

# Nonprofits and Social Enterprise: Finding the Right Fit for Your Organization

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# Agenda

1. What is a Social Enterprise?
2. Options for Legal Structure
3. Key Considerations



# What is a Social Enterprise?



# What is a Social Enterprise?

- » Social Enterprise means different things to different people, depending on circumstances
- » For Today ...

Social Enterprise is a business-like activity designed, at least in part, to do good, and not simply to generate profits.

—Robert Wexler, Adler & Colvin



# What is a Social Enterprise?

- » For Nonprofits, Social Enterprise includes ...
  - Business activity designed to generate resources to support mission
  - Business activity designed, itself, to advance mission



# Our Role as Lawyers ...



## **Understand:**

a new sector is emerging—one that blends the best of two worlds to drive profits *and* social change



## **Counsel:**

work with clients to provide the best legal structure for their enterprise, *after* considering their business plan



## **Lead:**

monitor and shape new options, laws and regulations to support our clients and this emerging sector



WAGS CONSIGNMENTS

# Options for Legal Structure

# Options for Legal Structure

P

## For-profit

- Business corporation
- LLC (multi-member)
- Partnership

H

## Hybrid

- L3C
- Benefit Corporation

N

## Nonprofit

- 501(c)(3) Entity
- 501(c)(4) Entity
- LLC (single member)





# Options for Legal Structure:

- P** For-Profit Entity
- H** Hybrid Entity
- N** Nonprofit Entity

# Business Corporation



For-profit

- » Preferred by venture capitalists
- » Earnings taxed at corporate and shareholder levels
- » For tax-exempt shareholders, dividends  $\neq$  UBTI
- » Careful with S corporations!

# LLC or Partnership

- » Required by tax credit investors
- » Earnings taxed at member/partner level
- » For tax-exempt owners, earnings = tax-exempt or UBTI, depending on character
- » Evaluate under joint venture rules!



# Best suited for ...



For-profit

## Social Enterprises with:

- » Strong, if not primary, focus on maximizing profit
- » Desire to share risk/reward with equity partners
- » No need for traditional philanthropy
- » Limited benefits from tax-exempt status relative to regulatory burdens
- » Desire for more privacy over operations

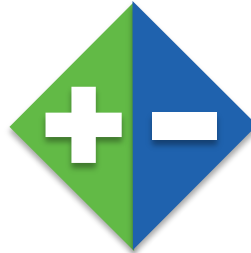


# Advantages/Disadvantages



For-profit

- » Well-known legal structure, requiring little explanation
- » Access to investment capital (debt + equity)
- » Flexible and least regulated
- » Enables equity-based comp
- » Relatively easy to sell or shutter
- » Easier to convert to nonprofit entity than vice versa

