Social Enterprise Toolkit

University of North Carolina School of Law

Community Development Law Clinic

Beth Nelson & Aurora Jaques, Certified Law Students

and

Thomas Kelley, J. Dickson Phillips, Jr. Distinguished Professor of Law

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Part I: Introduction

& Purpose

The term “social enterprise” describes any number of for-profit and nonprofit business endeavors all with the objective of serving a mission driven cause in their community. While many publications on the topic discuss the need for such organizations, the motivations of the social entrepreneur, and generalities on successful formation, this toolkit strives to provide more detailed guidance, including:

1. An overview of four different organizational structures that social enterprises use to carry out their mission-driven businesses.
2. A discussion of benefits and drawbacks of the various social enterprise structures, including tax considerations.
3. Instructions regarding initial steps and ongoing compliance measures that dual-entity or “hybrid” social enterprises (organizations with both nonprofit and for-profit entities working in tandem) should take to obtain and maintain tax exemption.

The toolkit begins by outlining each of the organizational structures. Following that overview, there are four sections devoted to evaluating the characteristics of these organizational structures. Those characteristics are: control of the organization, resource management, sources of funding, and required filings. The final section distills the information from the previous sections into pro/con tables and a checklist for further decision making.

Part II: Organizational Structures

# Overview of Organizational Structures

## Structure #1 – Solely 501(c)(3) Organization

Nonprofit organizations typically exist to provide some kind of benefit to the public. To qualify for 501(c)(3)[[1]](#footnote-2) federal tax-exempt status, nonprofit organizations must be organized and operated for one of the purposes outlined in the tax code, such as religious, charitable, or scientific purposes, to name a few. Operations of the nonprofit must be primarily in furtherance of this “exempt” purpose in order for the organization to obtain and keep tax-exempt status. Nonprofits can be organized as a nonprofit corporation or can remain unincorporated. The chief characteristic of nonprofits is that they cannot distribute profits to shareholders (or members, or owners of the business), and instead must dedicate all profits to their charitable missions. Nonprofit law refers to this as the “non-distribution constraint.” In the context of nonprofit corporations, this removes the shareholder role from management and ownership.

## Structure #2 – For-Profit Organization

In contrast to nonprofits, a for-profit organization exists to make and distribute profits to its owners. For-profit organizations can take many different forms from partnerships and Limited Liability Company (“LLCs”) to corporations. Factors such as tax and individual liability typically help founders determine which organizational form is best for them.

## Structure #3 – Hybrid/Dual Entity Organizations

Although more complicated, dual entity organizations (those with both nonprofit and for-profit arms working in tandem) offer the benefits of both organizational structures for their social venture.

Within this category there are two options for structuring the relationship between the for-profit and nonprofit. The first is a parent/subsidiary relationship with the nonprofit as the parent (because, as noted above, a nonprofit does not have owners) and the for-profit as the subsidiary. Alternatively, the two organizations can function as side-by-side entities relying on contracts to dictate the relationship between the two.

# Control of the Organization

## Nonprofit:

Nonprofit organizations are controlled by a board of directors. All directors owe the fiduciary duties of loyalty and care to the organization. Unlike in the for-profit sector, where the board of directors is elected by shareholders, nonprofit boards are self-perpetuating. The board of directors appoints officers of the organization. Maintaining a board of directors for a nonprofit corporation can be more burdensome than other for-profit control structures, specifically, an LLC or a partnership.

*For-profits:*

Varies based on the type of for-profit entity selected. In a corporation, managers are typically responsible for the day-to-day operations of the organization while the board of directors (elected by the corporation’s owners) is responsible for ensuring that the corporation is serving the owners’ best interests. In an LLC or partnership, owners typically play a more direct role, managing the day-to-day affairs of the organization directly.[[2]](#footnote-3)

*Hybrid:*

**Parent/Subsidiary Relationship:** In this organizational structure, the nonprofit parent would have majority control over the for-profit subsidiary. The nonprofit parent would have its own board of directors exerting control over the nonprofit.

**Side-by-Side Relationship:** In a side-by-side structure, each arm would have separate management and control. The ways in which each arm of the organization interacts with the other would be negotiated via contract. When approving the contracts between the side-by-side entities, both organizations must be aware of board members who may have a conflict of interest by serving on the boards for both the for-profit and nonprofit.

1. **Operationally Complicated.** Both forms of dual entity organizations would require additional support from legal, accounting, and tax advisors to ensure that all requirements have been met so that the nonprofit arm of the organization maintains its tax exemption.

# Resource Management

## Nonprofit:

## Distributions of Funds & Liquidations

Unlike traditional business ventures, nonprofits are limited in how they can use the money that they earn. Any profits that the organization earns must be invested back in the organization or used to further another exempt purpose. Nonprofits are not permitted to distribute their earnings to private individuals or for-profit endeavors.

## Commerciality & UBIT Concerns

For an organization to maintain its tax-exempt status, it must be primarily operated for an exempt purpose.

