A Social Entrepreneur's Guide to Business Formation

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Benjamin Takis
Tax-Exempt Solutions, PLLC
btakis@taxexemptsolutions.com
www.taxexemptsolutions.com

Heather Batzel
Batzel Law PLLC
hbatzel@batzellaw.com
www.batzellaw.com

Tax-Exempt Solutions PLLC

Batzel Law PLLC

Introduction

What is social entrepreneurship?

"Social entrepreneurs are individuals with innovative solutions to society's most pressing social problems. They are ambitious and persistent, tackling major social issues and offering new ideas for wide-scale change. Rather than leaving societal needs to the government or business sectors, social entrepreneurs find what is not working and solve the problem by changing the system, spreading the solution, and persuading entire societies to move in different directions."

-- Ashoka: https://www.ashoka.org/social_entrepreneur

Introduction

Three important aspects to social entrepreneurship:

- The intersection of self-interest and social interest
- New ways to address social issues
- New ways to raise money

Introduction

What kind of social entrepreneur are you?

Start by asking yourself three questions:

- What is your self-interest?
- How will you address the social interest?
- How will you raise money?

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Introduction

The answers to these three questions will largely dictate what type of business entity is the best fit:

- Non-profit (e.g. 501(c)(3) organization)
- For-profit (e.g. limited liability company, corporation)
- Hybrid (e.g. benefit corporation)

Introduction

But first, a word of caution …

- Good press and a worthy mission does not ensure the success of your venture. *You won't be able to help anyone unless you have a viable business model.*
- Case study: Cause (a DC "Philanthropub") www.ssireview.org/blog/entry/when_mission_doesnt_matter_enough

Non-profit organizations

Non-profits are entities typically organized as "non-profit corporations" (sometimes called "non-stock corporations"), which may qualify for tax-exempt status.

- Different kinds of non-profits: 501(c)(3) public charities, 501(c)(3) private foundations, 501(c)(4), 501(c)(6), donor advised funds.
- Offers the possibility of tax benefits and access to grants, but …
- Non-profits are highly regulated and costly/difficult to administer.

Non-profit organizations

<u>Self-Interest</u>: In the course of running a non-profit, it's generally fine to network and build your stature in the community. Other forms of self-interest are problematic.

- Control: must be shared by a Board of Directors (generally at least 3 people).
- Compensation: must be "reasonable" compared to similar non-profits and approved by an independent Board of Directors.
- Profits: must be held inside the organization to pursue the mission. See "private inurement" and "intermediate sanctions" rules.

Getting rich through a non-profit is practically impossible, and even making a living presents difficult challenges.

Non-profit organizations

Social Interest: Non-profits can address social problems in a wide variety of ways, provided the mission and activities are consistent with tax-exempt status.

- 501(c)(3): charity, education, religion, science, health, social welfare, arts, environmental protection
- 501(c)(4): promotion of social welfare, i.e. improving society and the general welfare of the community
- 501(c)(6): improve business conditions of one or more lines of business

Beware the "private benefit" rule: 501(c)(3) and 501(c)(4) organizations must be run for the benefit of the public. Any benefit to private individuals must be incidental to the public benefit.

Non-profit organizations

Raising Money: Non-profits may qualify for tax advantages that facilitate certain types of fundraising. Other types of revenue raising activities are discouraged.

- Exempt from income tax: Non-profits that qualify for tax-exempt status generally do not pay income taxes on their net profits.
- Individual and corporate donations: Contributions to a 501(c)(3) organization generally are eligible for the charitable deduction.
- Grants: 501(c)(3) organizations are eligible for grants from private foundations.

However, business activities may trigger "unrelated business income tax" or jeopardize tax-exempt status under the "commerciality doctrine."

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Non-profit organizations

Hypothetical case study: A group of five prominent and well-connected artists wishes to form an organization to hold art events to raise money for arts education and provide after-school arts classes for inner city children. Two of the five artists work full-time for other non-profits and have relationships with foundations that are willing to provide grants to the new organization. All five artists make a good living through their art and intend to work for the organization for no compensation.

Solution: A non-profit 501(c)(3) makes sense for this group. The organization has a solid 501(c)(3) purpose, and the artists have reputations, knowledge, and relationships that will add much value to the organization. The organization has a clear plan for raising revenue, and the artists have no need or desire to take a salary, which will enable the organization to grow at a reasonable pace.

Non-profit organizations

Forming a non-profit 501(c)(3) organization:

(1) Draft and file Articles of Incorporation.

(2) Get an Employer Identification Number from the IRS (aka TIN).

(3) Draft Bylaws, Corporate Policies and Resolutions. Have your first Board Meeting and adopt these documents.

