee or a single manager, typically elected by the members.</td>
<td>Membership contributions; possible PRI funding.</td>
<td>Distributions to members. LLC can make charitable contributions and allocate them to the members to claim on their own returns.</td>
<td>Net assets to members, after paying creditors.</td>
</tr>
<tr>
<td>Low-Fat, Organic, Substantially Grown</td>
<td>See LLC above.</td>
<td>See LLC above.</td>
<td>See for-profit corporations above; plus, set up to accept PRI money more easily.</td>
<td>See for-profit above. May be set up to make contributions to charities or socially beneficial causes, although no deductibility advantage.</td>
<td>Net assets usually to shareholders, but distributions to charity may be possible as well.</td>
</tr>
<tr>
<td>The B corporation (a for-profit corporation that also has a social mission and is licensed to use the trade name “B corporation”)</td>
<td>See for-profit corporation above.</td>
<td>See for-profit corporation above.</td>
<td>See for-profit corporations above. A B corporation may be in a better position to attract and accept PRI money.</td>
<td>Net assets</td>
<td></td>
</tr>
<tr>
<td>L3C (an LLC that is formed as a low-profit limited liability company)</td>
<td>See LLC above.</td>
<td>See LLC above.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vegetarian</td>
<td>Not taxed on income, unless it’s UBTI. Can offer tax deductions to donors.</td>
<td>Board of directors controls. Some corporations have members who elect directors or appointees/designators who appoint directors.</td>
<td>Charitable contributions and grants. Easily eligible for PRI loans.</td>
<td>Grants for charitable purposes.</td>
<td>Net assets to another 501(c)(3) with like exempt purposes.</td>
</tr>
<tr>
<td>Nonprofit corporation 501(c)(3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonprofit corporation 501(c)(4)</td>
<td>Not taxed on income, unless it’s UBTI. No tax deduction for donors.</td>
<td>See 501(c)(3) above.</td>
<td>Nondeductible contributions; grants; possible PRI money.</td>
<td>Can make grants for charitable or public and social welfare purposes.</td>
<td>Net assets to another 501(c)(4) or to a 501(c)(3), in either case with like exempt purposes.</td>
</tr>
</tbody>
</table>
client in making selections from the menu. Finally, I provide a brief framework for analyzing the information collected from the client in order to suggest the most practical legal form under the circumstances.

I. Menu of Social Enterprise Options

The menu (p. 2) consists of three sections: Meat; Low-Fat, Organic, Subsustainably Grown; and Vegetarian. Combination platters are also offered, by choosing one menu item from meat or low-fat meat and one from the vegetarian menu.

The following items are not on our menu because they present no relative advantages over the choices listed above: S corporations; trusts; unincorporated associations; general partnerships; limited partnerships; LLCs that elect to be taxed as corporations, including those that qualify under section 501(c)(3); single member LLCs; and nonprofit corporations that do not seek to qualify for tax-exempt status.

Reading and understanding the menu:

Meat

The meat portion of the menu offers the two most viable options for an entirely for-profit experience. There are many articles and treatises written on the relative tax and legal advantages and disadvantages of the LLC versus the corporation, which are beyond the scope of this article. Entrepreneurs who, at this point, have no interest in the low-fat or vegetarian options and who have no interest in seeking tax-exempt investors probably need read no further.

But when a for-profit social enterprise intends to seek one or more 501(c)(3) or (c)(4) tax-exempt investors, whether in an LLC as members, or in a corporation as shareholders, the entrepreneur must understand that the tax-exempt investor will almost always prefer to invest in a vehicle that minimizes or eliminates any unrelated business taxable income (UBTI). Generally, such a tax-exempt investor will pay no unrelated business income tax (UBIT) on dividends or capital distributions it receives from a corporation (unless it is an S corporation (section 512(e)) or unless the investor has purchased its shares using borrowed money (section 514)). A section 501(c)(3) private foundation (along with its disqualified persons) generally will not be able to own more than 20 percent of the shares of a corporation, unless the investment qualifies as a program-related investment (sections 4943 and 4944).

In contrast, the tax-exempt investor in an LLC will have to consider the character of the income derived from its LLC investment. If the LLC, as is likely here, is generating UBIT, the tax-exempt investor will pay UBIT on its share of net income from the LLC. In some cases, the tax-exempt investor may be able to claim that the income is substantially related to the performance of its exempt activity, and therefore is not UBIT. The private foundation investor may own no more than 20 percent of the profits interest in an LLC (including the shares owned by its disqualified persons), unless the investment is a valid program-related investment (sections 4943 and 4944). Any social enterprise considering an LLC will also need to be aware of the tax-exempt investor’s concerns about the line of revenue rulings and related cases dealing with whole entity and ancillary joint ventures (see Rev. Rul. 98-15 and Rev. Rul. 2004-51). A tax-exempt investor in an LLC should consider whether participation in the LLC might jeopardize the investor’s exempt status or generate UBIT.