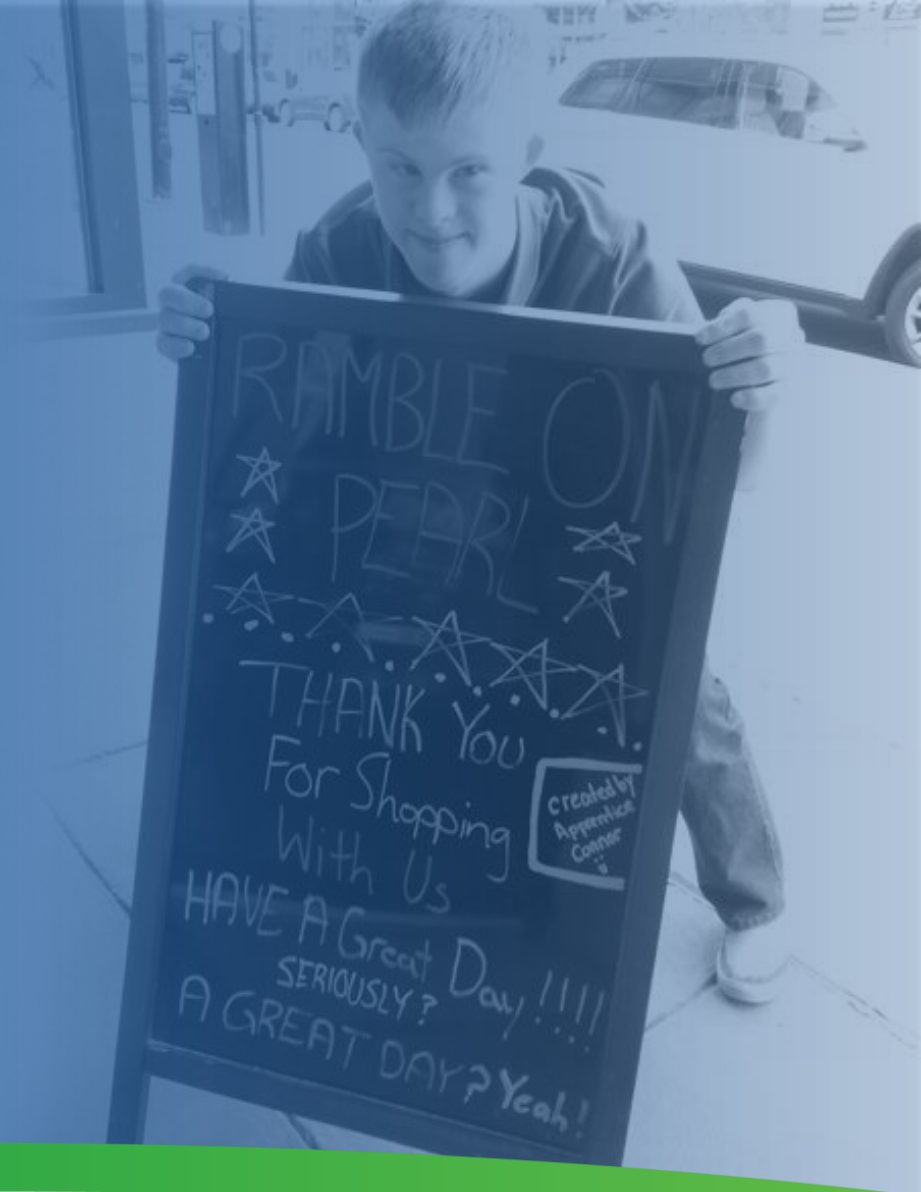


- » Social impact dependent on leadership, not structure
- » Limited or no access to grants and donations
- » Tension caused by fiduciary duty to owners (to maximize profit)
- » No tax-exemption



# Options for Legal Structure:

- P** For-Profit Entity
- H** Hybrid Entity
- N** Nonprofit Entity



# What is a Hybrid?



## Dual Purpose Entity: Profit + Social Impact

- » For-profit entity with private owners and investors
- » Taxable as corporation or partnership
- » Social mission is “baked” into legal structure
- » Proponents developed to:
  - Address limitations of for-profit and nonprofit structures
  - Facilitate PRIs\* and MRIs\* by tax-exempt investors

\* PRI is a program-related investment and MRI is a mission-related investment



# Low-Profit Limited Liability Company (L3C)



- » For-profit, taxable LLC with members
- » Incorporates *PRI standards* into legal structure:
  - Company significantly advances charitable purposes and would not have been formed but for those purposes
  - No significant purpose of income production or capital appreciation
  - No political or legislative purpose
- » Colorado: rejected L3C legislation as unnecessary and problematic, though limited availability in other states

## CLARIFICATION ON L3C

L3C *is not* a tax designation (like 501(c)(3))

L3C *is* a type of legal entity



# Benefit Corporation



Hybrid

- » For-profit, taxable corporation with shareholders
- » Incorporates *general public benefit requirement* into legal structure (specific public benefit is optional) \*
  - Clarifies need to consider non-pecuniary interests in board decisions
  - Requires reports on social impact
- » Colorado: adopted its own legislation, rather than model legislation, resulting in “public benefit corporation” designation rather than “benefit corporation” designation

\* In Colorado, specific benefit required, general public benefit optional

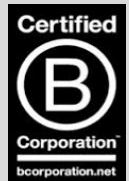
## CLARIFICATION ON B CORPORATION

B Corporation *is not*:

- Type of legal entity
- Abbreviation for benefit corporation
- Tax designation (like C or S corp.)

B Corporation *is* a certification mark awarded by B Lab to companies voluntarily adhering to standards for:

- Social impact
- Accountability
- Transparency





# Best suited for ...



## Social Enterprises with:

- » Core belief that profits and social good are inextricably intertwined
- » Capital needs that will attract new, impact-driven investors
- » No need or desire for traditional philanthropy or tax-exempt status
- » Tolerance for accountability and transparency as to social impact
- » Desire for “new and modern” image and perceived “halo” effect

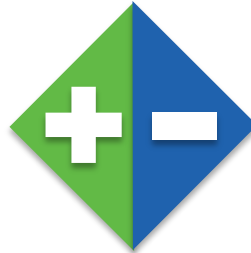


# Advantages/Disadvantages



Hybrid

- » Similar to for-profit entity
- » Social mission built into legal structure
- » Diminishes tension arising from duty to shareholders
- » Access to “new” capital markets (impact investing, crowd-funding)
- » Branding/marketing benefits from social mission