(4) Open a bank account.

(5) File Form 1023 or 1023-EZ, and any necessary applications under state law (27-month deadline for retroactive 501(c)(3) status).

(6) Consider finding a fiscal sponsor while you wait for tax-exempt status.

(7) File Forms 990 (even while you're waiting for tax-exempt status).

For-profit companies

There are a variety of entity options for a for-profit company, each with different tax and liability characteristics.

Unregistered Entities

- Sole proprietorship
- General Partnership

Registered/Incorporated Entities

- C Corporation, S Corporation
- Limited Liability Company (LLC)
- Limited partnership, limited liability partnership

For-profit companies

Self-Interest: In a for-profit company, you are generally free to pursue your own self-interest in whatever manner you choose (subject to applicable laws).

- Control: You are free to run a for-profit company by yourself, seek partners or investors, or sell to a bigger company. You can have various lines of business which may or may not be related.
- Compensation: Generally, no legal limitations.
- Profits: Can be reinvested or held as reserves in the company, distributed to the owners or donated, as desired.

For-profit companies

<u>Social Interest</u>: For-profit companies are generally free to pursue a social mission in whatever manner the company chooses.

- The shareholders, directors and officers have latitude to make decisions taking into the account the things they think reasonable.
- Note the potential hurdle of "duty to maximize shareholder value."
- A company is free to write whatever lawful purpose desired into its governing documents.

For-profit companies

Raising Money: For-profit companies are well-suited to experiment with different business models, raise money as they wish (whether debt, equity, private or public markets), or sell the business to another company or individual.

- Of course, unlike non-profits, contributions to a for-profit company are not eligible for the charitable deduction, and for-profit companies generally do not qualify for grants from private foundations.
- Options include crowdfunding, EB5 investors, debt financing, angel and VC funding, IPO…
- Federal and state securities laws apply to some of these.

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For-profit companies

Tax and Liability Considerations

- Sole proprietorships and general partnerships offer flow-through tax treatment (single taxation), but no liability protection.
- LLCs, S Corps and LLPs offer a shield from personal liability and flow-through tax treatment.
  - Some states do not recognize the flow-through treatment of S Corporations.
  - An LLP is not an option for a business owned by one person.
- C Corps offer a shield from personal liability, but the earnings of a C Corp are double taxed, i.e. taxed to the corporation when earned and then taxed to the shareholders when distributed as dividends.

For-profit companies

Hypothetical case study: A group of three college students have developed a social media app that tracks the travel destinations of their friends and uses this information to provide recommendations and deals for flights and hotels in similar but less-traveled locations. They are looking venture capital funding, and their goal is to make $100 million and retire by the age of 25, either through an IPO or by selling the app to Expedia. At the same time, they hope the app boosts tourism and thereby alleviates poverty in less prosperous countries, and the students feel it is essential to give back to the local communities and be seen as good global citizens.

Solution: A for-profit company makes sense here. While these entrepreneurs want to be good global citizens, their main goal is to make a lot of money. A Corp makes sense here given their financing objectives.

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For-profit companies

Forming a **sole proprietorship**:

(1) Commence doing business.

(2) Consider insurance, bank account and trade name, if applicable/desirable.

(3) Check requirements relating to conducting business from home, other permits, information filing and licenses.

(4) If you have employee(s), get an Employer Identification Number from the IRS.

For-profit companies

Forming a **partnership**:

(1) GP: Start conducting business as an association of more than one person.

(2) LLP: (i) Approve change in entity form with required vote and (ii) Draft and file Statement of Qualification.

(3) In either case, it's strongly recommended to draft and execute a partnership agreement.

(4) Get an Employer Identification Number from the IRS.

(5) Consider insurance, bank account, trade name, and applicable permits and licenses.

For-profit companies

Forming a **limited liability company**:

(1) Draft and file Articles of Organization.

(2) Get an Employer Identification Number from the IRS.

(3) Draft Operating Agreement and Resolutions.

(4) Hold your first Member/Manager Meeting and adopt corporate documents, appoint managers if applicable and authorize opening of bank account.

(5) Consider insurance, trade name, and applicable permits and licenses.

(6) Open a bank account.

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For-profit companies

Forming a **corporation**:

(1) Draft and file Articles of Incorporation.

(2) Get an Employer Identification Number from the IRS.

(3) Consider S Corp election on IRS Form 2553.

(4) Draft Bylaws and Resolutions.

(5) Hold organizational meeting adopting bylaws, electing director(s)/officer(s), approving S Corp election if applicable, and any other business.

(6) Consider insurance, trade name, and applicable permits and licenses.

(7) Open a bank account.