When a tax-exempt investor’s investment in an LLC or for-profit corporation is considered to be either substantially related to the investor’s exempt purposes or a program-related investment, the tax consequences to the investor are generally favorable. The income from investment is not UBIT; the investment does not jeopardize the investor’s exempt status, and, for a private foundation investor, none of the section 4940 series excise taxes should apply. However, an investment in an LLC or corporation often will not be substantially related to an investor’s exempt purpose, and it may not qualify as a program-related investment for a private foundation investor.

<table>
<thead>
<tr>
<th>Type of Entity</th>
<th>Profits</th>
<th>Distributions to the EO</th>
<th>Rents, Royalties, and Interest When EO Controls</th>
<th>Rents, Royalties and Interest When EO Does Not Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>Taxed at the corporate level only</td>
<td>Dividends paid by the corporation are not taxed to the exempt organization shareholder, but are not deducted by for-profit</td>
<td>Taxed as UBIT to the EO; deductible by the corporation</td>
<td>Not taxed to the EO; deductible by the corporation</td>
</tr>
<tr>
<td>LLC</td>
<td>LLC provides EO with a K-1, and EO files a 990-T UBIT return to pay tax on its share of income</td>
<td>LLCs do not pay dividends and distributions are not separately taxed to the EO</td>
<td>Taxed as UBIT to the EO; expensed by the LLC, effectively reducing other EO taxable income</td>
<td>Not taxed as UBIT; expensed by the LLC, effectively reducing other EO taxable income</td>
</tr>
</tbody>
</table>

Although they may find it useful, this article is not addressed to established tax-exempt organizations that are seeking to leverage and expand a skill, product, or service that they already have developed within their section 501(c)(3) entities to enter into a new revenue-generating activity. Those organizations might review an article published on my firm’s Web site titled “Revenue-Generating Activities of Charitable Organizations” (http://www.adlercolvin.com).
The following sections summarize the tax effect to an exempt investor of operating and taking distributions from a corporation or an LLC, when the investment is not considered to be substantially related or a valid program-related investment:

A. Income From Ordinary Operations

In the course of operations, the social enterprise will generate funds that will be distributed to investors in a variety of forms. Sometimes the tax-exempt investor is merely a shareholder in a corporation or a member in an LLC. In other situations, the exempt investor will lend money to the venture and receive interest payments in return, license the name of the exempt entity to the venture in return for a royalty, or lease real estate to the venture. If a tax-exempt entity owns more than 50 percent of the stock in a corporation or 50 percent of the profits interest in an LLC, section 512(b)(13) treats any rental income, interest income, or royalties paid to the tax-exempt parent as UBTI (with some limited transitional exceptions from the 2006 Pension Protection Act). (See chart at top of p. 3 for more details.)

B. Liquidation of Entity

At some point the entity will likely terminate and liquidate or sell its assets. (See chart at top of this page for more details.)

Low-Fat, Organic, Sustainably Grown Meat

The low-fat portion of the menu presents two types of entities, both of which are for-profit, taxable entities, but that are designed to engage in some social benefit activities.

The first is the low-profit limited liability company, or L3C. The L3C nomenclature can be quite frustrating to exempt organization lawyers who have been working for years to stop their clients from expressing with all apparent confidence to members of the public that they are exempt under “section 501(c).” In the case of the L3C, however, the three “L’s” refer to “low-profit,” “limited,” and “liability,” and the “C” to “company.”

As of May 15, 2009, the L3C has been adopted in several states, including Vermont, Michigan, Wyoming, North Dakota, and Utah, and it has been introduced in at least a half dozen more, but anyone can, of course, form an L3C in one of these states that does business in any state. Other states are considering adopting the L3C form, and the Crow Indian Nation also has adopted an L3C statute. See http://www.americansforcommunitydevelopment.org for an update.

The L3C is an LLC for all legal and tax purposes, formed under applicable state laws, except that it has incorporated particular socially beneficial standards into its governing documents and operating principles that entitle it to license the brand name “B corporation” from a for-profit entity called B Labs. Many regard this certification as signifying that the B corporation is, while operating for profit, operating in a way that promotes favorable employment practices, environmental standards, and engages in some level of social welfare or charitable activity. See www.b-corporation.net for more information. B Labs’ Web site states:

B Corporations are a new type of corporation which uses the power of business to solve social and environmental problems. B Corporations are unlike traditional responsible businesses because they:
meet comprehensive and transparent social and environmental performance standards; institutionalize stakeholder interests; and build collective voice through the power of a unifying brand.

Accordingly, even though the L3C and the B corporation are designed to promote social good, their tax effects for EO investors are the same as those provided above under the meat section. The debate as to the value of the B corporation brand and the L3C form is likely to continue for some years to come.

I also am part of a task force of volunteer attorneys in California that is drafting legislation to create a new type of California corporation whose management would be legally permitted to operate for the benefit of labor, environmental, and charitable interests, in addition to the interests of shareholders. If adopted, this new type of entity will go beyond the “constituency statutes” that many other states have already adopted by, among other things, requiring management to measure and report how it has provided a social return on investment to its shareholders. Constituency statutes are code sections within a state’s corporations code that permit a board of directors to consider interests other than those of the shareholders. It can be difficult, although not impossible, to qualify as a B corporation without incorporating in a state with a constituency statute.

