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Using New Hybrid Legal Forms: Three Case Studies, Four Important Questions, and a Bunch of Analysis

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Introduction

On October 9, 2011, Gov. Jerry Brown signed two bills into law in California, both of which will take effect on January 1, 2012. The Corporate Flexibility Act of 2011 establishes the flexible purpose corporation in California. The flexible purpose corporation is a unique new corporate form that formally permits a corporation to blend a business purpose and social or charitable purposes. It will be useful for individual social entrepreneurs starting new ventures, existing corporations that want to make the switch, and 501(c)(3) organizations that are interested in establishing partly or wholly owned for-profit subsidiaries.

The second important bill established the benefit corporation in California. The benefit corporation, with somewhat different provisions, has also been adopted in Maryland, Vermont, New Jersey, Virginia, and Hawaii, all in the past two years, and it is being considered by other states. At the same time, the low-profit limited liability company (L3C) has taken form in nine states and two Indian nations, and serves as a hybrid alternative to the typical LLC.

The world is changing, and new legal forms are emerging. There will be many opportunities for social entrepreneurs to set up flexible purpose corporations, benefit corporations, and L3Cs, but our question is, as always:

How do these new laws affect our clients in the nonprofit sector?

Our clients, existing nonprofit organizations or nonprofit organizations in formation, arrive at this issue from two vantage points. First, existing nonprofit organizations will be asked to grant to, or invest in, these new corporate forms. We are not going to address this side of the equation in this article. Although the L3C may very well be a valuable tool for attracting program-related investments (PRIs) from private foundations, there is nothing in particular about the benefit corporation or the flexible purpose corporation that is specifically designed to attract nonprofit investments. Nonprofit investments in, and grants to, hybrids will need to be evaluated just like investments in, and grants to, traditional for-profit entities.

Second, individuals who want to talk about setting up a new social enterprise — maybe as a nonprofit, maybe as a for-profit — and existing public charities and private foundations that want to set up for-profit subsidiaries or affiliates will think about using these new forms instead of the traditional LLC or corporation, and it is to this point that we address this article. We first provide three case studies as the basis for our analysis, and then we describe how we go about considering the proper legal form.

Three Case Studies

Case 1: Sara and Ellen (S&E) are interested in setting up a social enterprise. They want legal advice. Sara is a nutritional scientist and Ellen is a recent graduate from an outstanding business school that teaches social entrepreneurship. They believe that they have a first-rate idea for how to produce and sell low-cost, good-tasting nutrition bars that contain 50 percent of a person's daily required calories and 100 percent of a person's daily required vitamins and minerals. The bars could be particularly beneficial to low-income individuals in the United States and abroad who lack access to appropriate nutrition. S&E have little financial resources of their own, but they have spoken with several potentially interested investors.

Case 2: Work Hard — Eat Well (WHEW) is a tax-exempt 501(c)(3) public charity that operates two restaurants that that provide job training to homeless adults. Trainees typically work for less than two years, and most find employment afterward. WHEW wants to use its restaurant operation skills to open two more restaurants, but these restaurants would employ already skilled and experienced applicants, including some of the graduates of the job training restaurants. WHEW needs capital to build the new restaurants.

Case 3: The Children's Health Charity (CHC) is a tax-exempt 501(c)(3) private foundation that educates children and their families about children's health issues. In the course of its work, CHC has developed a small electronic device that when worn by a person, can measure the person's activity level and calorie intake and transmit that information to a website that tracks activity and intake. CHC has been providing the devices for free to low-income children and their families. CHC is now

interested in manufacturing and selling the devices to a broader community of children in the belief that doing so will further the health of children everywhere. The foundation does not want to limit this exceptional technology to low-income children, although it intends to require that the devices must continue to be made available to them for free or at an extraordinarily low price. CHC has two other private foundations that are interested in investing (but not granting) to help develop the product.

Four Important Questions

Before advising, we need to be comfortable that we know the answers to four questions: who, what, why, and where?

1. WHO are you?[1] Most clients that want to set up a social enterprise are either one or more individuals with a business idea (for example, S&E in Case 1) or an existing nonprofit that wants to consider taking on a new revenue-generating activity that might involve spinning out a for-profit entity (for example, WHEW or CHC). In Case 2, WHEW is a public charity, and in Case 3, CHC is a private foundation.

2. WHAT is the precise social enterprise activity that you want to develop? The client needs to be able to write out a business plan or — if short of a fully developed business plan — at least a few pages describing the revenue-generating activity with something like a preliminary three-to-five year budget. If a client cannot prepare a basic business plan, the client is probably not ready to choose a legal structure. We all need to be talking about the same "what." For our purposes, we will use the brief case study descriptions above as the "what." A thoughtful business plan is going to, at minimum, articulate the basic business concept, evaluate potential competition, determine whether there is a market for the new enterprise, develop an operational and organizational plan, and develop a fairly realistic budget of both revenues and expenses. Social entrepreneurs can find excellent templates for evaluating the feasibility of new social enterprise and even for writing a business plan at http://www.redf.org.

3. WHY are you starting this enterprise? Even if a client can properly describe its revenue-generating activity in a business plan, the client also must have a clear idea of why it wants to embark on the project, and why now. Is the client motivated by money or mission or both? What are the expectations at the end of the day on the ability to sell the new venture? If the client is an individual or individuals, are they seeking a personal profit? Where are they in their lives in terms of retirement and self-sufficiency? Do they think they need to control the venture?

