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Social Entrepreneurship: Business Strategies For Nonprofit Organizations

THE LEGAL OVERVIEW

1. **What are the critical success factors related to the legal aspect of establishing a for-profit business through a nonprofit organization?**
 - A. Competent legal advice (too many legal and tax “land mines” to risk engaging in for-profit activity without counsel in advance)
 - B. Competent accounting/tax advice
 - C. Conflict of Interest Policies in place
 - D. Duties of loyalty clearly understood
 - E. Permitted by the organization’s charter documents
 - F. Who, what, why, how, effect on (use of facilities, employees and other resources of) exempt organization (and its mission)
 - G. The more closely the proposed business activity has to the organization’s mission (at least in a reasonably ancillary way) the more likely the venture is to succeed in all respects, unless the business activity or venture or income-producing opportunity is entirely out-sourced to a third party and the organization’s resources are not significantly impacted by the activity.

2. **What legal issues should the nonprofit organization be aware of?**
- A. See Questions 1, 3, 4, 5 and 6!
 - B. Unrelated business income tax (UBI or UBIT)
 - C. Business structure and impact on tax exempt status
 - D. Are the organization's Articles and Bylaws well drafted (more than the text book or corporate filing service "boilerplate") and recently reviewed?
 - E. Does the organization have well-thought-through financial, conflict of interest and other policies documented by legal counsel experienced in representing nonprofit organizations?
 - F. Does the organization's board of directors or trustees function well as a board, understanding their duties, liabilities, responsibilities and the organization's expectations of them?
 - G. Liability issues: protecting assets of the nonprofit organization from unrelated business activities
 - H. Charitable fund raising registration issues by for-profit subsidiaries (or on the Internet)
 - I. Sales tax issues
 - J. State and Federal anti-discrimination employment laws from which the nonprofit organization may be exempt (typically religious charities) will apply to the for-profit subsidiary, including California's new transvestite, transgender, non-gender bias and other laws.
 - K. Accounting and tax returns get more complex and therefore costly, as will the certified audit that may nonprofit organizations get each year

3. **How does operating a for-profit business affect the exempt status of a nonprofit organization?**
- A. General rule: a *trade or business* that is *regularly carried on* and *not substantially related to the nonprofit organization's exempt purpose* will cause the organization to **lose its tax exempt status**. Numerous exceptions apply, generally falling into the volunteer exception (at least 85% of all hours worked are performed by volunteers); the convenience exception (business carried on by a charity for the convenience of its members, students, patients or employees (university dorm; hospital cafeteria); retail sales of merchandise at least 85% of which is received as contributions (e.g. thrift stores selling donated goods).
 - B. A for-profit enterprise that does not fall into an exception to the unrelated business income tax rules may be operated through a wholly-owned subsidiary and avoid the potential loss of tax-exempt status.
 - C. Private foundations are subject to many additional and more restrictive rules, particularly related to activities with "disqualified persons." This summary does not address those special rules, and the recommendations that legal and tax counsel be consulted with prior to engaging in a for-profit activity are even more strongly repeated.

4. **What governing structure can be established when incorporating a business under a nonprofit organization?**

- A. A for-profit business enterprise should be operated through a corporation wholly owned by the nonprofit organization. If the trade or business will generate taxable unrelated business income (UBI), then the business must be conducted in a subsidiary corporation to protect the exempt status of the nonprofit organization.
- B. Protection of the nonprofit organization's assets from the claims of creditors and liability from tort claims by purchasers of the business's products or recipients of the business's services mandate the incorporation of the for-profit activity in a separate entity owned by the nonprofit organization.

C. The corporate subsidiary may be an "S" corporation for tax purposes (a nonprofit, tax-exempt entity is a qualified "S" shareholder).

