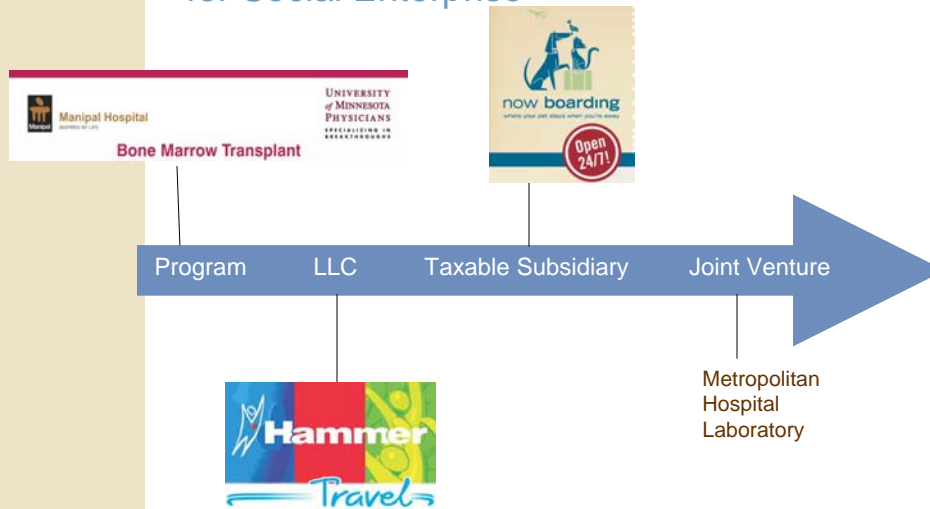


Think About it Early: Legal and Tax Basics for Social Enterprise

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April 29, 2010

Range of Structural Options for Social Enterprise



What do we mean by “nonprofit”

- Nonprofit corporation
 - State law concept
- Tax-exempt as a 501(c)(3) organization
 - Federal tax law concept
 - Requires application and recognition by IRS
 - Statements to IRS in exemption application establish the range of activities that are considered “related” to the organization’s tax-exempt purposes

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Is Social Enterprise legal?

Yes – but there are a few rules for tax-exempt organizations:

Substantially all activities must further the mission

All transactions must be Fair Market Value

Assets dedicated to charity at dissolution

No private benefit
No private inurement

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Nonprofits Can Make “Profit”

- No limit on ability to make profit
- “Profit” must be retained in corporation or paid out for reasonable expenses
- No individual shareholder distributions
- If from unrelated activity
 - Taxable as “unrelated business taxable income”

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Manipal Hospital
INSPIRED BY LIFE

UNIVERSITY
of MINNESOTA
PHYSICIANS
SPECIALIZING IN
BREAKTHROUGHS

Bone Marrow Transplant



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Income

From related activity

- no limit \$
- use \$ for mission

From unrelated activity

- UBTI
- if < 10-15%, ok
- if more, consider moving “outside” of exempt entity

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Is it related?

Activity itself substantially furthers mission

Selling Goods



Providing Services



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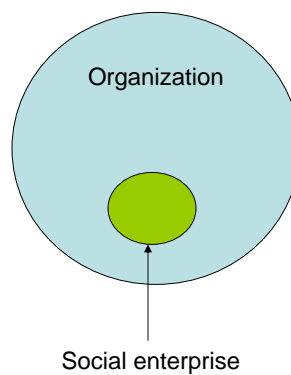
Relatedness Myths

- We use all the money to support our mission
- All our clients are nonprofits

Neither of these facts turn an unrelated activity into a related one

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Structural Options Keep it Inside



- Related
- Or, unrelated but small
- Simple
- Watch mission drift
- Watch growth if unrelated

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Structural Options Inside-out with an LLC or L3C

GRAY
PLANT
MOOTY

- Related
- Or, unrelated but small
- Tax-exemption – treated as *inside*
- Liability – treated as *outside*