In Case 1, S&E tell us they are looking to form this entity to do good works and make some money for themselves. They are interested in seeking investors who also have a mixed motive — money and good works. They may want to sell the business someday.

In Case 2, WHEW indicates that it simply wants to take the knowledge it already has and make money to support its charitable job training programs. It doesn't matter much to WHEW where the new capital comes from, but WHEW is interested in treating its workers well and operating in an environmentally friendly way. WHEW does not want to cede control if it means losing these important values.

In Case 3, CHC sees the new venture as a possible opportunity to make money, but the primary motivation is to find a way to make its innovative technology more accessible to more children in the interest of improving individual and societal health.

In each case, the "why" will help us determine the best legal structure.

4. WHERE is the money for this new activity going to come from and how much is needed? In addition to what the social enterprise will do and why, one question every social entrepreneur must answer is how it will be paid for. The "where" question needs to consider, first, the source of start-up capital and, second, the source of ongoing revenues, if any, beyond sales of products and services. Will the venture be looking to private foundations and other charities for initial funding or extended funding? Will it rely on private investors or government support? Will capital be provided in the form of grants, loans, equity, or some combination? The enterprise will have decisions to make regarding how best to raise capital, and the choice of entity may limit or enhance the availability of some revenue sources.

In Case 1, S&E report that they plan to speak with individuals, nontraditional venture capitalists, and angel investors that are concerned about a mix of profits and mission.

In Case 2, WHEW plans to look at loan guarantees from the Small Business Administration, bank loans, and a limited number of individuals to make equity contributions.

In Case 3, CHC has indicated that it will contribute more of its own private foundation resources and that it already has lined up a couple of other private foundations that want to help.

By the end of our discussions, each of the three clients has a fairly good sense of how much money is needed and where.

A Bunch of Analysis

Available Forms

Remember that our task is finding the best legal structure for the client's new enterprise. We need to know the answers to the four important questions, because legal form always should follow the client's needs, not the other way around. Legal forms are much like tools in a toolbox, and one needs the right tool for the right job.

What legal forms are available? Currently, we have four basic categories of legal tools:

- For-profit corporations;
- Nonprofit corporations;
- Passthrough entities (for example, partnerships and limited liability companies); and

[1] Pete Townshend, "Who Are You" (1978).

- Other, including cooperatives, trusts, and unincorporated associations.

We will ignore cooperatives, trusts, and unincorporated associations, which we believe are great for specific jobs but generally are less useful for most revenue-generating social enterprises. We also will disregard options that may be available for forming a nonprofit corporation, since this article focuses on opportunities for equity investment.

Within the category of for-profit corporations, we have traditional corporations and also the newer corporate vehicles intended to accommodate social enterprise: the benefit corporation, already adopted in several states, and the flexible purpose corporation in California, effective as of January 1, 2012. There likely will be others in the years to come. For tax purposes all of these are treated the same, either as C corporations or, if an election is made, as S corporations. We will discuss the state law differences later.

We won't be discussing B corporations, because they do not represent a corporate form but rather a brand or certification mark that can be obtained from a nonprofit organization called B Lab. Although a benefit corporation is a legal form available in several states, a B corporation is a certification mark; it can be quite valuable but it is not a legal form. B corporation certification is available to many types of for-profit entities, including benefit corporations, flexible purpose corporations, corporations in states with constituency statutes, LLCs and L3C's, provided that the entity is established to further socially responsible goals in addition to profits. See http://www.bcorporation.net for more information on B corporations.

Within the category of passthrough entities, we will most typically look to either LLCs or the new variant of LLCs, L3Cs. The L3C and the LLC are treated the same for tax purposes, and we will discuss the state law differences below.

Deciding Which Form to Use

Now that we know the array of legal tools and the client's answer to the four important questions, we will advise each of the three clients based on the following analysis:

1. Does the client need a new legal entity?

2. If yes, could the new entity qualify as a nonprofit, tax-exempt entity?

3. If it could qualify, should it nonetheless form as a for-profit entity based on other factors?

4. If the entity is to be for-profit, should it be a corporation or an LLC?

5. If the entity is best served by being a corporation, should it adopt one of the new hybrid corporate forms, such as a flexible purpose corporation or a benefit corporation?

6. If the entity is best served by being an LLC, should it be an L3C?

7. Is there any reason to have two new entities, one for-profit and one nonprofit?

We will now review these questions in more detail.

Analysis

1. Does the client need a new legal entity?

The main reasons for forming a new legal entity are to shield existing assets from liability, to accommodate the interests of more than one party, to address tax concerns (some of which are discussed in more detail below), and to provide administrative separation and convenience in the case of an existing entity seeking to spin out a new activity.

In Case 1, S&E will want to form a new entity, if for no other reason than there being two of them; if they are doing business together, sharing revenues and expenses in some fashion, they are intentionally or unintentionally going to be creating a new entity. Better to do so intentionally and choose the most favorable type. When two or more people do business together without officially forming a new entity, they have created a de facto general partnership or unincorporated association. In a general partnership, both partners are liable for the activities of the partnership. An unincorporated association may offer limited liability protections under applicable state law, but the protections aren't as well-developed or tested as the corporate form.