The “Commerciality Doctrine” asks whether the activities of a nonprofit organization are so commercial in nature that the nonprofit is no longer operated primarily for an exempt purpose. Put differently, an organization may not be operated for an exempt purpose if it has substantial commercial activities that further a nonexempt purpose. Regulators will raise commerciality concerns where, for example the nonprofit organization charges market rate for its goods or services in an effort to maximize profits, markets its goods or services in a way that is indistinguishable from commercial concerns, markets and sells to the general public rather than a discrete charitable class, and competes directly with for-profit enterprises.

Generally, an organization will not lose its tax-exempt status by engaging in commercial activities, but social enterprises should be particularly attuned to whether their organization is truly operated for an exempt purpose. Social enterprises should also be aware that the enforcement of this doctrine is unpredictable and thus they should err on the side of avoiding commerciality concerns.

Unrelated Business Income Tax (“UBIT”) is another issue that arises when the operations of a nonprofit stray from their exempt purpose. An organization that does not lose its tax-exempt status from its commercial activities may nonetheless be required to pay UBIT on the profits from their commercial activities—the same way a for-profit company would pay taxes on that income. UBIT applies when an exempt organization regularly engages in a trade or business that is not substantially related to the organization’s exempt purpose (aside from needing funds derived from the activity).

Because of the potential implications (losing exemption altogether and/or owing income taxes) it is important for all nonprofits, but especially social enterprises, to be aware of these areas of concern.

## For-profit:

## Distributions of Funds & Liquidations

Profits are distributed to the organization’s owners and any resources remaining after liquidation are similarly distributed to owners.

1. **Taxes.** Corporations are required to file their own tax return annually. Pass through entities (like partnerships or LLCs) will also must complete an informational filing, despite owners being taxed directly.

*Hybrid:*

## Distributions of Funds & Liquidations

The funds donated to, and grants received by the nonprofit arm of the dual entity organization would be subject to the non-distribution constraint, meaning these funds must be reinvested into the nonprofit or, upon dissolution, distributed to another nonprofit or government entity. The funds earned by the for-profit arm of the dual entity organization would not be subject to the non-distribution constraint and could be distributed to the owners in the form of dividends or return of capital.

## Administrative Burdens

1. **Operationally Complicated.** Both forms of dual entity organizations would require additional support from legal, accounting, and tax advisors to ensure that all requirements have been met so that the nonprofit arm of the organization maintains its tax exemption.
2. **Increased Costs.** Along with the complicated operations described above, establishing and maintaining a dual entity organization will come with increased costs for the services required to ensure that the nonprofit arm of the organization maintains its exemption.

# Sources of Funding

## Nonprofit:

Nonprofit organizations receive funding primarily from donations, grants, and charging for their charitable or educational services.

After an examination of grants made by the federal government in 2020, over nine billion dollars in grants were given to for-profit organizations (including Equiti’s grant spanning 2019-2021) while over thirty-seven billion dollars were given to nonprofit organizations.[[3]](#footnote-4) Additionally, private foundations are limited to making grants to organizations fulfilling an exempt purpose unless certain exceptions apply. Based on this information, nonprofit organizations are the best positioned of the organizational structures to receive grant funding.

Traditional venture funding is often unavailable because the non-distribution constraint prevents nonprofits from distributing profits to investors.

## For-profit:

Founder and outside investments are the primary source of funding for most for-profit organizations. There may be grants and other loans available to qualifying small businesses, but those opportunities are typically intended to be used for a short period of an organization’s life, not indefinitely.

## Hybrid:

Dual entity hybrid organizations can take advantage of both private investments and donations and grants. However, the different funding streams for the for-profit and nonprofit organization must remain separate to ensure the nonprofit retains its 501(c)(3) status.

# Required Filings

## Nonprofit:

## Federal Tax Considerations

Because of the benefits that nonprofit organizations offer to the public and the fact that they do not distribute their earnings to individuals or for-profit endeavors, nonprofit organizations are exempt from paying tax on their profits. Another, related tax benefit for 501(c)(3) organizations is that the law encourages individuals to donate by permitting them to deduct the amount of their contributions from their own taxable income.

1. **Annual 990 Report.** 501(c)(3) organizations must file an annual 990 report with the IRS. Depending on the size of the organization, this report can be quite intensive to complete. However, for smaller organizations (gross receipts normally below $50,000) the report is significantly less involved.[[4]](#footnote-5)

## For-Profit:

## Federal Tax Considerations

Entities like LLCs and partnerships offer pass-through taxation. Pass-through taxation means that the owners of the LLC or partners in the partnership are taxed directly for their share of organization’s profits. In contrast, a corporation is taxed directly on its net profits and then when the corporation distributes those earnings to its shareholders, the shareholders are taxed upon receipt. Typically, the double taxation of the for-profit corporate form is considered a disadvantage.

## Hybrid:

## Federal Tax Considerations

Funds donated to the nonprofit entity will not be taxed to the organization and will be deductible to the donor. Funds earned by the for-profit entity would be subject to normal state and federal taxation.