**Vegetarian**

Finally, the vegetarian section of the menu offers nonprofit corporations that are tax exempt as organizations described under either section 501(c)(3) or section 501(c)(4). Section 501(c)(3) organizations can, of course, accept tax-deductible charitable contributions, and publicly supported 501(c)(3) organizations can accept private foundation money without the need for expenditure responsibility. Section 501(c)(4) organizations, on the other hand, cannot accept tax-deductible contributions but have broader social welfare purposes that permit greater political engagement and may conduct some types of social enterprise activities that are not considered within the definition of section 501(c)(3). For entities that do not plan to seek contributions or grants as part of their business model, a 501(c)(4) classification may make a great deal of sense.

**Combinations**

A classic combination platter would consist of a for-profit corporation coupled with a 501(c)(3) public charity. Some menus might also feature a low-calorie combination platter that includes a 501(c)(3) public charity and a 501(c)(4), or possibly even a 501(c)(3) private foundation combined with a 501(c)(4) organization. While such combinations are classically employed for tandem organizations that have a lobbying arm and a charitable arm, they are now being used more often to enable one entity to accept charitable contributions and engage in educational activities while its sister 501(c)(4) generates revenues from a social-welfare-style activity that might not qualify for 501(c)(3) status.

Most clients who talk about a hybrid structure, however, are considering pairing a charitable organization that can receive grants and contributions and a for-profit that can use investment capital to develop a product or service and then provide that product or service to the charity at a fair market value rate. As illustrated below, the two most complicated issues that typically arise in the hybrid model are (1) taking substantive and procedural steps to avoid any excess benefits, and (2) ensuring that the activities of the for-profit and the charity can be sufficiently separated so that the activities of the business are not attributed to the charity, thereby compromising its tax-exempt status.

**II. The Questions**

With this menu in hand, how does one choose? When should an enterprise consider more than one choice from the menu? Just as a good waiter or sommelier will ask the right questions to help the thoughtful diner make the right choice, the lawyer should make a series of inquiries to help the social entrepreneur choose as well. What follows are some of the key questions to explore with a new social enterprise client, and for a new client to consider before speaking with the lawyer.

A lawyer who works primarily with for-profit entities might be inclined to advise a new client to use a 501(c)(3) only when there is a need for charitable contributions and grants. A lawyer who works primarily with tax-exempt entities might be inclined to look first to whether a 501(c)(3) or 501(c)(4) format might accommodate the business plan, and only bring in a for-profit if the need for private capital cannot be avoided. In contrast, the questions that follow will assume that meat — the for-profit option — is always on the menu, but that vegetarian — the tax-exempt option — may or may not be on the menu. Accordingly, the questions typically start by exploring whether a nonprofit, tax-exempt form is even on the table. Even if the tax-exempt option is available, however, it is not necessarily the best choice.

1. **May I see your business plan, please?**

One of the most difficult situations for a lawyer involves the new client who has a vague idea of what he or she wants to accomplish, then comes to the lawyer to understand the law so that the legal considerations can give initial shape to his or her business plan. This approach is quite backwards. The client’s business plan — including a clear understanding of the goods or services the client plans to provide, where the client plans to find capital, how the client plans to conduct operations, how much control the founders expect, and considerations of the long-range view of the project — should come first. The lawyer should use legal constructs to shape the client’s idea. The client should not be using legal constructs, in the first instance, to create a business plan based on what particular legal constructs permit.

For example, the social entrepreneur who comes in and says, “I have heard about the new L3C structure in Vermont, and I want to come up with a business idea to use that new legal form,” is missing the point entirely, in my view.
2. What is your fundamental program, activity, good, or service?

Almost all of my clients are tax-exempt organizations, yet I start from the premise that a for-profit structure is probably more appropriate for most social enterprises. Nonetheless, a good waiter makes sure he fully understands the diner’s preferences before recommending a dish. I want to know whether the client has the ability to stomach the vegetarian option, even if I might end up recommending the meat. Accordingly, once the attorney understands the core business plan, he or she should consider whether the activity can qualify for tax-exempt status under section 501(c)(3) or 501(c)(4).

Resolving this question is usually a matter of understanding the line of legal authority related to the specific activity the client is proposing. When evaluating a particular type of enterprise activity, it is rarely possible to generalize based on section 501(c)(3). Each activity has evolved its own line of authority. Let us consider some typical examples of social enterprise activities that might qualify for tax exemption:

A. Job Training

Many social enterprises have traditionally sought, and continue to seek, to operate some form of business that employs, and during the course of employment teaches job skills to, a disadvantaged charitable class. Job training is a recognized tax-exempt activity. There are both well-known practical examples and IRS rulings on point.

We find examples of tax-exempt job training programs around the country. In the San Francisco Bay area, we have Delancey Street Foundation (http://www.delanceystreetfoundation.org), which focuses on job training for individuals who were previously incarcerated and often have drug and alcohol problems. Juma Ventures (http://www.jumaventures.org) provides job training to economically disadvantaged youth, and Pedal Revolution, a social enterprise of New Door Ventures, helps at-risk youth learn how to develop job skills by working in a bicycle repair shop (http://www.pedalrevolution.org). All are tax-exempt as organizations described under section 501(c)(3), and they are just three of countless examples from around the country.

