<u>Legal Issues for Social Enterprise</u>

Notes from Insight Center for Community Economic Development Workshop, Nov 2009

Starting Principles

- Nonprofits are organized and regulated to exclusively serve charitable purposes
- IRS regulations are designed to prevent them from unfairly competing with private business
- Profits are perfectly OK so long as the money is used to advance the charitable (exempt) purpose of the organization

What Must Be Managed

I. An activity is related to exempt purpose only when it has a substantial, causal relationship to achieving the organization's exempt purposes, e.g. contributing importantly to mission.

- If engaging in an income generating activity that is <u>not</u> furthering your mission (i.e. is substantially unrelated) the organization, one's tax-exemption could be challenged if the activity is consuming a significant part (more than 10-15%) of the organization's resources.

[Episodic sales of something, having volunteers produce it generally OK]

- If "private benefit" (to persons or other organizations) is found, the organization could lose its tax exempt status. [Don't be doing your training in Hawaii]

The IRS uses what was said on your 1023 (request to be declared tax exempt) and what's said on your 990 to determine what you charitable/exempt purpose is.

Programs which employ clients or teach clients how to do something qualify as charitable and tax-exempt because they are related to the organization's exempt purpose and conducted in a manner that includes a charitable aspect.

Sales of products or services which are incidental to the mission are more risky. If they require more than 15% of the organization's resources, they could undermine tax-exempt status.

2. Unrelated Business Income Tax may have to be paid on the net income for ventures that are not substantially related to the organization's exempt purpose.

3 Part Test— is income generated through the operation of a trade or business?
Is it carried on regularly, similar to commercial business?
Is it substantially unrelated to the exempt purpose of the organization?

Generally, sales of goods produced through organization's exempt activities is NOT subject to UBIT. (Rubicon Bakery, HomeBoys, Goodwill, Thrift Stores). Neither is "passive" or "sponsorship"income.

3. If/when income from a social enterprise will be significant enough to threaten tax-exempt status, it would be best to set up a for profit subsidiary, thus segregating expenses and income.

Insulates organization from liability associated with the business
Increase access to funding from traditional investment sources
Make tax-exempt organization the major shareholder (corporation) or member (LLC)
Have separate boards

Prepared by Betsy Densmore, Academies for Social Enterprise, 949-500-2381

4. There are lots of fine points to the above overview so find an attorney to review your choices.