Both Case 2 (public charity) and Case 3 (private foundation) involve entities that already operate as nonprofit corporations; therefore, there is no automatic need to set up a new legal entity unless they plan to take on other investors.

However, to protect existing assets from liability, we would advise the charity and the foundation to set up a new entity. It is not always true that a tax-exempt entity will need to set up a new entity to engage in a new income-generating project, but for a new activity with potential liability, such as operating a restaurant, it is usually a good idea.

Unrelated Business Income Tax — A Brief Detour

Also, if the new activity were going to generate significant unrelated business income tax (UBIT) for the charity, a spin-out would make sense. This is a concern in Case 2 in particular. A complete discussion of UBIT is beyond the scope of this article, but in general a section 501(c) organization generates UBIT when it recognizes net income from a trade or business that is regularly carried on and that is not substantially related to the organization's exempt purpose. If any of these elements is absent, we need look no further — there is no UBIT.

a. Trade or business. A trade or business includes "any activity carried on for the production of income from the sale of goods or the performance of services."[2] Treasury regulations suggest the term "trade or business" has the same meaning as it has under Internal Revenue Code[3] section 162 in connection with analyzing the deductibility of business expenses.[4] Although there have been cases that analyze the trade or business element of the test, and

[2]Section 513(c); reg. section 1.513-1(b).

[3]Unless otherwise indicated, all code section references are to the Internal Revenue Code of 1986, and any subsequent amendments.

[4]Reg. section 1.513-1(b).

although it is possible to have an income-generating activity that is not a trade or business, as a practical matter most potential UBIT issues that come to the attention of a practitioner will satisfy the trade or business element of the test.

b. Regularly carried on. The regulations provide that whether a trade or business is regularly carried on is determined by examining the ''frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.'' [5] The stated purpose in the regulations is ''to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete.''[6] The analysis of whether a particular activity is regularly carried on depends, of course, on all the facts and circumstances. Guidelines can be drawn from cases, rulings, and regulations, although the rulings and cases are sometimes inconsistent.

c. Substantially related. Finally, if an exempt activity is substantially related to the organization's exempt purpose, it does not generate UBIT. The regulations say an activity is related to exempt purposes ''only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes,'' and the causal relationship must be substantial. (Reg. 1.513-1(d)(2)). Normally, but not always, the substantially related test is the mirror image of the test determining whether an activity satisfies the operational test for exemption.

d. Common exceptions or modifications to UBIT. Even if each of the three elements above is present, there are a variety of exceptions and modifications that can transform a UBIT activity into a nontaxable transaction. These exceptions and modifications include (but are not limited to):

- Interest income, dividends, and annuities. (section 512(b)(1).)
- Royalties. (section 512(b)(2)). Much of the discussion in connection with affinity credit cards has involved the definition of a royalty.
- Rents derived primarily from real estate and a limited amount of personal property leased with the real estate. (section 512(b)(3)). This exception does not apply if a lease involves too much personal property in addition to real estate, if the rental income is based at all on the net income or profits of the tenant, or if the lease involves the provision of significant services, other than those that are customary in a landlord-tenant relationship.
- Income from the sale of capital assets. (section 512(b)(5)).
- Activities conducted for the convenience of members, students, patients, officers, or employees. (section 513(a)(2)) This exception typically applies to venues such as some college bookstores and museums or school cafeterias.
- Activities conducted entirely by volunteers. (section 513(a)(1)). This is an important exception, because an activity that might otherwise clearly generate UBIT can be ''cleansed'' if it is conducted as an all-volunteer operation.
- Income from the sale of donated merchandise. (section 513(a)(3)).
- Some bingo games. (section 513(f)).
- Corporate sponsorship payments. (section 513(i)).
- Income from some trade shows and state fairs. (section 513(d)).
- Income from the rental of mailing lists to other charities. (section 513(h)).

e. Exceptions to the exceptions. An activity that satisfies each of the three UBIT tests, but appears not to be subject to UBIT because it qualifies under one of the exceptions above, may nonetheless be subject to UBIT if one of the following exceptions to the exceptions applies:

- Interest, rent, and royalties received from a controlled corporation. (section 512(b)(13)). While an exempt organization can normally receive interest, rents, and royalties from another entity without incurring UBIT, these items are taxable when received from an entity that the exempt organization controls.
- Under section 514, a portion of the income derived from property acquired with debt financing can result in UBIT. This issue most typically arises in the case of real estate acquired with debt, which is subsequently rented or sold for a purpose that is not substantially related to the organization's exempt purpose. It also can arise, however, in the case of securities acquired with debt, for example, on margin or in other situations.

f. So how much unrelated business income or unrelated activity is too much? Section 501(c)(3), taken literally, requires an organization to be operated *exclusively* for exempt purposes. The regulations, however, add some flexibility to what is known as the operational test. They make clear that an organization may qualify as a charity if it is operated *primarily* for exempt purposes. An ''insubstantial part'' of a charity's activities may be devoted to nonexempt purposes. (Reg. section 1.501(c)(3)-1(c)(1).) Thus, a charity may operate a trade or business the conduct of which is unrelated to the achievement of its exempt purposes without losing its charitable status. (Sections 511-515, generally; reg. section 1.501(c)(3)-1(e)(2).) There is no definition of ''insubstantial part.'' We do know that the focus is on the activities causing UBIT, not on the amount of revenue. It is possible to have 100 percent from a passive UBIT activity and still maintain exempt status.