What is the legal authority for a tax-exempt job training venture? In Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), the U.S. Tax Court considered the exemption of a charity that purchased and sold handicrafts to disadvantaged craftsmen. The charity sold the handicrafts to museums and other nonprofit shops and agencies. The Tax Court found that the sale of the items was related to the exempt purpose of the organization, in part because the activity alleviated economic deficiencies in communities of disadvantaged artisans. A similar conclusion was reached in Industrial Aid for the Blind v. Commissioner, 73 T.C. 96 (1979), in which the corporation purchased products manufactured by blind individuals and sold them to various purchasers.

In Rev. Rul. 73-128, 1973-1, the IRS determined that a business conducted for the primary purpose of providing skills training to the disadvantaged was operated for charitable purposes. In Rev. Rul. 75-472, 1975-2 C.B. 208, a charity directly employed disadvantaged persons in its business, which involved the production and sale of furniture made by residents of the corporation’s halfway house for alcoholics.

These cases and rulings make clear that the benefits to businesses that obtained trained workers as a result of job training programs are incidental to the primary charitable and educational purposes of the social enterprise. The IRS agents reviewing exemption applications are, as a general rule, well acquainted with this line of authority, and we rarely encounter difficulty in obtaining exemption for job training nonprofits.

B. Providing Technical Assistance

Some social enterprises seek to apply business methods to improve nonprofits’ operations by providing them with technical assistance, such as management consulting, accounting, legal, and other services. Unlike the job training area, it can be difficult to provide technical assistance as a 501(c)(3) entity because there are many for-profit entities and individuals who also consult with exempt organizations for a fee. Accordingly, the tests for charity are considerably more rigorous.

Many exempt organizations provide technical assistance as part of, or as their primary, exempt activity. CompassPoint Nonprofit Services (http://www.compasspoint.org) provides technical assistance to nonprofits in the San Francisco Bay area as one of its main exempt activities. Rockefeller Philanthropy Advisors (http://www.rockpa.org) is another example; it is a nationally based organization that provides technical assistance and donor services to wealthy families and to exempt organizations. Both organizations are supported by grants and contributions as well as fees, and they provide other services besides technical assistance.

How are these and similar organizations exempt? Providing technical assistance to nonprofits is a recognized 501(c)(3) activity if the fees charged are substantially below cost. The IRS developed the “substantially below cost” analysis in two revenue rulings. In Rev. Rul. 71-529, an organization was formed to aid other charities by helping them manage their endowment or investment funds more effectively. The member organizations paid only a nominal fee for those services; the organization’s operating expenses were primarily paid by grants from independent charitable organizations. The fees that the entity charged nonprofits for the services represented less than 15 percent of total costs of operation. The IRS found that the entity was exempt because it performed an essential function for charities at substantially below cost.

In Rev. Rul. 72-369, an organization provided managerial and consulting services to charities to improve the administration of their charitable programs. The organization entered into agreements with unrelated charities to furnish the services on a cost basis. The IRS found that providing the services on a cost basis did not constitute a charitable activity, because the organization lacked the donative element necessary to establish the activity as charitable.

An important factor demonstrating that technical services are being offered at substantially below cost is to show that the service provider raises funds from other independent charities or other donors, as in Rev. Rul.
provider is making a grant, in the form of donated services, to subsidize the services. In effect, the service is private letter rulings 200036049, 200332046, and the charitable nature of the provision of services. (See also private letter rulings 200036049, 200332046, and 9414003, which cite BSW.) The IRS and the Tax Court confirmed this line of thinking in At Cost Services Inc. v. Commr., 80 TCM 573 (2000), in which the court held that providing job training and placement services for fees equal to cost was not considered to be a charitable activity. (See also TAM 9232003, in which the IRS concluded that management for a fee equal to cost plus a percentage of management fee is not charitable.)

C. Producing Products for a Charitable Class

In recent years, particularly during the last 10, more and more social enterprises have sought to develop and produce products or services in a businesslike fashion, but then sell and distribute those products and services at a deep discount to the poor. Often the enterprises require charitable contributions and grants to capitalize operations, but ultimately they can become barely self-sufficient. This type of social enterprise is quite prevalent in practice, but slowly evolving in legal definition. Practical examples include the following organizations.

Kickstart International Inc. (http://www.kickstart.org) designs low-cost products for sale to help alleviate poverty in developing countries. The Institute for OneWorld Health (http://www.oneworldhealth.org) helps develop new medicines to help the poor and works with companies to help disseminate the medicines. The mission of Design That Matters (http://www.designthatmatters.org) is to create products that improve the services of social enterprises in developing countries.

EnterpriseWorks VITA (http://www.enterpriseworks.org) also uses revenue-generating strategies to help alleviate poverty. Design Revolution: Design for the Other 90%, also known as D-Rev (http://www.d-rev.org), designs products at low cost to benefit the poor (the other 90 percent) of the world for whom most products are not really designed.

