Operating In Two Worlds: Tandem Structures In Social Enterprise

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Can a charitable nonprofit successfully operate in tandem with a for profit? Yes, but it requires scrupulous attention to Code requirements.

A NONPROFIT CORPORATION that gains tax-exemption as a charity under section 501(c)(3) of the Internal Revenue Code (a "charitable nonprofit" or "charity") is a frequent choice of entity for social entrepreneurs. (Although beyond the scope of this article, entrepreneurs may have reasons to consider nonprofit choices other than charitable nonprofits, such as a nonprofit corporation with section 501(c)(4) exemption or a taxable nonprofit corporation. Section references in this article are to the Internal Revenue Code, unless otherwise indicated.) Charities enjoy tax exemption for most forms of income, can raise money from individuals through charitable donations, and have an easier time attracting private foundation grants and certain types of government support. Notwithstanding these benefits, a charity may not be the exclusive or best option if some or all of an entrepreneur's planned activities do not fall within the charitable scope permitted by section 501(c)(3). Even when proposed activities do arguably advance charitable purposes, entrepreneurs may nonetheless consider housing those activities in a for profit that can — unlike a charity — raise money through offering equity, options, and other similar secu-

rities. In addition, privately held for profits (unlike nonprofits) avoid extensive regulatory restrictions and disclosure regimes. As another consideration, entrepreneurs might want to take advantage of perceptions associated with different vehicles (e.g., that for profits are effectively run business operations or that charities clearly emphasize the philanthropic motivation behind the founders' endeavors). Finally, if the enterprise will operate internationally, the laws in other countries sometimes drive the choice of entity.

Increasingly, social entrepreneurs are questioning whether they have to choose only one entity. With correct planning, the entrepreneur can pursue a tandem structure, forming both a charitable nonprofit and a for profit that operate in a complementary fashion to pursue the founder's goals. (We avoid using the term "hybrid" to describe this structure, in order to distinguish two-entity tandem structures from hybrid entities, such as a low-profit limited liability company (L3C) or benefit corporation, that display nonprofit and for profit characteristics within one legal entity.) For example, a nonprofit entity that operates businesses (bakery, restaurant, catering, moving, computer repairs) to provide education and job training to certain populations might establish a for profit entity to house a very similar business that can provide jobs to graduates from the nonprofit program. As another example, a variety of for profit service providers (such as web design and publicity, fundraising, educational consultants, psychotherapists) have been involved in establishing charitable entities to provide similar services on a subsidized basis to other charities or particular disadvantaged groups.

In some tandems, which we refer to as having a brother-sister structure, the organizations are linked together, often only loosely, by some overlap in board members and possibly executive management, and often enter into licensing, services, resource sharing, or other agreements. Alternatively, an entrepreneur can use a parent-subsidiary structure in which the charity holds some or all of the equity in a for profit subsidiary, and thus has some or total control over the for profit. (Less commonly in the social enterprise arena, a for profit entity can control a nonprofit entity as its member or designator. This structure is typical for a company and company foundation, for example. However, if the charity engages in operations that are similar to those of the for profit, such control by a for profit entity of a charity makes it difficult for the charity to demonstrate sufficient independence and focus on its own charitable goals. Thus, control by the for profit entity over the charity is typically not a good fit for a social enterprise tandem.)

Tandem structures allow entrepreneurs to take advantage of some of the benefits offered by both charities and for profits. However, operating in two worlds is not without its complications. In exchange for their tax exemption and ability to receive tax-deductible contributions, charities must comply with a broad range of rules, and are regulated by the IRS, state attorneys general, state tax authorities, and possibly additional agencies. This article discusses ten key considerations applicable to a charitable nonprofit involved in a tandem relationship with a for profit entity. Unless otherwise noted, the considerations are relevant to both the brother-sister and parent-subsidiary contexts.

1. Charities Must Further A Recognized Charitable Purpose

While the social entrepreneur may think of the tandem she creates as being part of one social enterprise in which the two parts work together for some greater social good, the charity needs a distinct and specific kind of identity. In order for the charitable nonprofit to receive and maintain section 501(c)(3) tax exemption, it is crucial for the charity to have a clearly identified charitable purpose that it furthers through its activities. The purpose must fall under those purposes recognized as charitable under section 501(c)(3), accompanying regulations, and rul-

ings, such as aiding the poor and distressed, educating individuals or the public, promoting health, or protecting the environment. Very importantly, the charity's initial exemption application that a charity presents to the IRS, as well as future annual filings and other information on the charity, should demonstrate that the intent of the charity is *not* to further the purposes of the for profit entity (which the IRS will tend to assume are not charitable), or even some joint purpose that does not clearly fall under the section 501(c)(3) definition. While the section 501(c)(3) rules are flexible enough to permit insubstantial non-charitable activities, the charity needs to show that it primarily furthers IRS-recognized charitable purposes.