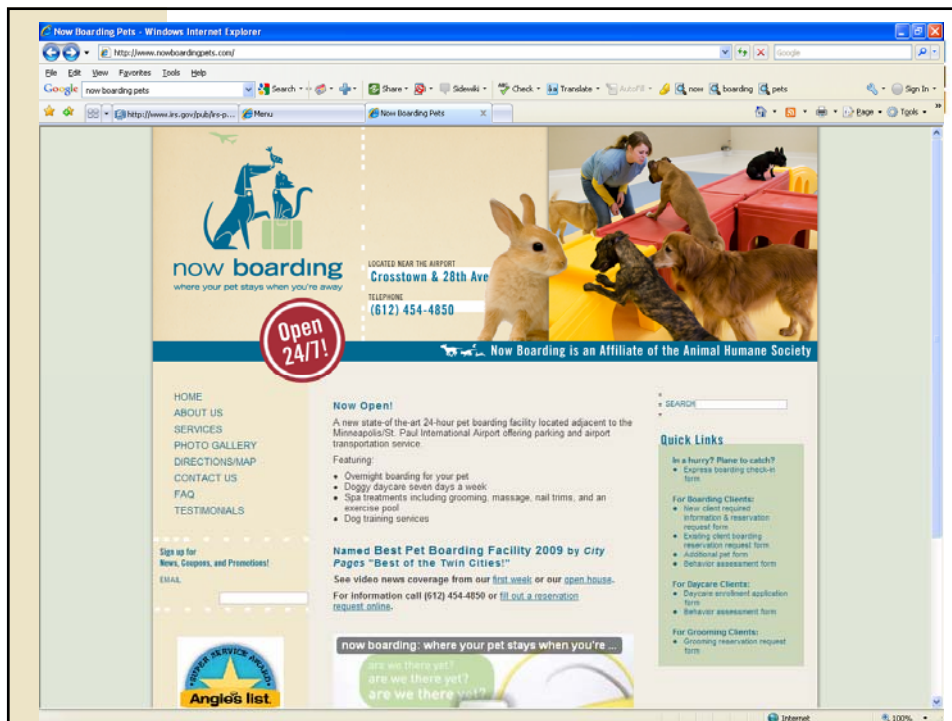
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L3C's



- Low-profit limited liability company
- Signifies social purpose business
 - No significant purpose is production of income
- Exempt organization holds membership on same or preferable terms as other investors
 - Could put strings on investment and transfer of assets to ensure goals are met

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Unrelated Business Taxable Income (UBTI)



- Income from
 - Trade or business
 - Regularly carried on
 - Not related to tax-exempt purposes

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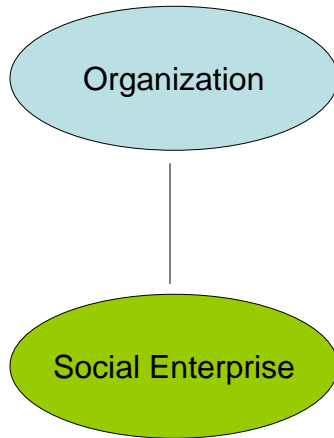
UBTI Exceptions



- Passive income
 - Rents from real property
 - Royalties
 - Dividends, interest, capital gains
 - But, if rents, interest or royalties from “controlled” subsidiary, this exception not available
- Qualified sponsorships
- Work conducted substantially by volunteers
- Thrift shops

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Structural Options Move it Outside - Taxable Subsidiary



- Unrelated activity
- Legal protection
- Protects parent from too much UBTI
- Profits distributed to parent as dividends
- Respect corporate formalities
- Arms' length transactions

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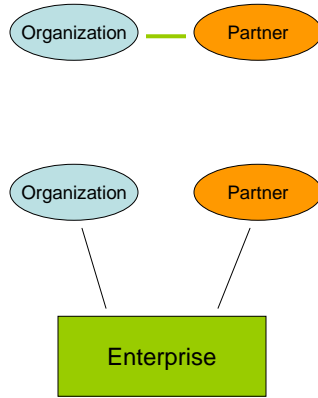
Taxable Subsidiaries



- Other Legal Considerations
 - UBTI & tax-exempt status of parent
 - State corporate law - choice of form
 - Tax-exempt bonds
 - Property tax
 - Employee benefits
 - Real estate
 - Intermediate sanctions

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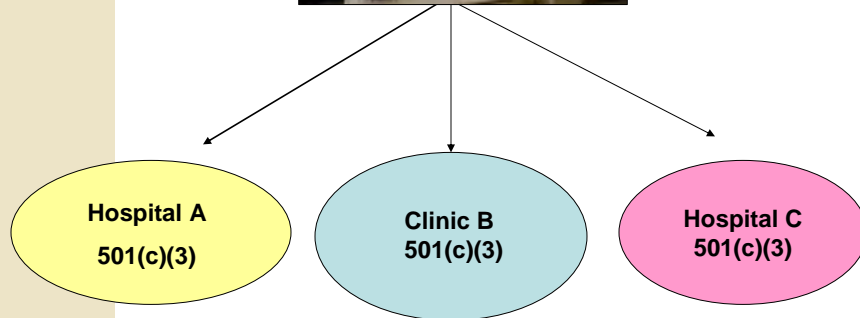
Structural Options Work with a Partner



- Have the will but not expertise
- Need for capital
- Options - contract vs. new entity
- All FMV & proportional
- Protect charitable assets

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Metropolitan Hospital Labs, LLC



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Legal Issues

- All 501(c)(3) entities
 - No private inurement or private benefit concerns
- Still must make a relatedness analysis
 - Here, all related to provision of health care, primary reason for exempt status
- LLC Form
 - Liability protection
 - Flow through of income
 - Related income so no UBTI analysis

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Legal Issues

- Contract Issues
 - Each party with a Services Agreement with LLC
 - Financial Obligations
 - Service Standards
 - Control and Governance
- Property Tax
 - May be implicated depending on state law
- Employee Benefits and Employment
 - All staff employed by LLC or one of the partners

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