Despite the prevalence of those types of organizations, every exemption application that I have submitted for an organization that seeks to produce products or develop services to benefit the poor has received several rounds of IRS questions. Why? In my view, the IRS questions are not at all out of line given the lack of authority in this evolving area. IRS exemption application reviewers typically have few concrete guidelines to help them when evaluating this type of exemption application, and they cannot be blamed for being cautious.

What follows is an actual set of IRS questions on a recently approved exemption application, together with the organization’s responses. The colloquy will help illustrate the legal ambiguity in this area:

IRS: You explained your purposes and proposed operations in your recent correspondence attempting to justify why you engineer new products from design to development with purposes to assist small farmers and help relieve poverty as a result of your products. Your organization will hold patents on designs, contract with one or more for profit corporations to manufacture and produce products. Generally designing, development, patents for designs, productions and distributions are purposes, operations and characteristics of a for profit commercial entity, not a charitable nonprofit corporation.

You state that your organization is an incubator that brings about affordable income-generating products and services to the point that they are ready for full-scale dissemination through successive stages of: (1) proof of concept prototype development and testing; (2) beta field tests; and (3) mass dissemination. Your organization appears similar to organizations in Revenue Rulings 68-373, 69-632, and 78-426 that were found not to be exempt because of commercial operations.

In Revenue Ruling 68-373, an organization was engaged in the clinical testing of drugs for commercial pharmaceutical firms. Clinical testing benefited commercial firms and is ordinarily an incident of a pharmaceutical company’s marketing operations. The organization was determined not tax exempt. Similarly, in Revenue Ruling 78-426, an organization whose activities consisted of inspection, testing, and safety certification of cargo shipping containers used in international and domestic transport and also conducted research, development, and reporting of information in the field of containerization did not qualify for exemption under IRC 501(c)(3).

In Revenue Ruling 69-632, a non-profit association composed of members of a particular industry formed to develop new and improved uses for the existing products in the industry benefited its members rather than the public. The association’s research program enabled its members to increase their sales by creating new uses and markets for their products. The organization was held not to qualify for exemption under IRC 501(c)(3).

The Supreme Court of the United States held that a better business bureau was not exclusively educational or charitable. Its activities were in part aimed at promoting the prosperity of the business community, even though there was also benefit to the public. This was a substantial private benefit that precluded exemption. Better Business Bureau of Washington, D.C. Inc. v. United States, 326 U.S. 279 (1945).

It was noted in your response you referenced General Counsel Memorandum 37403. In the memorandum, it described a case that clearly involved a community which was impoverished, although the courts did not rely on this factor in reaching their conclusion on whether or not the
organization might otherwise qualify for exemption under Code 501(c)(3). The fact that the community was located in a poverty area may account in large part for the governmental interest in helping it obtain a water supply, and clearly accounted for the extent of financial assistance from the Federal government. Although once the county government became involved in such a project, in the manner and to the extent described above, the organization qualified for exemption under Code 501(c)(3) because it was lessening a burden of that government irrespective of the economic status of the residents of the community. It was noted that the exempt organization was noncommercial in nature which is in contrast to your organization that is commercial in nature.

Charity: The Regulations provide that term “charitable,” as used in Section 501(c)(3) in its generally accepted legal sense, can include activities that might also be described as educational, religious, or scientific. The term “charitable” includes: relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

The organization’s core mission is charitable. The relief of poverty is a well-recognized charitable purpose. The organization’s core activity is to design products that are not being designed in the for-profit sector, specifically to benefit the poor — those making less than $2 a day. The organization seeks simple solutions to help alleviate poverty.

Designing products and services for the poor, who would otherwise not be served, is a charitable activity. These are not products that are designed for the middle class or the wealthy. These are not products designed to help any industry. This organization is NOT commercial in nature. It is not designing products in a way that looks to maximizing profits or even making money at all. It is looking to design products that: (1) will help poor people and (2) can be sold at a very low price that is affordable to the poor. A commercial company would not work to incubate ideas and develop products that are only sold at very low cost to the poorest of the poor. We are talking about the same individuals who benefit from micro-finance loans — individuals making less than $2 a day.

The organization is also engaged in scientific research, in a manner consistent with the Regulations. The Regulations (1.501(c)(3)-1(d)(5)) provide: ...

...since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a scientific organization must be organized and operated in the public interest. Therefore, the term scientific, as used in section 501(c)(3), includes the carrying on of scientific research in the public interest.

The Regulations tell us that scientific research will be regarded as carried on in the public interest if ... [quoting theRegs]

...The Regulations clarify that for purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public.

The Organization’s research is clearly directed toward benefiting the public because the whole point behind the research is to alleviate poverty. In addition, the Organization will make the results of all of its research available to the public on a nondiscriminatory basis. It will publish information on its website about all of its designs. It may, or may not, choose to take out a patent on any particular design, but whether or not it takes out a patent, any company that wants to license the Organization’s scientific findings and designs will be afforded the opportunity to do so.

The rulings cited in the IRS’ inquiries all deal with entities that are designing commercial products, not intended for the poor, or that involve testing products for a for-profit company, at its direction. The Organization is not testing products that have been developed by another company; it creates its own designs. The Organization is not designing products for any company, and The Organization is not creating commercial products. The Rulings cited are simply inapplicable.