2. Be Careful Using Pass-Through Entities Or Single-Member LLCs For The For Profit

In tandem structures where the entrepreneur wants the charity to hold equity in the for profit, the entrepreneur needs to exercise some caution in the type of legal entity he or she chooses for the for profit subsidiary. Choices could include a C corporation, a limited liability company (LLC) or a partnership. (Charitable nonprofits typically avoid holding shares of an S corporation because of unrelated business income tax concerns, so all references to corporations are to C Corporations.)

Partnerships and multiple member LLCs are typically, taxed on a "pass through" basis, meaning the entity pays no entity-level tax, and simply passes profits and losses (and the related tax obligations) through to the partners/members. If there are no outside investors, the for profit entity could also be structured as single-member LLC, which typically elects to be disregarded for federal tax purposes. Treas. Reg. section 301-7701-3.

As discussed above, charities must be substantially operated for charitable purposes or else risk their tax exempt status. Activities (including those unrelated to a charitable purpose) that are housed in a for profit C corporation are not generally attributable to charities that hold stock in the corporation, and thus should not threaten the charity's exemption. In contrast, where a charity holds equity in, and participates in the management of, a pass-through for profit, the IRS may view the charity as participating to some extent in the activities of that for profit. (The activities of an LLC treated as a partnership are considered to be the activities of the nonprofit member when evaluating whether the nonprofit is operated exclusively for exempt purposes). Rev. Rul. 98-15, 1998-1 C.B. 718. If the pass-through entity is carrying out unrelated activities, those activities may be partially attributed to the charity. If the activities attributed to the charity are a large enough portion of what the charity does, they may endanger the charity's exempt status. (Similar issues arise where a charity is engaged in a joint venture with an unrelated for profit.)

If the unrelated activities of the pass-through generate net income, the charity may receive unrelated business taxable income (UBTI) and need to pay taxes. IRC section 512(c) requires a tax-exempt partner to include as UBTI any income earned by a partnership from activities that would be unrelated businesses if operated directly by the tax-exempt partner. In a single-member LLC, the activities of the LLC will be attributed to the charity for purposes of analyzing if the charity is operating in furtherance of charitable purposes. (Announcement 99-102, 1999-2 C.B. 545 and Richard A. McCray and Ward L. Thomas, *Limited Liability Companies as Exempt Organizations—Update,* IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001 (2001) at 29.) For purposes of further discussion, we will assume that the social entrepreneur chooses a taxable C Corporation for the for profit portion of the tandem structure.

3. Consider Carefully Who Will Control Each Entity: Avoid 100 Percent Overlap On Boards

Two key governance decisions for the entrepreneur establishing a tandem social enterprise are who will appoint and remove the governing board of each entity and who will serve as directors on each governing board. With respect to for profits, in a brother-sister tandem, the founding entrepreneur, possibly with other collaborators and/or investors, may be the controlling equity holder of the for profit, and thus may appoint herself and others to the for profit's governing board. In a parent-subsidiary structure, the nonprofit is the only (or at least the controlling) equity holder of the for profit, and thus appoints the for profit's directors. On the nonprofit side, it is legally possible for the founder to act as member or designator with the right to appoint all or a majority of the nonprofit's governing board. On the other hand, a typical nonprofit governance structure is to have directors elect their own successors. The nonprofit's bylaws can also permit a combination of these options. Either entity's bylaws could also require a certain amount of overlap between the two boards. Having control through appointment power and/or overlapping boards ensures that the two entities will stay aligned in their parallel missions. However, there are several reasons to avoid 100 percent control and overlap between the two entities.

Focus On Charitable Purpose

As mentioned above, a charity needs to operate for clearly defined charitable purposes that are not blurred with the purposes of the for profit. Having board members of the charity that only serve on the charity's board and have no connection to the for profit can help the charity to focus on its charitable purposes and help convince charity regulators that it is operated for charitable purposes. Avoiding 100 percent overlap also helps the directors on both boards be very clear about when they are meeting as the board of the for profit or the board of the nonprofit, which can get confused if the board compositions are identical.

