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Legal Issues Unique to Social Enterprise

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social enterprise alliance℠

Where mission meets the marketplace.

How can the for-profit social enterprise meet its "shareholder primacy" duty to its owners without compromising its mission?

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The Tension Between Conflicting Duties

- Duty to maximize profits
- "Business judgment rule" protects managers only if their decisions drive shareholder value.
- Promoting social good through adoption of environmentally safe production standards may increase profitability
- Constituency statutes

Is Constituency Statute Protection Real?

- Fend off take-overs
- <u>May</u> allow managers to consider stakeholder interests when making day-to-day decisions
- Most statutes are permissible; others are mandatory, but only in takeover situations
- Threat of shareholder derivative suits for waste or lack of due care may loom.
- Benefit corporation

For which social enterprises do benefit corporations and L3Cs really make sense?

Benefit corporations: benefiting the public

- Third-party vetting for defining, reporting, and assessing social and environmental performance.
- Annual benefit report
- Directors given "immunity from liability" <u>in the reasonable performance of duties</u>.
- What's reasonable?
- What if directors don't do enough?

The L3C: The Rap

- A gimmick?
- Requires Congressional or IRS action
- Market-rate returns to private sector investors undercut charitable purpose
- Managers can't reconcile competing fiduciary duties
- Charitable giving put at risk

The L3C: The Reality

- Simplification of due diligence
- Branding
- Sensitizes foundations to multiplier effect
- Invites harmonization of goals
- PRIs continue to require rigorous due diligence

The L3C: The Candidates

- Qualifying social ventures seeking PRI support
- Single-purpose subsidaries of tax-exempt organizations
- Ventures seeking to draw consumer and funder attention to their social enterprise status
- Coalitions of nonprofits tackling a social problem together through the application of sound business principles

How can the nonprofit social enterprise successfully avoid the tax on "unrelated business taxable income?"

When will a tax-exempt organization be liable for tax on its unrelated business income?

- If it receives net income from a trade or business,
- That is regularly carried on, and
- That is not substantially “related” to its exempt purposes

But exemptions may apply!

A trade or business is "related" if:

- It bears a causal, and substantial, relationship to the achievement of an organization's exempt purposes (aside from the need for funds).

- It "contribute[s] importantly" to the accomplishment of "any purpose for which an organization is granted exemption."

Some Exceptions

- Interest income
- Royalties
- Dividends
- "Qualified sponsorship payments"

How can the social enterprise tax-efficiently include endorsements, sponsorships, and cause-related marketing initiatives in its revenue mix?

- “Qualified sponsorship payments” will not be subject to UBIT.

- A “qualified sponsorship payment” is “any payment [of money, property or services] by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit.”

- Substantial return benefits” are benefits provided to the corporate sponsor other than (i) permissible forms of acknowledgment or (ii) benefits that have an aggregate value of not more than 2% of the amount of the payment.

What’s permissible?

- Using the sponsor’s name or logo of the sponsor’s business, as long as the use is not qualitative or comparative.
- Listing the sponsor’s location, telephone number or internet address (including a hyperlink from the exempt organization’s website to the sponsor’s website).
- Value-neutral descriptions of the sponsor’s product lines or services
- Sponsor’s brand or names and product listings
- Designating a sponsor as an “exclusive sponsor.”
- Distributing the sponsor’s product at a sponsored activity.

"Substantial return benefits" include:

- Advertising
- Providing goods, facilities, services or other privileges to the sponsor, unless the privileges are of "insubstantial value."
- Granting the sponsor rights to use the trademark or logo of the exempt organization; or
- Designating a sponsor as an "exclusive provider."

But what about endorsements . . .

- When a tax-exempt organization "endorses" a vendor's product or service to its membership by allowing the vendor to use the organization name, logo or membership mailing list in marketing the product to the organization's members.
- For example: credit card affinity programs or insurance programs where an exempt organization licenses it name and logo to a business in exchange for a portion of the revenue.

… and cause-related marketing?

- When a business and a nonprofit organization agree to advertise a product through the use of the nonprofit's name or log for the benefits of both organizations.
- For example: "Buy The Company's product and a contribution will be made to The Charity."

Taxability

- Royalty for the <u>use</u> of an organization's name, mailing lists or other intellectual property are tax-free.
- Payments for <u>services</u> are taxable.

The Contract Tells the Tale

- Call it a "royalty agreement" or a "license agreement," not a services agreement.
- And not a "joint venture," "partnership" or "agency" agreement.
- The tax-exempt organization should not agree assist in marketing.
- Measure royalty against gross income, not net.
- When there's a for-profit sub, have the sub enter into any services agreement.
- The tax-exempt organization should always exercise quality control.

How can the hybrid social enterprise attract top talent through incentive compensation without inviting an IRS challenge?

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Private inurement restrictions require that compensation be reasonable, but what is reasonable?

- Type and extent of services rendered
- Scarcity of qualified employees
- Qualifications and prior earning capacity
- Contributions to the venture
- Net earnings of the employer
- Prevailing compensation paid to employees with comparable jobs
- Peculiar characteristics of employer's business
- Arm's-length, conflict-free decision-making

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