IRS cites Revenue Rulings 68-373, 69-632, and 78-426. In Rev. Rul. 68-373, the IRS ruled that an organization set up to test drugs developed by a pharmaceutical company was not exempt. The Organization is not testing drugs developed by any company, nor is it even in the business of designing or testing drugs. However, the IRS has recognized that identifying and disseminating drugs to the public can be an exempt activity. See www.one-worldhealth.org. In Rev. Rul. 69-632, an organization was set up to evaluate products for a particular industry. It did not do independent research. The Organization is not captive to any industry. It does its own research and design based on the needs of the charitable class it serves — not the needs of an industry. Rev. Rul. 78-426 deals with an organization testing ship cargo containers against federal safety standards. This ruling bears no relationship
to the Organization’s activities, which do not involve testing for public safety.

The IRS’s questions illustrate the agency’s difficulty in approaching this area, absent clear authority, but the response ultimately satisfied the IRS reviewers, as it should have.

E. Microfinance

There are both practical examples and a limited number of rulings to support the tax-exempt nature of microfinance lending. Microfinance is a social enterprise activity because it involves applying a business model to lending small amounts of money to underserved populations. Revenue is generated from interest, and loans can be recycled, potentially creating a self-sustainable entity.

Kiva (http://www.kiva.org) is a 501(c)(3) charity that facilitates and promotes microfinance loans. Its Web site defines microfinance as “the supply of loans, savings, and other basic financial services to the poor” (citing the Consultative Group to Assist the Poor (http://www.CGAP.org)). Kiva notes further that “as the financial services of microfinance usually involve small amounts of money — small loans, small savings etc. — the term ‘microfinance’ helps to differentiate these services from those which formal banks provide.” Microfinance loans tend to be in the $500 to $5,000 range, and they are typically made by a microfinance institution (MFI). An MFI can be a bank or a for-profit organization or a nonprofit entity. Kiva.org also notes that “the World Bank estimates that there are now over 7,000 microfinance institutions, serving some 16 million poor people in developing countries. The total cash turnover of MFIs world-wide is estimated at US $2.3 billion and the potential for new growth is outstanding.” Grameen Foundation (http://www.grameenfoundation.org), affiliated with Grameen Bank, which largely pioneered this area of social enterprise, and MicroCredit Enterprises (http://www.mcenterprises.org) are also examples of 501(c)(3) entities that loan money to MFIs.

Despite the prevalence of MFIs and the clear charitable nature of MFI loans, new IRS applications for organizations that intend to lend to MFIs or directly to the poor continue to receive a great deal of scrutiny. Why? The area of microfinance lending is relatively new, and evolving, and the IRS reviewers do not have appropriate guidance, in the form of checklists or otherwise, when reviewing microfinance exemption applications. In a recent question, for example, a reviewer asked how an applicant could be said to be engaged in microfinance lending when it intended to lend money to microfinance institutions and not directly to the poor. We explained that it is not always efficient for a U.S. charity to lend money to individuals in another country on a person-by-person basis when there is an established MFI in that country to which the U.S. can lend money and the MFI will be able to do a better job.

What, then, is the legal authority for the charitability of microfinance lending? One of the most established charitable purposes under section 501(c)(3) is the “relief of the poor and distressed or the underprivileged.” See reg. section 1.501(c)(3)-1(d)(2). In Rev. Rul. 74-587, 1974-2 C.B. 162, for example, the IRS approved as charitable an organization whose mission was to stimulate economic development in “high density urban areas inhabited by low-income minority or other disadvantaged groups.” These areas lacked capital for development and suffered from a depressed economy. The IRS noted that local business owners had “limited entrepreneurial skills.” The charity sought to improve the area by providing low-cost loans to local businesses.

The IRS also has approved loan programs to for-profit businesses engaged in microfinance lending as proper PRIs. In LTR 200325005, the IRS ruled that an equity investment in foreign microfinance banks served a valid charitable purpose under section 501(c)(3). The banks used capital contributions to provide unsecured microenterprise loans to the poor. The grantor made capital contributions to the banks and monitored their poverty focus through regular reports. The IRS ruled that the investments differed from a typical capital venture, because the banks were involved in financing microloans and providing savings services to the poor and underserved.

In LTR 200034037, a foundation proposed to make a series of below-market-rate loans to media businesses in Central and Eastern Europe, Latin America, Southeast Asia, and Africa to ensure their autonomy from local governments. The IRS found that the loan program accomplished a charitable purpose because it was intended to promote the development of independent, nonprofit media in some regions of the world and because the foundation would make loans only to those that were not able to obtain funds through commercial sources.

Although each situation needs to be reviewed on its merits, there is ample precedent to show that the IRS recognizes the relief of poverty through microfinance as a charitable activity.

Whether the business plan calls for job training, technical assistance, producing products or services for the poor, microfinance, or some other form of social enterprise, after we have determined whether the activity can fit within a 501(c)(3), we continue the inquiry.

3. If all of the activities cannot qualify for exempt status, can the core activities be bifurcated into those that could qualify for tax exemption and those that cannot, or are they too closely linked?