Approving Interested Party Transactions

For certain legal transactions, it is required or at least highly desirable for the charity to have some board members who are not affiliated with the for profit entity. Various regimes provide that in a transaction between the two entities within a tandem, where anyone in a position to influence the charity's decisions has an interest in the for profit, the interest must be disclosed, and the transaction needs to be approved by the "disinterested directors" of the charity; i.e., those directors who do not have an interest in the transaction because of their relationship to the for profit. Furthermore, under typical state corporate laws, directors of the charity have a duty of loyalty to the charity, making it difficult for them to review and vote on transactions with the for profit entity if they have a financial stake in or have fiduciary duties to the for profit entity as well. Again, to avoid a breach of fiduciary duties, only directors of the charity without interests in the for profit should approve transactions between the two entities. (The same fiduciary duties apply to the directors of the for profit corporation; a for profit director who has an interest in or fiduciary duty to the nonprofit should abstain from voting on transactions with the nonprofit.) It is legally unclear whether the fact that a for profit insider, such as the founder, appoints otherwise unaffiliated directors to the nonprofit board makes those directors "interested," since there is a sense that they are beholden to the person who appointed them. The conservative approach would be to treat them as interested directors as well.

Separate Identities

As indicated above, if a for profit is set up in corporate form, even if the charity is the sole shareholder, the IRS will tend to respect the two legal entities and not ascribe the for profit's activities to the charity (which could result in loss of exemption). However, in some rulings, the IRS has expressed some reluctance to treating the activities of a char-

ity's for profit subsidiary as separate if, among other things, too many of the subsidiary's directors consist of directors or officers of the charity parent. Priv. Ltr. Rul. 95-42-045 (July 28, 1995).

4. Special Issues Where A Charity Holds a Controlling Share Of The Stock Of A For Profit.

In addition to the considerations discussed above regarding control and overlap between the tandem entities, special legal issues are raised when a charity has a controlling share of the stock of a for profit. Note that with limited exceptions for program related investments and functionally related businesses, discussion of which go beyond the scope of this article, charities that are categorized as private foundations holdings must avoid owning a controlling stake in for profits so this section applies only to charities classified as public charities for federal tax purposes. (Discussed below.)

Unrelated Business Taxable Income

The unrelated business taxable income rules set forth in sections 511 through 514 go beyond the scope of this article. However, if a charity has more than 50 percent control over a for profit subsidiary, then certain otherwise non-taxable passive income streams from the for profit to the charity (e.g., rents, royalties, capital gains, interest) become taxable to the charity. For a subsidy set up as a regular stock corporation, control is determined by reference to vote or value, for a partnership, control is determined by the total profits interest or the total capital interests, and for other entities, control is determined by the beneficial interests. §512(b)(13)(D). If such income is anticipated or necessary under the entrepreneur's business plan, the charity may consider reducing its equity and thus its control over the for profit to less than 50 percent. Depending on the circumstances, it may alternatively plan to avoid or reduce those types of income streams, or simply decide that it is acceptable to pay the tax.

Disclosure Rules Capturing Related Organizations

Charities over a certain size have to file the Form 990 information return with the IRS (and often with state regulators) on an annual basis. Although there is a Form 990-EZ for organizations between the $50,000 and $200,000 marker (for 2011), charities that control a for profit cannot file Form 990-EZ, and must instead file the regular Form 990. (The comments in this section are not relevant to filers of the very simple Form 990-N (for 2011, charities with gross receipts that are normally less than $50,000).) The Form 990 is a public document. When charities own more than 50 percent of the stock (by vote or value) of a subsidiary, the charity has to disclose information about that for profit (and sometimes its employees) that would otherwise have remained private. Entrepreneurs may find it surprising that if any of the charity's directors, officers, or key personnel are also on the payroll of the subsidiary, their pay from that for profit is included in a very prominent compensation table within the charity's Form 990. In addition, there is a stand-alone schedule at the back of the Form 990 in which the charity identifies its interest in the subsidiary and describes the type and amount of the transactions between the charity and the for profit. Charities should also be familiar with state disclosure rules applicable to them, some of which can be broader than the federal regime. Depending on the specifics of the relationship, aspects of a brother-sister tandem relationship may also need to be disclosed.