Part III: Evaluation

& Moving Forward

# Which Form is Right for My Organization?

After reviewing the information above, complete the below worksheets to help you determine which organizational structure is the best fit for your social enterprise. Some of the pro/cons below apply to all organizations, which we’ve included in the below charts, but there may be specific factors to consider for your company.

*Note:*

The pro/con charts for each organizational structure contain both general advantages and disadvantages for organizations. This toolkit also includes purple text in the pro/con charts that contain points specific to Equiti’s evaluation of the different organizational structures.

**Nonprofit Organization**

|  |  |
| --- | --- |
| Pros | Cons |
| Tax-exemption | No distribution of profits to founders  |
| No need to divide operations/activities all housed in one organization | Limited funding sources  |
|  | Transition from for-profit to solely a non-profit would be complicated |
|  |  |
|  |  |
|  |  |
|  |  |

**For-Profit Organization**

|  |  |
| --- | --- |
| Pros | Cons |
| Profit distributions to owners  | Taxes, potentially a double layer of tax depending on the organization’s structure |
| Broader funding sources |  |
| No transition necessary |  |
|  |  |
|  |  |
|  |  |
|  |  |

**Hybrid #1: Parent/Subsidiary Relationship**

|  |  |
| --- | --- |
| Pros | Cons |
| Subsidiary, after consultation with accountants, may be able to distribute tax-exempt dividends to parent  | Likely the most operationally complex of the four organizational structures  |
| For-profit’s earnings can be distributions to owners | Requires additional resources to set up and maintain complicated entity |
| Broader funding sources  |  |
| Could likely leave the LLC in place, fewer transitions |  |
|  |  |
|  |  |
|  |  |

**Hybrid #2: Side-by-Side Relationship**

|  |  |
| --- | --- |
| Pros | Cons |
| For-profit’s earnings can be distributions to owners | Requires additional resources to set up and maintain complicated entity |
| Broader funding sources |  |
| Could likely leave the LLC in place, fewer transitions |  |
|  |  |
|  |  |
|  |  |
|  |  |

# Hybrid Organization Next Steps

All governance and financial structures must be separate; however, individuals are permitted to work for both organizations and the two entities may share space and equipment, as long as all of the expenses are properly attributed to each organization.

## Entity Formation

* File necessary articles of incorporation or business registration with your state’s Secretary of State for both organizations.
* For the nonprofit corporation’s articles of incorporation, include required language regarding the nonprofit’s purpose, prohibited activities, and distributions upon dissolution.
* Adopt bylaws and a conflicts of interest policy for each organization.

## Financial Considerations

* Enlist an accountant with experience advising social enterprises to help determine the best way to attribute the cost of personnel, equipment, real estate, and other expenses between the two organizations.
* Consult a tax specialist if questions remain about dividend distributions and cashflow between the organizations.

## Reducing Conflicts of Interest

* The IRS requires that 51% of board members for a nonprofit board be unrelated to one another. Parties can be related by familial relationships or (as is relevant here) business relationships. If parties own collectively more than 35% of a for-profit corporation then they are related. Given this definition, the number of board members who are related will depend on who owns the for-profit. Thus, if multiple members of the nonprofit’s board are also owners of the for-profit, it will be important to ensure that at least 51% of the nonprofit’s board members are unrelated.
* While conflicts might not be an issue at the early stages of the two organizations, conflicted board members are likely to cause an issue down the road for the nonprofit. Based on the nonprofit’s conflict of interest policy, board members with a potential conflict must abstain from voting on transactions where they have a conflict. If too many members of the nonprofit have conflicts with the for-profit, then the nonprofit may lack quorum for approving transactions, which can deadlock decision-making.

## Hybrid #1: Parent/Subsidiary Relationship

* General Toolkit: Work with attorneys to create subsidiary organization.
* Equiti: Work with attorneys to merge existing LLC into subsidiary of nonprofit organization.

## Hybrid #2: Side-by-Side Relationship

* Work with attorneys to draft agreements dictating the relationship between the two organizations.
1. The focus of this toolkit is on nonprofit non-membership corporations that have 501(c)(3) tax exempt status, although it is worth mentioning that organization can receive tax-exempt status under other subsections of 501(c), such as social welfare organizations under 501(c)(4). [↑](#footnote-ref-2)
2. This toolkit does not articulate the pros and cons to different for-profit organizational structures, including differences in owner liability. However, resources are available online. *Choose a Business Structure*, U.S. Small Bus. Admin., https://www.sba.gov/business-guide/launch-your-business/choose-business-structure. [↑](#footnote-ref-3)
3. *Government Spending Open Data*, USA Spending, USASpending.gov. [↑](#footnote-ref-4)
4. The IRS outlines which form an organization must file. *Form 990 Series: Which Forms Do Exempt Organizations File*, IRS,https://www.irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in. [↑](#footnote-ref-5)