5. **What are the most common legal mistakes made by nonprofit organizations as they work on planning and implementing for-profit ventures?**

- A. Poorly structured nonprofit organization
- B. Mission and objectives not well defined
- C. Poorly functioning board of directors
- D. Too much reliance upon free counsel (typically from professionals who do not specialize in nonprofit matters), or counsel from friends-of-the-board who are not specialists in nonprofit legal and accounting matters.
- E. Assuming the organization cannot do it ("it's illegal," meaning that the activity may generate taxable income)
- F. Assuming the organization can do anything (and "get away with it") because it's a nonprofit organization
- G. Lack of control or supervision
- H. Conflicts of interest
- I. Poor bookkeeping and accounting records
- J. Poor financial controls

6. What legal risks does the nonprofit organization face when venturing out to form a for-profit business under its umbrella?

- A. Loss of tax-exempt status
- B. Generating taxable income
- C. Application of state and federal employment laws

7. What resources are available for nonprofit executives to learn more about the legal aspects of establishing a for-profit business?

A. Lawyers specializing in nonprofit organizations (ask other nonprofit executive directors for referrals; ask the large foundation directors for referrals, call the large law firms in town for lawyers (some of which have nonprofit specialists))

B. Accountants specializing in nonprofit organizations (ask other nonprofit executive directors for referrals; ask the large foundation directors for referrals, call the large accounting firms in town for accountants (some of which have nonprofit specialists))

C. Internet (www.irs.gov for tax code, Regulations, publications; www.charitychannel.org; www.nonprofit.gov; www.mapnp.org/library; www.cnm.org; www.nonprofit-startup.com; www.aristotle.net/~nonprofit; www.volunteercenter.org; go to google.com or other search engines and type in “UBI” or “unrelated business income”. Many other resources are available online.

D. Volunteer Center of Orange County

ADDITIONAL DISCUSSION

In an era where nonprofit organizations are scrambling for what seems like an increasingly shrinking donor pool of available funds, or facing increasing competition for the same funds, many organizations are looking at revenue producing activities or ventures to supplement shrinking revenues.

Common fund-raising events include raffles (new rules go into effect in California July 1, 2004), golf tournaments, silent auctions, and dinners with entertainment and speakers who are well-known in the organization’s area of focus. Less common but well known are business enterprises such as thrift stores, bookstores connected to churches or mail-order book, tape and related-product sales by religious radio broadcasters, and so on. Some nonprofits get into marketing and selling products unrelated to their mission, licensing their tradename for use on services or products, and other activities that generate revenues. Some receive donations of rental properties and lease these out for

profit. Others own (through subsidiary corporations) own and operate totally unrelated for-profit businesses.

These activities raise many legal, accounting and tax issues, and potentially run the risk of jeopardizing the organization's tax-exempt status if handled improperly. Such enterprises or activities also raise issues of conflicts of interest (do board members, founders, officers (or their family members or other close relatives own interests in or receive compensation from vendors providing products or services to the venture, or receive other direct or indirect benefit from the activity), duties of loyalty (what is in the best interests of the organization), and related issues.

Just as important and relevant, though seldom mentioned in the literature on the subject, are issues such as whether entering into business enterprises or other income-producing activities result in shifting the organization's focus away from the principal mission and objectives to such an extent that the organization's principal focus is diluted and misdirected more towards fund-raising than achieving the organization's objectives. Perhaps hiring experienced grant writers and professional fund raisers would be a better method of raising additional funds, and just as remunerative in the end, with fewer problems, than tackling a separate money-making enterprise.

However, many organizations hold successful fundraising events each year that do not result in a misdirection of focus and mission, become a regular part of the organizations annual programs, and that do not realize unrelated business income or risk loss of tax-exempt status.

A common misconception is that nonprofit organizations cannot run programs or small business ventures that "make a profit" in the accounting or tax sense, or that a nonprofit organization is prohibited from owning a for-profit business, or operating a business from which it derives income that will inure to the benefit of the organization. These are, generally speaking, both incorrect assumptions, but the ownership and operation of a for-profit business does raise a number of legal and tax issues that must be understood and carefully reviewed with legal and tax counsel, and conducted with care to avoid problems.