5. The Two Entities Must Respect Their Separate Legal Status

Under state corporate law, the separation of sister corporations or parent-subsidiary corporations may not be acknowledged, and thus someone suing one corporation may be able to reach the assets of the other corporation, if in fact the two corporations do not operate as two separate entities, but

rather as a "single enterprise." One important factor in protecting the separation of the two corporations is to carefully observe all corporate formalities, such as separate meetings of staff, boards, and committees, and separate minutes of meetings. Another factor is avoiding commingling of assets, by always using separate bank accounts. The entities should maintain an arm's length relationship, for example by not using the assets of one entity to pay for an obligation of the other entity without a written agreement, or having one entity provide goods or services to the other entity without a written agreement. Keeping these legal boundaries separate can be important for liability protection, as well as to help persuade the IRS that the charity has discrete charitable operations and is carefully managing its charitable assets with well-defined boundaries between itself and its for profit counterpart. If the two entities do want to share resources such as staff or offices, a written resource sharing or services agreement is important.

6. The Charity Must Demonstrate Independence In Its Operations

In many tandems, the parties are interested in entering into licensing or services contracts with each other. For example, a public relations for profit may plan to offer its services to a tandem charity, which will in turn offer these public relations services to other charities at a significantly discounted rate. The charity must have a sense of independence in working with the for profit. A charity should only enter into a services or resource-sharing contract with the for profit if the terms are at least as favorable as those it could achieve with a third party. If another service provider can offer a better deal, the charity needs to have the willingness and ability to work with the other entity. In addition, the IRS typically does not like to see contracts in which the charity would be required to work with the related for profit for a long period of time without the ability to terminate the contract. If the charity does end up primarily working with the tandem for profit, its Board meeting records should reflect a thoughtful consideration of that choice, and the disinterested directors should approve the agreement. Note that the focus is on protecting the options of the charity. It would be acceptable, for example, for the charity to require the for profit to only engage with the charity for certain purposes that benefit the charity, if the charity has the option to terminate the contract.

7. Be Aware of Restrictions On The Use of Charitable Capital

In some tandems, the entrepreneur is interested in having the charity invest charitable dollars in the for profit, either as an equity investment or possibly as a loan. In cases where a tandem structure is being used for some reason other than the need to spin out so-called "unrelated activities" to a subsidiary, the charity may be able to make the argument that its contribution to the for profit (debt or equity) should fall outside the ambit of any state law investment standards because the charity's outlay of cash is directly furthering its charitable purposes and that its investment is a program-related asset, similar to a grant. In contrast, where a tandem is being used because of the presence of unrelated activities in the for profit, the charity's contribution in return for stock or loan is typically treated as a "real" investment. In addition to complying with any restrictions in its own charter documents or any gift instruments through which it received its assets, the charity should be aware of any applicable state law prudent investment standards, which may be found, among other places in versions of The Uniform Prudent Management of Institutional Funds Act, adopted in many states. (If the nonprofit is categorized as a private foundation for federal tax reasons, it is subject to another (not necessarily the same) prudent investor standard set forth in section 4944.) Based on these standards, the charity will often be limited in the amount of charitable assets it

can invest in the for profit, especially a new, speculative venture.

8. The Charity Should Attempt To Avoid Private Foundation Status

We have assumed that the charitable entity in the tandem structure is a charity described in section 501(c)(3). section 501(c)(3) entities are classified for federal tax purposes as either private foundations or public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a two percent tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying entirely, and restrict the organization's operations in other ways. Also, large donors to a private foundation have a lower ceiling on the amount of deductible gifts they can claim each year. Given that a private foundation is limited in how much of a for profit enterprise it can own, a charity wanting to own a for-profit subsidiary may want to consider how to avoid private foundation status.

A section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any of three ways:

- By being a certain kind of institution, such as a church, school, or hospital. §509(a)(1).;
- By meeting one of two mathematical public support tests. §509(a)(2); or
- By qualifying as a supporting organization to another public charity. §509(a)(3).

Given the restrictions on private foundations, it is worth careful consideration whether the charity in a tandem structure can qualify as a public charity. For example, one strategy may be to raise public donations into the charity but direct other types of revenues, such as royalties, to the for profit subsidiary.

9. Charities Cannot Unduly Benefit Private Actors, Especially Insiders

A general federal tax principle applicable to all section 501(c)(3) organizations prohibits them from operating in a way that benefits private rather than public interests. Private interests could include the financial interests of a sister or partly-owned subsidiary (or outside investors in such entities). Egregious violations of this broad prohibition could result in revocation of tax-exempt status.