Revenue Ruling 64-182, 1964-1 (part 2) C.B. 186, sets forth the ''commensurate in scope'' test, which is still followed today. The ruling stands for the principle that an organization may receive a significant amount of UBI (whether taxable or nontaxable under an exception) as long as it carries out charitable programs that are commensurate in scope with its financial resources. In the example in the ruling, the organization presumably received 100 percent of its income from the rental of real estate, but it engaged in grant- making activities that were commensurate in scope with its financial resources.

Other rulings expand on this concept to suggest that we do not look entirely at the percentage of income from

[5] Reg. section 1.513-1(c).
[6] *Id.*

an unrelated activity, but rather the full scope of operations of the charity. How much time is the charity spending on its exempt activities in relation to the time it is spending on generating income from investments and nonexempt activities?[7]

A leading treatise on the taxation of exempt organizations articulates the test well:

> If the tax-exempt organization carries on one or more activities that further exempt purposes, such as operating a museum, hospital, school . . . and also conducts a clearly commercial activity, such as operating a restaurant, a determination must be made as to whether the effort expended to carry out exempt purposes is commensurate in scope with the organization's financial resources. This requires an evaluation of the time and effort undertaken by the organization in the conduct of the exempt activity or program, the impact of the exempt activity or programs, how the organization holds itself out to the public, and the use of net after-tax UBI. [footnotes omitted].[8]

Although there is no clear rule on how much unrelated activity is too much, we advise that if unrelated activities begin to exceed 25 to 30 percent of overall activities, the organization may be at risk of losing its exempt status and should review its legal options carefully.

2. If we decide that the client needs a new legal entity, can the entity qualify as a tax-exempt entity?

We will normally advise establishing a nonprofit entity only if the entity can also qualify for tax-exempt status. Nonprofit entities that do not qualify for tax-exempt status pay taxes on their income but have no owners to whom to distribute profits. A lose-lose situation in most cases.

Whether an entity can qualify for tax-exempt status, particularly as described under section 501(c)(3), will depend on its ability to satisfy each test for exemption.

Section 501(c)(3) defines tax-exempt organizations as follows:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for 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, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Put more simply, to qualify as a tax-exempt charitable organization, an entity must be organized and operated for one or more of the exempt purposes listed above, and it must refrain from inurement, electioneering, and substantial lobbying.

For purposes of this article, we assume that we can draft articles of incorporation and bylaws so that the organization is properly organized and therefore satisfies the organizational test and that the articles of incorporation contain a broadly written purposes clause that permits the income-generating activity being contemplated. If the articles lack a broad purposes clause that would cover the activity being contemplated, they should be amended before the organization engages in the activity.[9]

We also assume that the new organization won't engage in impermissible activities such as excessive lobbying, electioneering, private inurement, or private benefit transactions. That is not to say that private inurement and private benefit issues, such as excess compensation, don't arise in situations involving social enterprise activities, particularly when a related for-profit corporation or business is involved. Rather, we assume for purposes of this article that the new organization will take appropriate steps to ensure that any compensation or other benefits provided to insiders or to related for-profit entities is reasonable in amount and is properly approved, for instance, by following procedures outlined in section 4958.[10]

Next, we focus on the operational test. Does the operation of the contemplated activity fall within the range of activities permitted under section 501(c)(3)? If it does, the activity is permissible, and the new entity pays no tax on the income generated by the activity. If the activity is not permitted under section 501(c)(3), the entity may still be able to engage in the activity and possibly pay UBIT, or the activity may be so substantial that the entity needs to relocate the activity into a separate legal entity, such as a subsidiary corporation.

In analyzing whether an income-generating activity is an appropriate exempt activity, the IRS and courts have examined a variety of factors, many of which ultimately

[7] *See* LTR 200021056 (this ruling reached the correct result through some unusual reasoning); *see also* TAM 9711003 (charity retained exemption even though 95 percent of its income was UBI); *see also* LTR 8038004.

[8] *Taxation of Exempt Organizations*, Hill and Mancino, Warren, Gorham & Lamont of RIA, pages 21-17 through 21-18, updated regularly.

[9] State law charitable trust rules, however, may limit the ability of a public benefit corporation to use assets that were received for one purpose, before an articles amendment, for a new purpose.

[10] Section 4958 provides excise taxes for transactions that result in excess benefits being paid by a public charity to insiders. Public charities can follow particular disclosure and abstention procedures to qualify for a presumption of reasonableness. Section 4958 also applies to section 501(c)(4) social welfare organizations.

result in a smell test: Does the activity smell more like a commercial or an exempt activity? As the United State District Court has said, does the activity have a ''commercial hue''? (*Airlie Foundation v. IRS*, D. D.C. No. 02-0785 (9/24/03).)

There is no single test for evaluating whether an income-generating activity is an appropriate exempt activity. Over time, the courts and the IRS have developed legal tests and frameworks for different types of activities that generate income. The more an activity fits within the realm of activities that have traditionally been recognized as charitable, the more likely any income generated by the activity will be tax-exempt. The less the activity looks and feels like a traditional charitable endeavor, the more scrutiny the IRS will apply. For example, it is relatively easy for hospitals and schools — institutions that have traditionally been exempt — to qualify for exemption as long as they do not improperly benefit insiders, do not discriminate, and provide an appropriate level of service to those who cannot afford to pay. On the other hand, the tests are more difficult to satisfy in areas such as publishing or fee-based management or consulting services.

