Legal Issues Unique to Social Enterprise

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How can the for-profit social enterprise meet its “shareholder primacy” duty to its owners without compromising its mission?
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
- May 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” in the reasonable performance of duties.

- 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 subsidiaries 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 its 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 logo 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 use of an organization’s name, mailing lists or other intellectual property are tax-free.

• Payments for services 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 to 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?
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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