Another common misconception is that unrelated business income tax is 'bad' and to be avoided at all costs, and will jeopardize the organization's tax exempt status. First, a nonprofit organization certainly can "make a profit" from a strict income minus expenses bookkeeping standpoint, and suffer no tax or legal consequences with respect to activities that are substantially related to the organization's charitable purposes. Secondly, while operating a business activity that is not substantially related to the organization's charitable purposes can in fact jeopardize an organization's tax exempt status if operated by the nonprofit organization and not through a for-profit subsidiary, that risk can be avoided with proper legal and accounting counsel. Furthermore, as long as the corporate income tax rate is not 100%, and the for-profit subsidiary can in fact make a profit for accounting and tax purposes, the business activity may be a perfectly fine one to conduct. What's more, the activity, even if "substantial," may not in fact generate

unrelated business income tax, as discussed below, if the activity falls in one or more of the three principal exceptions to the general rule.

Generally, income from activities that have no direct relationship to the exempt purpose of a nonprofit organization is “unrelated business income” (UBI). Specifically, an unrelated trade or business is one that is regularly carried on by the nonprofit organization and is not substantially related to the organization’s exempt purpose. IRC §512(a).

Where a tax-exempt organization engages in an unrelated activities (e.g. activities that generate UBI that is subject to tax), if the activities are substantial as compared to its exempt activities, the tax-exempt status of the entity is jeopardized. When unrelated activities become substantial (e.g. if revenues, expenses or employee time devoted to unrelated activities approaches or exceeds 15%), a tax-exempt organization must consider transferring those activities to a for-profit subsidiary so that its exempt status will not be jeopardized.

There are a number of ways to channel revenue from a for-profit subsidiary to its tax-exempt parent. For example, because the staff and other resources of the for-profit subsidiary are often the same as those of its tax-exempt parent, the taxable subsidiary can—and should—reimburse the exempt organization parent for the subsidiary’s occupancy costs, allocable share of employee time, and use of the parent’s equipment and supplies. The tax –exempt parent might lend money to it subsidiary, with the loan bearing a fair market rate of interest and other commercially reasonable terms (payment, duration of loan, secured perhaps). The parent can also license the use of its name or log to a for-profit subsidiary that sells products or services, so the subsidiary pays a royalty to the parent. The subsidiary may also distribute its earnings and profits to the parent in the form of dividends. Under the UBI rules, passive income, such as dividends, interest and royalties, is generally exempt from the unrelated business income tax provided that the distribution is *not* deductible by the subsidiary.

What are the General Rules?

An activity is an unrelated business (and subject to UBIT) if it meets three requirements:

1. It is a trade or business;
2. It is regularly carried on; and
3. It is not substantially related to the furtherance of the exempt purpose of the organization.

There are, however, a number of exclusions and modifications to this general rule.

The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services. It is not limited to

integrated aggregates of assets, activities, and goodwill that comprise businesses for purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes.

Business activities of an exempt organization ordinarily are considered "regularly carried on" if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations.

To determine if a business activity is "substantially related" requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related.

The Internal Revenue Code contains a number of modifications, exclusions, and exceptions to unrelated business income. For example, dividends, interest, certain other investment income, royalties, certain rental income, certain income from research activities, and gains or losses from the disposition of property are excluded when computing unrelated business income. In addition, the following activities are specifically excluded from the definition of unrelated trade or business:

- **Volunteer Labor:** Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. Some fund-raising activities, such as volunteer operated bake sales, may meet this exception, as do most golf tournaments, "silent" auctions (where merchandise may or may not be donated).
- **Convenience of Members:** Any trade or business is excluded that is carried on by an organization described in section 501(c) (3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees. Typical examples of this are a school cafeteria, dorm, bookstore, hospital cafeteria.
- **Selling Donated Merchandise:** Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions. Many thrift shop operations of exempt organizations would meet this exception. (e.g. Goodwill, CHOC, Salvation Army Thrift Stores, church-run thrift stores and food banks)