A review of all of the different ways in which the operational test has been applied to different income-generating activities, needless to say, is beyond the scope of this article. However, let us look at the three cases.

In Case 1, selling nutritional supplement bars is normally a commercial, for-profit activity. It probably could be accomplished via a tax-exempt entity because it furthers the section 501(c)(3) purpose of promoting health, *if* the bars were all sold to low-income individuals at very low prices. Otherwise, the business likely would be too similar to any other business selling nutritious foods. Despite the growing prevalence of this type of social enterprise, there is still no clear legal guidance on when selling low-cost health improvement products to the poor can qualify as tax-exempt. Nonetheless, our sense is that while S&E do very much want to help the poor, they don't want to limit themselves to selling only to the poor, nor do they want to limit their pricing structure solely to obtain tax-exempt status. Accordingly, the nonprofit, tax-exempt form does not make sense for them.

In Case 2, operating two additional restaurants won't qualify for exemption because operating a restaurant in general is not a tax-exempt activity. Operating a restaurant for the purpose of offering job training for a disadvantaged class is a tax-exempt activity, but operating a restaurant for graduates of the job training program is not. If the two restaurants were operated as part of WHEW, it would generate UBI. If the activity were deemed too substantial, it would jeopardize the tax-exempt status of WHEW. Accordingly, it would be best to put these activities into a new entity, and the new entity should be a for-profit.

In Case 3, it may be possible to characterize manufacturing and selling the new technology as either exempt or nonexempt, depending on whether CHC is willing to limit the scope of the recipients of its product (for example, low-income individuals) or its pricing structure and perhaps give up other potential profit-making opportunities that may arise. As with Case 1, the law in this area is unclear. Also as with Case 1, to avoid limiting CHC, we would advise using a for-profit form here.

3. If an organization could qualify for exemption, should it nonetheless form as a for-profit entity, based on other factors?

Since we have already decided that all three clients in the above cases will form for-profit entities, this question is not of immediate concern. However, we generally ask the ''where'' question above to help make this decision, because even if an entity could qualify for exemption, it does not make sense to form a nonprofit if the entity will require capital investment that is not in the form of donations, grants, or loans. In Case 1, for example, even if S&E could structure their program to qualify as tax-exempt, they wouldn't want a nonprofit entity, because they are seeking private investment. In case 2, only a for-profit corporation can qualify for small business administration loans and guarantees.

In addition, we ask the ''why'' question to understand the founders' motivation in creating the business. For instance, if the new entity is something that the founders want to be able to own and later sell, it shouldn't be placed into a tax-exempt vehicle. Too many times young entrepreneurs form a nonprofit entity to carry out their life's work and later realize that they have not made sufficient plans for their retirement or their family's future. Once the business is formed as a nonprofit tax-exempt entity, the founders no longer own the business and cannot benefit as equity owners would from an appreciation in value.

4. If the entity is to be for-profit, should it be a corporation or an LLC?

There are many forms of for-profit entities, but the two most useful forms for social enterprise tend to be the for-profit corporation and the LLC. Normally in considering a corporation or an LLC, one considers several factors: limited liability, management structure, and taxation.

Although treatises have been written — and continue to be written — on these factors, as a practical matter both the LLC and the corporation, if properly set up and maintained, will provide protection against liability.

As to management and control, it is often said that the LLC affords more flexibility because the management, ownership, and control structures are established in the LLC operating agreement, which makes the structures essentially a matter of contract, whereas the corporate law of most states provides a body of rules that corporations must follow. In reality, in an entity with a limited number of owners, creative corporate lawyers can use different classes of shares and voting agreements to achieve largely the same results in a corporate structure as in an LLC structure. In a larger entity, the corporate structure is going to be less flexible, but that isn't necessarily a bad result. Also, in our experience, more institutional investors and venture capitalists prefer the corporate structure, particularly if the entity is to go public or to be sold later.

Table 1. Normal Oeprations			
CASE	**Taxable Income**	**Distributions**	**Interest, Rent, Royalties**
1 (S&E)	LLC income is allocated to its members on a Schedule K-1 and members owe taxes, whether or not they receive distributions.	LLC members generally do not pay additional taxes on cash distributions.	If a member receives additional payments of interest, rents, or royalties under a separate contract with the LLC, it pays tax on the net income.
2 (WHEW)	Corporate subsidiary pays taxes on its own net income.	Tax-exempt public charity shareholder pays no taxes on dividends.	A tax-exempt shareholder that owns more than 50 percent of a subsidiary pays UBIT on interest, rents, and royalties that it receives (unless the income is substantially related).
3 (CHC)	Corporate subsidiary pays taxes on its own net income.	Private foundation shareholder pays 2 percent section 4940 tax on dividends.	A tax-exempt shareholder that owns more than 50 percent of a subsidiary pays UBIT on interest, rents, and royalties that it receives (unless the income is substantially related).