The question surfaces whether a nonprofit/for-profit hybrid might be appropriate. Again, just because part of the activity could qualify for exemption as charitable does not mean that a charitable vehicle is appropriate, but this fundamental analysis is necessary to determine exactly what is on the menu tonight.

Many of my clients over the last few years have indicated an interest, for example, in forming a nonprofit, exempt entity to “own” a Web site that provides educational content, and then to form a for-profit entity that will “manage” the Web site and also attract advertising for it. In this type of situation, the question is whether these two activities are too closely linked to separate into different legal entities.
A second common scenario involves an entity that seeks to form a nonprofit, tax-exempt job training entity to help a charitable class, such as the homeless, learn job skills in the process of operating a business. At the same time, the social entrepreneur also wants to form a for-profit business in the same line of work to provide a place for graduates of the nonprofit and others in the community to be employed on a long-term basis, after the job training is completed. Can these two activities be reasonably separated into two entities?

A third example involves a design think tank dedicated to creating low-cost products for the poor. This entity, however, also decides to form a for-profit company to sell the products that it designs. Why? The concern was that if the tax-exempt entity developed products to benefit the poorest of the poor, no established manufacturing or distribution firm would be willing to take the risk of making or selling these products. Until it can be proved that making products to help the poor can be at least self-sustaining, if not marginally profitable, this client perceived the need to form a for-profit company to make and sell some of the products that the nonprofit designed. Of course, the products would be open for any for-profit to make and sell, but if none would do so, the related for-profit could at least begin the process and help prove sustainability.

Without more facts, I would initially surmise that the Web site activity will be harder to separate out than the job training activity or the product development and sale activity, but there are examples of Web-site-based activities that have successfully used a for-profit and a nonprofit counterpart. One has to look no further than eBay and its nonprofit collaborator MissionFish.

4. Where do you expect to find your capital?

It clearly makes sense to set up a nonprofit entity if the business model requires grants and contributions or if the nonprofit status will open up access to capital that might not be available to a for-profit business. This is perhaps the most important question when determining what type of entity to form. Clearly, if an enterprise expects to receive most of its funding from individual donors and foundation grants, it should seriously consider forming as a section 501(c)(3) entity, if legally possible. If all of its activities cannot qualify for exemption, it must consider a hybrid structure so that it can still accept charitable contributions to fund qualifying activities.

If an enterprise expects to receive a significant part of its capital from investors, it has no choice but to establish a for-profit entity. Whether such an entity is a corporation or an LLC will depend on other factors that are beyond the scope of the discussion.

A hybrid structure that pairs a taxable entity with a tax-exempt entity sounds ideal because the founders can attract both charitable contributions and grants, as well as equity investments. As described above, however, care is required to ensure that the grants and contributed funds only go to support activities that would otherwise qualify for exemption and are not funneled directly to support the activities that are for profit. Depending on the type of activity, it might be easier or more difficult to separate the different functions.

A 501(c)(4) entity might be appropriate when a single corporate founder or a small group of founders are willing to forgo the tax deduction that comes with 501(c)(3) status in return for greater flexibility as to activities available to 501(c)(4) organizations. For example, salesforce.com recently established and received tax-exempt status for a section 501(c)(4) entity that will help distribute its salesforce.com Internet application to charities in the U.S. and nongovernmental organizations abroad. The 501(c)(4) offers many of the application licenses for free, typically up to 10 per entity, while others above 10 are sold. Because the initial capital and the licenses come from a single company and because the entity will not seek charitable contributions, section 501(c)(4) status was deemed more appropriate.

5. What personal benefit, if any, do the founders want or need to derive from this activity?

If the founders expect anything other than a reasonable salary for their services at a level that would pass muster under section 4958, they should consider a for-profit alternative. Some founders will expect a share of profits, and others will expect to be able to sell their interests later, neither of which works within a tax-exempt entity.

The section 4958 analysis can become exceedingly complex with a hybrid entity because, depending on the relationships between the two entities, the IRS may consider the salary or other benefits paid by both entities to be compensation subject to section 4958 analysis.

For a for-profit and an exempt entity to function permissibly within the confines of section 4958, it will almost always be necessary for the exempt entity to have a board of directors with a majority of individuals who are not involved with the for-profit. That board will need to follow the section 4958 procedures carefully to obtain the benefit of the rebuttable presumption of reasonableness under the section 4958 regulations. Also, the exempt entity should maintain and follow solidly drafted policies on conflicts of interest and disclosure. Any contracts between the exempt and for-profit entities should be negotiated in such a manner that the exempt entity does not become the captive of the for-profit. For example, the exempt entity may need to put the contract out for bid to at least solicit offers from unrelated for-profit providers.

6. How important is control to the founders, in the short and long term?

Investors typically want a good deal of control, but absent investors, it is quite possible to provide for founder control in both a nonprofit and a for-profit form. If an exempt entity is involved, however, it is essential to consider good governance practices, particularly in light of the questions that the organization will now need to answer in connection with parts IV, V, and VI of the new IRS Form 990. Conflicts policies, compensation approval procedures, and having a majority of disinterested board members are probably now par for the course, at least in a 501(c)(3) public charity.
7. What are the perceived branding issues?