- » Similar to for-profit entity
- » New entity, relatively unknown, requiring some explanation
- » Social overlay untested in courts and market
- » Less access to traditional capital markets
- » Exit strategies more difficult than for-profit entity



# Options for Legal Structure:

- P** For-Profit Entity
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Nonprofit

## 501(c)(3) Entity

- » Tax-exempt income (excluding UBTI)
- » Tax-deductible donations
- » Grants and PRIs *without* expenditure responsibility (if charity)
- » Limited lobbying, no political activities

## 501(c)(4) Entity

- » Tax-exempt income (excluding UBTI)
- » *Non*-deductible donations
- » Grants and PRI *with* expenditure responsibility
- » Unlimited lobbying, limited political activities



# Single-Member LLC



## An Alternative to New Tax-Exempt Entity or Sole Proprietorship ...

- » Separate legal entity, disregarded for tax purpose
- » Helps prepare enterprise for follow-on investment or future sale
- » Provides some protection against claims of parent's creditors
- » Preserves most tax benefits until no longer needed or available
- » Easy to sell or shutter
- » Easy to convert to for-profit or hybrid  
(e.g., admit new members or elect to be taxed as corporation)



# Best suited for ...



## Social Enterprises with:

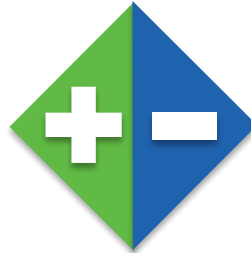
- » Strong, if not primary, focus on social impact
- » Earnings that qualify as tax-exempt income
- » Need for traditional philanthropy to fill gaps in earnings or capital
- » Capital needs that can be met by debt, not equity
- » Tolerance for regulatory burdens and transparency
- » Desire for perceived “halo” effect



# Advantages/Disadvantages



- » Tax-exemption
- » Access to grants, donations and other subsidies
- » Easier investment for tax-exempt investors (MRIs, PRIs)
- » Social mission built into legal and tax structure
- » Potential PR/branding benefits



- » Greater regulation + oversight
- » No access to equity market
- » Precludes equity-based comp
- » Difficulty in balancing profit and social impact
- » High level of public transparency



# A Few More Options ...

- » **Tandem Structures**

Combination of for-profit or hybrid entity and nonprofit entity, to secure advantages of each

- » **Cooperatives**

Business owned and controlled by participants for their mutual benefit and to promote their common economic and social needs

- » **Taxable Nonprofit Corporation**

Nonprofit corporation taxed as C corporation

- » **Social Purpose Corporations**

Hybrid entity, adopted in a few states, which requires specific (not general) benefit purposes to be built into legal structure and gives directors option (not obligation) to consider benefit purposes





# Key Considerations

# Key Considerations

1. What is the fundamental nature of the business activity? Where do profit and social impact as motivators fall on spectrum?
2. What are the capital needs? Who will invest and what will they require? Will traditional philanthropy be needed at any stage?
3. Does the business activity qualify under 501(c)(3) or 501(c)(4)? If so, do the benefits of tax-exemption outweigh the regulatory burdens?
4. Is privacy or transparency a concern as to management or operations?
5. What's the long game? And what's the exit strategy if it doesn't work out?



# But Don't Forget ...

## Potential application of:

- ✓ Securities laws, federal and state
- ✓ Tax doctrines, such as alter ego, ancillary joint ventures, private inurement, private benefit, intermediate sanctions, commerciality, unrelated trade or business income tax
- ✓ Private foundation rules, for private foundation participants
- ✓ Charitable solicitations laws



A special thank you to **Boulder Treasures** for sharing photos from their first social enterprise endeavor, **Ramble On Pearl**.

Boulder Treasures, a nonprofit 501(c)(3) organization, owns and operates Ramble on Pearl, a retail boutique which offers customers access to premium quality active lifestyle clothing and accessories at below retail prices. For most shoppers, it's one of several retail boutiques along the popular Pearl Street Mall in Boulder. To the founders and benefactors of Boulder Treasures, it's a learning lab where adults with developmental disabilities can learn the hard and soft skills of employment they need to gain independent employment within the community. And for these special apprentices, it's a place where they can experience a sense of pride and achievement, forever changing the many ways they engage with world. For more information, see [bouldertreasures.org](http://bouldertreasures.org).

# Thank you.



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Leaffer Law Group has one focus: providing legal counsel to support, advance and guide the work of nonprofit organizations and charitable foundations, so they can focus on their essential work.

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