Table 2. Winding Up			
CASE	**Sale of Stock or LLC Interests**	**Sale of Assets**	**Dissolution**
1 (S&E)	LLC members pay tax on the net gain from sale of their memberships.	If the LLC sells its assets, it will allocate any gain from the sale to its members, who will pay tax.	Generally no taxes.
2 (WHEW)	A tax-exempt charity will normally not pay tax on the net gain from the sale of its subsidiary stock.	The corporate subsidiary will pay tax on any gains from sale.	A deemed sale of subsidiary assets will result in tax to the subsidiary, which may not have cash to pay the tax.
3 (CHC)	A tax-exempt private foundation will normally pay only a 2 percent section 4940 tax on the net gain from the sale of its subsidiary stock.	The corporate subsidiary will pay tax on any gains from sale.	A deemed sale of subsidiary assets will result in tax to the subsidiary, which may not have cash to pay the tax.

In our experience, most decisions on whether to use the LLC or the corporate form are based on tax considerations. LLCs have the option of electing to be taxed as passthrough entities, avoiding the corporate-level tax. This approach can be advantageous to investors who already pay taxes, such as S&E in Case 1. However, with limited exceptions, the LLC form is generally not advantageous to tax-exempt investors.[11]

For purposes of our analysis, let's assume that S&E will look primarily to a small group of angel investors and prefer the LLC to the corporation to avoid double taxation. Normally, we would advise S&E to ask their prospective investors what they prefer.

In Case 2, we have a public charity and an activity that we have determined won't be substantially related to its exempt purpose (operating two new restaurants). This means that if WHEW sets up and invests in an LLC, which is treated as a passthrough entity for tax purposes, then WHEW's share of income is likely to be taxed as UBI. That's because of the underlying activity to be conducted by the subsidiary — the restaurants. Also, the IRS will regard the nonexempt activities carried on by the LLC to be the activities of its tax-exempt member. For these reasons, we would recommend that WHEW set up a corporate subsidiary. The income of the subsidiary will be taxed at the subsidiary level. If the subsidiary pays dividends to WHEW, the dividends won't be taxable to WHEW (section 512(b)(1)). We would advise WHEW to be careful about lending funds to its subsidiary, licensing intellectual property to it, or renting space to it, because if WHEW owns more than 50 percent of the stock of its subsidiary, then interest, rents, and royalties paid by the subsidiary to WHEW will be subject to UBIT.

In Case 3, CHC is a private foundation. So under section 4943, it generally cannot own more than 20 percent of a corporation or an LLC unless the corporation or LLC is operating a business that is functionally related to CHC's mission. Also, to invest in the entity, CHC either must determine that the investment is a prudent investment and not a jeopardizing investment (section 4944), or that it is making the investment as a program-related investment (PRI). A PRI per se is also not an excess business holding for purposes of section 4943. We would

[11]One exception involves a tax-exempt entity forming a single-member LLC to hold property, such as real estate, in an attempt to shield its other assets from potential liability. Another exception involves an LLC that is clearly related to the tax-exempt entity's tax-exempt purpose, such as an LLC established to operate low-income housing and sell tax credits.

suggest to CHC that it set up a corporation and treat its investment in the corporation as a PRI. A PRI will require extra documentation and expenditure responsibility under section 4945, but that is achievable, especially because CHC probably will control the new entity. The new entity will pay taxes on its own income, but dividends paid to CHC won't be UBI to CHC.

Before setting up a corporate subsidiary, a charity should also consider the exit strategy. If a for-profit subsidiary is liquidated, the fair market value of the assets of the subsidiary will be deemed to be sold, subjecting the subsidiary to tax. (See Sections 332, 337(b)(2)).

The tax consequences in Cases 1, 2, and 3 can be summarized as shown in table 1 and table 2 on the previous page.

5. If the entity should be a corporation, should it adopt one of the new hybrid corporate forms, such as a flexible purpose corporation or a benefit corporation?

The new corporate forms developing in various states, such as the flexible purpose corporation and the benefit corporation, are designed to accommodate a social as well as financial purpose for the entity and provide flexibility for the corporation's directors to take this social purpose into account when making decisions on behalf of the corporation. Table 3, at the end of this article, compares a ''regular corporation,'' a corporation in a state with a constituency statute, a California flexible purpose corporation, and a California benefit corporation (both California forms were signed into law on October 9, 2011, and are available for use on January 1, 2012). The benefit corporation is also available in several other states, although the terms differ somewhat from state to state.

Existing business entities also have flexibility in determining whether to take advantage of the new hybrid forms. It is possible for other entities to convert into and out of flexible purpose and benefit corporation status if the required supermajority votes are obtained and other procedures are followed. Also, a foreign business entity from another state that lacks these hybrid forms can merge or otherwise convert into a flexible purpose corporation formed in California or to a benefit corporation in one of the several states that has adopted this legislation (see Table 3).

In sum, an alternative corporate form makes sense if the founders want the corporation's board to be free to consider, on a regular and unlimited basis, a social or charitable mission, without concern about failure to maximize profits. The flexible purpose corporation permits the founders of the corporation to establish specific and clear flexible purposes, that is, purposes that aren't business purposes, and the corporation is then to act in connection with those purposes and to report to the shareholders on its success or failure in achieving them.

The relationship between purposes and directors' duties is less clear in the benefit corporation, where even though specific alternate purposes might be articulated, the directors also are required to consider an array of alternative issues, such as customers, suppliers, the environment, the community, and others. Also, the directors must live up to a third-party standard set by an outside standard body, but it is unclear whether a careful lawyer will advise the board to self-evaluate under those standards or to go the extra step of seeking certification by the standard-setting body.