Sometimes, wholly apart from tax, corporate, and other legal issues, a client perceives that being a nonprofit is essential to the success of the enterprise. We sometimes refer to this phenomenon as the “halo effect.” This may or may not be a well-considered notion, and it is worth exploring further with the client. Usually this concern is linked to the question of where the client expects to receive funding. Exempt entities and individual donors motivated largely by tax deductions or by the validity of the cause may be disinclined to donate to or invest in a for-profit. On the other hand, venture capitalists and traditional investors may be disinclined to work with an exempt entity or even a taxable nonprofit entity. In that case, the client should also consider the perceived branding advantages of being formed as an L3C. Some think using the B corporation model will attract particular investors and will also provide networking and marketing opportunities to an entity that might not otherwise be available. Accordingly, if being a nonprofit entity is too much for a client to stomach, forming an L3C or a corporation that becomes certified as a B corporation may be the answer.

III. The Advice

At long last it comes time to order from the menu. So, what is the best legal structure for a particular social enterprise? Often the client seeks to implement the most complicated scheme imaginable on the theory that complicated means sophisticated, innovative, entrepreneurial, and therefore better. In truth, as with cooking, complexity for complexity’s sake is foolish. Rather, the following simple analysis should provide a practical framework for selecting the right entity or combination of entities.

A. Reasons to avoid the exempt organization structure. The social enterprise should avoid forming an exempt organization in at least the following situations:

• No part of the proposed activities would qualify for exemption. In this case the exempt, vegetarian option is off the table.
• All of the capital will be coming from investors, rather than from grants and contributions. In this case, there is probably no need for an exempt entity and the additional regulations that necessarily attach to it.
• The founders will devote significant personal energy to the business and want to have something to build and sell for profit later in their careers. An individual cannot profit from the sale of an exempt entity or its assets.

If any of those reasons applies, the enterprise should select solely from the meat or low-fat meat portion of the menu.

B. Deciding between the meat and low-fat meat options. Almost any social enterprise can be legally structured as a for-profit corporation or LLC. The enterprise should consider the L3C or B corporation status as follows:

• Consider the L3C option if the organization hopes to obtain significant capital or loans from private foundations.
• Consider B corporation status when the organization will seek to attract investors who might be drawn by more than the prospect of financial returns. Some investors may be truly drawn to a corporation that expresses a commitment to better labor practices, better environmental practices, and/or engages in more charitable activity than a typical for-profit corporation. When the corporate form is preferred, B corporation status also may help attract private foundation investments.

C. Reasons to create an exempt entity. Even though most social enterprises will find the meat and low-fat meat sections more to their liking, there are clear situations in which it makes sense to use an exempt entity, particularly a section 501(c)(3) entity. Assuming that we have determined that the activity can qualify under section 501(c)(3), the reasons include the following:

• Grants and charitable contributions are a major component of the initial capital and, possibly, of funding ongoing operations. Obtaining donations is the main reason to consider a tax-exempt entity.
• The business model will not succeed if the organization must pay taxes on its net income. This reason will rarely be compelling in a properly designed business model.
• Potential collaborators, like government agencies, will only work with an exempt entity. For example, some student exchange organizations traditionally have formed as exempt entities because they must be exempt to contract with USAID.

D. Reasons to apply for exemption as a section 501(c)(4) entity. Normally, when an organization needs deductible contributions or requires grants, 501(c)(3) status is optimal. Section 501(c)(4) status may make sense, however, when all of the funding is coming from a single corporation or from a single donor who, for whatever reasons, cannot take advantage of the charitable contribution deduction and when no outside investors are needed. Also, 501(c)(4) is useful if the entity wants to engage in significant lobbying or candidate-related activities.

E. Reasons to form an exempt and for-profit combination. Entrepreneurs do not always want to focus on formal boundaries and rules, but to work with a hybrid entity, it is imperative to do so. A for-profit combined with an exempt entity to carry out a social enterprise makes sense as follows:

• when only a portion of the activity can qualify for exemption;
• when capital is required both in the form of private investment and from grants and contributions; and
• when the founders want to build a business to sell, but also are willing to dedicate some portion of the enterprise to charity in perpetuity.

Whenever an enterprise considers a hybrid structure, it must, at a minimum:

• be prepared to delineate clearly the activity that will rest in the exempt versus for-profit structure; there must be a logical and practical way to divide the activities;
• be cognizant of, and be prepared to comply with the procedures to avoid, intermediate sanctions under
section 4958; the enterprise must develop and follow clear conflict of interest policies and disclose financial interests to the disinterested members of the nonprofit board of directors;

- give up legal control of the exempt entity to those who will not benefit financially from the for-profit business; the disinterested members of the tax-exempt board need to be individuals who will understand their independent fiduciary duty and not simply rubber-stamp the decisions of the for-profit founders; and

- ensure that the private investors, particularly any venture capitalists, understand that they do not control, and cannot control or benefit from, the exempt side of the enterprise.

Conclusion

In the end, the new social enterprise needs to select the right restaurant and the right server, study the menu carefully, and order wisely. For those who dare to do this — bon appétit!