Examples of For-Profit Activities Operated by Nonprofit Organizations

1. **Colleges and Universities** operating dormitories (housing at a university is substantially related to education); operating cafeterias, student stores (with respect to books and school supplies, but *not* as to ancillary products (stuffed animals, coffee mugs, etc.).
2. **Travel tours** when the purpose of destinations of the tour are substantially related to the organization's charitable purpose (museum conducting annual tours to La Hermitage, Louve, Metropolitan Museum of Art and Vatican).
3. **Sales by museums** of greeting cards that display printed reproductions of selected works from the museum's collection, because the sale of such cards "contributes importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest and appreciation of art." However, novelty or luxury items, such as a zoo selling designer scarves with animal print designs) are not substantially related to exempt purposes. The IRS applies a "utilitarian" test to some products, asking if the primary purpose of the article is "utilitarian" and not educational, then the utilitarian aspects are the predominant reason for the article and therefore should be considered "related" (and therefore non-taxable).
4. **Selling Membership Lists**: The IRS has held that the sales of membership mailing lists by a tax-exempt educational organization to businesses for the production of income generate UBI. However rental of an organization's mailing list may generate royalty income that is exempt from the UBIT.
5. **Corporate Sponsorships**: Is it a donation, or payment for advertising which is subject to UBIT? An acknowledgement of a sponsor's donation does not rise to the level of providing a significant advertising benefit return to the sponsor may be a "qualified sponsorship payment" that does not generate UBIT. But printing an endorsement of the sponsor's products or encouraging the purchase of its products or use of its services will cause the donation to be taxable as UBI. Generally the level of advertising and focus on the sponsor that is seen at the "Nextel Cotton Bowl" or other name college football games causes the advertising revenues received by the otherwise tax-exempt organization(s) to be UBI.
6. **UBI and the Internet**: Charity web pages have become so popular that the first page of the RIS Form 1023 Application for Recognition of Exemption now asks for an applicant's website address. When a nonprofit organization uses its website to generate income, there is always the possibility that income it receives will be UBI (among other issues, such as registration with the state attorney general or other authorities in states where fund-raising appears are directed; whether those assisting with the website hosting are "fund raising professionals" or "fund raising counsel")

under charitable solicitation statutes and require registration). For example, a charity might seek a corporate sponsor to pay for the establishment and maintenance of its web page in exchange for a donor acknowledgement on the web site. Is this a “qualified sponsorship payment?” The line can be very fine, and often unclear under current IRS regulations and rulings. If the website is characterized as a “periodical,” (“regularly scheduled and printed material published by or on behalf of the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization” (IRC §513(i)(2)(B)(ii)(I)), then the tax-exempt organization cannot take advantage of the “qualified sponsorship payments” exemption from the UBI rules.

Another area in which there is not current guidance from the IRS or Regs relates to hyperlinks, where a charity’s website contains a sponsor’s logo and a link to the sponsor’s website. The mere display of the sponsor’s logo arguably meets the requirements for “qualified sponsorship payments.” But if the linked sponsor’s site contains comparative or qualitative statements about the sponsor or its products, the risk of a sponsorship payment as being view as UBI substantially increases. In the most recent cases, the IRS seems to take the position that merely maintaining a passive link to a sponsor’s website may not generate UBI, where a sponsor’s banner that moves across the non-profit organization’s website is more likely to be considered advertising.

A non-profit organization that establishes an online gift shop faces the same UBI issues as any other non-profit that operates a retail gift shop: are the items sold substantially related to the organization’s exempt function?