6. If the entity is best served by being an LLC, should it be an L3C?

The L3C can be a valuable tool when the founders are seeking investments in the form of PRIs or when the founders want to lock in a charitable mission and have a set of investors who will support that mission.

Consider the language in the Vermont L3C, for example, that differentiates it from a typical Vermont LLC. First, the preamble to the law reads:

> A low-profit LLC is a new type of company, called an ''L3C.'' Vermont is the first state to enact this new type of company. The Low-profit Limited Liability Company is a cross between a nonprofit organization and a for-profit corporation. The entity is designated as low-profit with charitable or educational goals. Any entity seeking 501(c)(3) status would still want to organize as a non-profit corporation, under T.11B, to qualify for that tax status.
>
> Organizing the L3C is the same as the regular LLC except that the L3C designation must be indicated when the articles of organization are filed and the name must include the words ''L3C'' — Section 3005(2). The organization form has been amended to include the L3C designation. The filing fees, amendments, agent requirements, etc. including the annual report filing has not been changed and applies to both. The basic purpose of the L3C is to signal to foundations and donor directed funds that entities formed under this provision intend to conduct their activities in a way that would qualify as program related investments.
>
> The only additional language in the law reads:
>
> ''L3C'' or ''Low-profit limited liability company'' means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements.
>
> (A) The Company significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
>
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D).

(D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit LLC, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company. The name of the company must be changed to be in conformance with subsection 3005(a).

These provisions are taken directly from section 4944 for PRIs. The L3C goes further than the benefit corporation and the flexible purpose corporation, in that both of those are set up to be for-profit, money-making enterprises that also have social or charitable missions. For an L3C, the primary purpose must ''further the accomplishment of one or more charitable or educational purposes,'' and producing income cannot be a significant purpose of the venture. Although the L3C does not need to be limited to activities that could be undertaken by a 501(c)(3) organization, it clearly must undertake an activity that significantly furthers an exempt purpose — one in which a private foundation could make a PRI investment.

For example, an L3C that opens a business in a poor neighborhood to provide jobs and boost the economy could qualify as an L3C, even though it would not qualify for 501(c)(3) status because its fundamental activity is operating a business.

Some have commented that an LLC's operations are largely contractually driven by the operating agreement, and therefore an L3C is unnecessary because one can put whatever language and rules one wants in that agreement. Also, an investing private foundation still must meet the tax requirements for making a PRI, including expenditure responsibility, and receives no preferential treatment from investing in an L3C as opposed to an ordinary LLC. However, although it is true that the LLC operating agreement can be drafted to mirror the L3C, and that the same tax rules apply in either case, many practitioners believe starting with the L3C form still may help attract PRIs.

Accordingly, if an LLC is a proper vehicle for a social enterprise, an L3C might be an even better vehicle in many cases. See http://www.americansforcommunity development.org for more information on the L3C.

7. Is there any reason to have two new entities, one for-profit and one nonprofit?

Sometimes it makes sense to operate two new entities side by side — a for-profit and a nonprofit — to take advantage of the benefits offered by both forms. We do not address this tandem legal structure in this article. See *Operating in Two Worlds: Tandem Structures in Social Enterprise*, by Ingrid Mittermaier and Joey Neugart, *Practical Tax Lawyer*, page 5 (Fall 2011) for a further discussion of the issues that arise in tandems, including brother-sister and parent-subsidiary relationships.

Conclusions

We have provided three case studies that are somewhat typical of the fact patterns we are seeing on a regular basis. In Case 1, one or more individual entrepreneurs want to set up a new enterprise that has a financial as well as a social purpose. In Case 2, an existing public charity wants to use its existing knowledge and intellectual property to set up a new entity to expand its operations beyond its current charitable activities. In Case 3, a private foundation wants to do the same through a PRI. Cases 1 and 2 are more common than Case 3.

On a general level, our overall recommendation is that potential clients think through the four important questions before approaching their lawyers for legal advice and that all lawyers encourage their clients to think through these questions before they embark on the legal analysis. We also recommend, as always, that legal form follow the business plan and that the business plan not be constrained or tailored by legal form.

* * * * *

This overview is provided for educational purposes only and should not be construed as legal advice or substitute for consultation with qualified legal counsel concerning the application of the law to any specific factual situation. Any tax advice contained in this document is not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.

Table 3

Subject Area	Regular Corporation	Constituency Statute	California Flexible Purpose	California Benefit
Corporate purposes	A corporation is generally set up for business purposes. Some states are more flexible about allowing the founders to include alternative purposes in the Articles. We have found that California has not been flexible.	A corporation in a constituency statute state will generally still have standard business purposes in its Articles.	Can engage in any lawful business purpose PLUS (i) one or more enumerated charitable or public purpose activities that could be carried out by a nonprofit public benefit corporation **and / or** (ii) the purpose of promoting positive short-term or long-term effects or minimizing adverse short-term or long-term effects of the flexible purpose corporation's activities upon any of the following: employees, suppliers, customers, creditors, the community, or the environment. Whatever the alternative purposes, they must be spelled out in the Articles. Changes can be made only by at least a 2/3 vote of each class of outstanding shares.	Can engage in any lawful business purpose PLUS must provide a general public benefit, which means a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard. In addition, it can have one or more specific public benefit purposes, which does not limit the obligation to create a general public benefit. Specific public benefits include: (A) providing low income or underserved individuals or communities with beneficial products or services; (B) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; (C) preserving or improving the environment; (D) improving human health; (E) promoting the arts or sciences or the advancement of knowledge; (F) increasing the flow of capital to entities with a public benefit purpose; and (G) the accomplishment of any other identifiable benefit for society or the environment. Changes can be made only by at least a 2/3 vote of each class or series of outstanding shares.