The IRS is particularly sensitive to a charity providing benefits to charity insiders. Section 4941 prohibits many financial transactions between private foundations and certain insiders, such as leases or licensing agreements, even those which may have been done at fair market value,. For public charities, section 4958 contains technical rules (albeit more permissive than section 4941) about "excess benefit transactions" between charities and anyone in a position to exercise substantial influence over the charity (or certain of their family members or businesses in which such insiders or family members hold more than a 35 percent interest) — a group that the Code calls "disqualified persons." Notably, if an entrepreneur forms a tandem in which she sits on the Board of the charity, and in which she has a greater than 35 percent personal stake in the for profit, the for profit itself becomes a disqualified person and inter-company dealings (e.g., if the charity makes a loan to the for profit) become subject to section 4958. The Code allows the IRS to levy a penalty tax on any disqualified person who is deemed to receive more from a charity (or its controlled subsidiary) than what the charity receives in return. (In addition to a penalty levied against the charity, any charity managers who knowingly participated in the excess benefit transaction could be exposed to personal tax liability related to the value of the excess benefit conferred.) Also under section 4958, the disqualified person is required to correct the transaction and repay the excess benefit to the charity. Section 4958 provides that if a

charity engages in careful due diligence and has the disinterested directors approve a transaction, the transaction receives a rebuttable presumption of reasonableness. Thus, such a procedure is recommended for most public charity transactions with disqualified persons. One strategy to avoid this heightened IRS scrutiny, or, for a private foundation, the outright prohibition of a transaction, is to ensure that certain individuals or entities avoid disqualified person status in the first place.

10. Getting Assets Back Out Of An Entity Can Be Difficult

Before an entrepreneur puts assets into either of the tandem vehicles, he or she should consider carefully the limits on getting the assets back out again. Once assets have been transferred to or developed in the charity it can only transfer assets to a related for profit (or to any other non-charity or private individual) if such a transfer is in the charity's best interest, complies with any purpose restrictions imposed on the assets, and typically only if it obtains fair market value. Private foundations would not be able to enter into this kind of transfer at all if the for profit or individual transferee is an insider under section 4941. The charity would, in many cases, be exempt from tax on the gains recognized in the transfer. In contrast, although there are no charitable restrictions on removing assets from the for profit, corporate for profits will face tax consequences if the entrepreneur decides at a later point in time to liquidate the for profit or to dispose of the for profit's assets. As a general matter, sections 336 and 337 require corporations to recognize gain or loss when appreciated or depreciated property is distributed in complete liquidation or sold in connection with such liquidation. Thus, if the for profit corporation holds highly appreciated real property, for example, a liquidation could result in considerable capital gains tax on the appreciation.

CONCLUSION • Social enterprise is very much about avoiding rigid distinctions between business and charitable vehicles and focusing rather on the social good an entrepreneur wants to accomplish. However, given the highly regulated nature of section 501(c)(3) charities, entrepreneurs need to be attentive to and precise about requirements for correctly operating them, especially when a charitable nonprofit is operating in tandem with a for profit. Fortunately, with sufficient attention to these requirements, an entrepreneur can operate successfully in the two worlds of for profits and nonprofits.

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Summary Table

Ten Considerations for Tandems Involving a Charity	Model	
	Brother / Sister Model	Nonprofit Parent - For Profit Subsidiary
1. Charity Must Further 501(c)(3) Charitable Purposes	Yes	Yes
2. Careful about Structuring For Profit Entity as Pass Through Entity	Not a problem	Careful - activities may be attributed to parent charity
3. Avoid 100% Overlap of Boards	Avoid	Avoid
4 a. Control Can Lead to Unrelated Business Taxable Income	Not an issue	Control can result in UBTI
4 b. Control Can Trigger 990 Disclosure Issues	No control, but aspects of relationship still may need to be disclosed	Yes
5. Need to Respect Corporate Formalities, etc.	Yes	Yes
6. Charity Must Demonstrate Independence in Operations	Yes	Yes, except that charity may require for profit to do certain things
7. Careful about Charity Investing in For Profit Entity	Careful, may be deemed imprudent	Careful, although investment in controlled subsidiary more likely to be deemed prudent
8. Charity Should Attempt to Avoid Private Foundation Status	Yes	Yes, especially to avoid excess business holding rules
9. Charity Must Avoid Private Benefit, Benefit to Insiders	Yes	Yes
10. Difficulties Getting Assets Out of Entities	Similar considerations	Similar considerations