The IRS has not taken a definitive position on the tax consequences of a charity’s website that contains a link to a sponsor’s site, where the internet user can buy products on the sponsor’s site and the charity receives a percentage of the sponsor’s profits. If the payment is characterized as a “royalty,” the payment to the charity by the sponsor is exempt from UBIT. If the payment is characterized as a “referral fee,” then the question may relate to whether the referrals (to the sponsor’s site) significantly further the exempt mission of the charity (referrals by a local bar association to lawyers may further the organization’s purpose of providing “the best information, advice, and legal services possible to every citizen in the community.” (PLR 8432003).

Charity mall sites permit an individual to link from a charity’s website to a variety of online stores and with which an independent third party (“charity mall operator”) has an agreement. The individual makes a purchase, and a portion of the purchase price is donated to the charity selected by the buyer, at no additional cost to the buyer. In this context, it is less likely that the charity will be characterized as conducting a business, so payments to the charity will look more like a royalty from the mall operator.

7. **Thrift stores** are common examples of for-profit enterprises that, when run by largely volunteer staff and all products are donated, or staff is paid, but all goods sold or donated.
8. **Bookstores** run by churches that sell mostly religious books, tapes, music and related items are common examples of business enterprises that are substantially related to the organization's exempt purpose, although the sale of certain products (coffee bars, food products, and "utilitarian" products) may raise UBIT issues. Sales tax issues are also important to consider in this or any product-selling business enterprise: just because the enterprise is exempt from UBIT because it fits one or more of the exceptions, does not mean that local or state sales taxes do not apply.
9. **Income from Investment Transactions.** Arguably, passive investment activity does not rise to the level of a trade or business. Dividends, interest, annuities, royalties, gains or losses from sales or exchanges of property that is neither inventory nor held for sale to customers in the ordinary course of business, and other income from investment activities are specifically excluded from unrelated business taxable income unless they are derived from debt-financed property. Where an exempt organization's book publications and sales might result in income taxable as UBI, royalty received from licensing the publication rights to a commercial publisher would not.
10. **Rental Income.** Income from renting real property is not included in UBIT unless it is derived from debt-financed property, unless the lessor renders services in connection of space only. Supplying maid service in connection with the rental of living quarters is a disqualifying service, but furnishing heat and light, cleaning public areas, and collecting trash are not. If more than 50% of the rental income is attributable to personal property leased with the real property, then the exclusion from UBIT does not apply.
11. **Bingo Games.** Conducting bingo games in accordance with state or local law is not treated as unrelated trade or business (IRC §513(f)).
12. **"S" Corporation Income.** An organization exempt under IRC §501(c)(3) may be a shareholder in an S corporation (IRC §1361(c)(6)), but all income realized by the 501(c)(3) organization as a result of being a shareholder of an S corporation is taxable as UBI even if the income consists of dividends, royalties, interest and capital gains earned by the S corporation.

The summary and overview given in the previous ten pages is by no means complete or exhaustive, and generalizes many topics which have numerous unmentioned exceptions or nuances, and does not mention many exceptions or other matters which may be pertinent to the examples given or a reader's specific circumstances. The IRS, the tax and appellate courts are considering and reconsidering these issues all the time, and the subject needs the constant attention of and counsel from competent legal and tax

professionals, as well as others. The summary above is not, must not be construed to be, and must not be relied upon as legal advice, nor is any attorney-client relationship established by the publication of this material. A nonprofit organization that is considering the start-up or acquisition of a for-profit venture must seek competent legal and accounting/tax advice from professionals that specialize in the nonprofit arena on a regular basis.

The foregoing summary was provided by Paul S. Nash, an attorney in Irvine, California. Mr. Nash has been practicing law for 30 years, and specializes in representing nonprofit and for-profit organizations. He serves as general counsel to about thirty nonprofit organizations, serves on the boards of several, and regularly consults with nonprofit boards on matters of board governance, operating issues, conducts “legal audits” of nonprofit organizations, and consults on matters of Bylaw revisions, formulation and adoption of key operating policies, foreign grant-making issues and issues, and so on. You may contact Mr. Nash by any of the media noted in the “letterhead” at the beginning of this paper.