Table 3 *(continued)*

Subject Area	Regular Corporation	Constituency Statute	California Flexible Purpose	California Benefit
Director's duties	Standard duty of care and loyalty requires directors to act in the best interests of the corporation, employing the judgment of an ordinary person, with the ability to rely on experts when needed.	In addition, constituency statutes generally provide that a director, in determining what the director reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in the director's discretion, may consider any of the following: (1) The interests of the corporation's employees, suppliers, creditors, and customers; (2) The economy of the state and nation; (3) Community and societal considerations; (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation. (Ohio) In some states the constituency rules only apply to decisions made in connection with selling the assets of the corporation or merging or being acquired, but not on day to day decisions.	In addition to the normal duties of care and loyalty, in discharging his or her duties, a director may consider those factors, and give weight to those factors, as the director deems relevant, including the short-term and long-term prospects of the flexible purpose corporation, the best interests of the flexible purpose corporation and its shareholders, and the purposes of the flexible purpose corporation as set forth in its articles. The special duties of directors are specifically linked to special purposes actually articulated in the Articles, not to a broad array of social benefits.	In addition to the normal duties of care and loyalty, (1) the director must consider: the employees and workforce of the benefit corporation and its subsidiaries and suppliers; the interests of customers to the extent they are beneficiaries of the general or specific public benefit purposes of the benefit corporation; community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or its subsidiaries or suppliers are located; the local and global environment; and the long-term and short-term interests of the benefit corporation; (2) may consider any other pertinent factors or the interests of any other group that the director determines are appropriate to consider; (3) shall not be required to give priority to the interests of any particular person or group referred unless the benefit corporation has stated its intention to give priority to interests related to its specific public benefit purpose in its articles of incorporation; and (4) shall not be subject to a different or higher standard of care when an action or inaction might affect control of the benefit corporation.

Table 3 *(continued)*

Subject Area	Regular Corporation	Constituency Statute	California Flexible Purpose	California Benefit
Director liability	Normally, directors who act in good faith and with normal prudence are protected by the business judgment rule. In a typical corporation, directors do, from time to time take into account issues other than the financial interests of the company and its shareholders. Corporations make grants and engage in corporate social responsibility. While directors in a traditional corporation clearly have some leeway under the business judgment rule, it is not clear how far they could go in pursuing activities that might be deemed to jeopardize profits.	Case law is not clear whether directors have a more lenient standard if they consider purposes beyond financial ones to any great degree.	Directors are subject to liability just like directors in a normal for-profit corporation, except that the law makes it clear that they do not owe a duty to outside parties because of the enhanced social mission. The law provides that ''Nothing in this section, express or implied, is intended to create or grant or shall create or grant any right in or for any person or any cause of action by or for any person, and a director shall not be responsible to any party other than the flexible purpose corporation and its shareholders.'' In performing their duties above, the statute makes it clear that the director ''shall have no liability based upon any alleged failure to discharge the director's obligations as a director.''	A director is not liable for the failure of a benefit corporation to create general or specific public benefit. But the law does provide a special provision for ''benefit enforcement proceedings'' which does not appear to impose liability on individual directors: The law says: (b) A benefit enforcement proceeding may be commenced or maintained only as follows: (1) Directly by the benefit corporation. (2) Derivatively by any of the following: (A) A shareholder. (B) A director. (C) A person or group of persons that owns beneficially or of record 5 percent or more of the equity interests in an entity of which the benefit corporation is a subsidiary. (D) Other persons as have been specified in the articles or bylaws of the benefit corporation. (c) A benefit corporation shall not be liable for monetary damages under this part for any failure of the benefit corporation to create a general or specific public benefit. (d) If the court in a benefit enforcement proceeding finds that a failure to comply with this part was without justification, the court may award an amount sufficient to reimburse the plaintiff for the reasonable expenses incurred by the plaintiff, including attorney's fees and expenses, in connection with the benefit enforcement proceeding.

Table 3 *(continued)*

Subject Area	Regular Corporation	Constituency Statute	California Flexible Purpose	California Benefit
Shareholder rights	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits.	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits.	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits. Shareholders have special approval rights on electing into or out of FPC status, including being able to require the corporation to purchase dissenting shares at fair market value. Shareholders must approve changes in the special purposes.	Shareholders can vote to remove directors, elect different directors, an in some cases bring law suits. Shareholders have special rights for electing into or out of Benefit corporation status, including being able to require the corporation to purchase dissenting shares at fair market value.
Third party rights	None, except government.	None, except government.	None, except government.	Not clear, but likely none except government.
Disclosure & Monitoring	Shareholders receive reports. Public companies make SEC filings.	Shareholders receive reports. Public companies make SEC filings.	Shareholders receive extensive reporting on the special purposes. Reports shall be made public.	Shareholders receive extensive reporting on the general and specific public benefits pursued by the corporation. Reports shall be made public. The board must state in the annual report whether, in its opinion, the corporation failed to pursue its general, and any specific, public benefit purpose during the reporting period.