Hybrid entities

Benefit Corporations

- Corporations that pursue a business purpose and are required to have a material positive impact on society and the environment, as measured by a third-party standard (a “general public benefit”).
  - Also, may choose to pursue “specific public benefit” purpose written into the Articles or Bylaws (similar to 501(c)(3) purpose).
  - The Board of Directors is required to consider certain other stakeholder interests in addition to the interests of shareholders.
  - Required to issue annual public report detailing public benefit.
- Taxed as a C Corporation or, if elected, S Corporation.
- Maryland and Oregon have “Benefit LLCs.”
- Not to be confused with “B Corps.”

Hybrid entities

Other hybrid corporations

- Some states offer similar but less rigorous alternatives to the benefit corporation.
  - California, Florida, Texas, and Washington: social purpose corporation
  - Delaware: public benefit corporation
- In general, these options allow you to choose a specific social mission that is written into your Articles of Incorporation, but the "general public benefit" and third-party standard doesn't apply.
- In some cases the written report requirement is less stringent or doesn't apply.
- **Be sure to check applicable state law for the specific rules.**

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Hybrid entities

Low-Profit Limited Liability Companies (L3Cs)

- Recognized in 9 states.
- These are LLCs that pursue 501(c)(3) as well a limited for-profit purpose, with some of the restrictions applicable to 501(c)(3) organizations.
  - Must significantly further a charitable or educational purpose.
  - No significant purpose of the company is the production of income or appreciation of property.
  - No purpose of the company is lobbying or political activity.
- Designed to attract "program related investments" from private foundations.
- Same flexible tax treatment as regular LLCs.

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Hybrid entities

Self-Interest: Benefit corporations may pursue self-interest but tempered by requirement for "material positive impact on society and the environment," as measured by a third party standard.

- Control: You are free to run a benefit corporation by yourself, seek partners or investors, or sell to a bigger company. You can have various lines of business which may or may not be related.
- Compensation: Generally, no legal limitations. In some jurisdictions compensation to directors must be disclosed in annual report.
- Profits: Can be reinvested or held as reserves in the company, or distributed to the owners, or used for social benefit. However, the Board must also consider stakeholder interests, not just profits.

Hybrid entities

<u>Social Interest</u>: Benefit corporations are generally free to pursue a social mission in whatever manner the company chooses, provided the company satisfies "general public benefit" standard and adheres to statute.

- For a big public company, being a benefit corporation could enshrine the values of the company and discourage actions motivated only by profit.
  - Note: There are not yet any benefit corporations that are big public companies. Consider whether being a benefit corporation could hinder a company's growth.
- A fundamental concept is the clarification that a public benefit purpose can be pursued even where profits suffer, plus protection from shareholder lawsuits for such decisions.

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Hybrid entities

Raising Money: Benefit corporations are permitted to raise money in whatever manner the company chooses, although some investors may be deterred by the restrictions and requirements of benefit corporation status.

- Benefit corporations, or benefit LLCs where applicable, have no special tax status or tax advantages. They are treated just like any other for-profit corporation or LLC, respectively.
- For a small company, the advantage of being a benefit corporation is largely about image, marketing, and being part of the benefit corporation community.

Hybrid entities

Hypothetical case study: A group of real estate investors wishes to form a joint venture with the city government and several local arts organizations for the purpose of constructing a new multi-media arts center. The center would feature performances and exhibits by renowned artists, educational opportunities for local students, and a new location for one of the area's top restaurants/bars. The project would be funded primarily with city money, with additional funding provided by the real estate investors and arts organizations.

Solution: A benefit corporation could be a good fit for this project. The arts organizations prefer a corporate structure (for tax reasons). Also, the social purpose embodied in the benefit corporation structure is attractive to the city and arts organizations for political reasons and helps assure them that the project will be consistent with their respective missions.

Hybrid entities

Forming a benefit corporation: It's similar to forming a typical corporation except it has the following additional requirements –

1. Articles of Incorporation must state that it is a benefit corporation and include language regarding the "general public benefit" as well as, if desired, any "specific public benefit" the corporation wishes to pursue.
2. In some jurisdictions a Benefit Director must be appointed. A Benefit Officer may be elected.
3. Annual benefit report must be submitted to shareholders, posted on the company's website, and in some jurisdictions filed with the government.

Existing corporations generally may amend their Articles to become a benefit corporation.

Final Thoughts

- Non-profits should be approached with caution. Generally, it’s not advisable to form a new non-profit unless you already have non-profit experience and/or know where your grants and donations will come from.
- For-profit businesses offer the most flexibility to pursue profit and a social interest at the same time.
- Benefit corporations can work in certain cases when this status is core to the image of the business. For small companies, this is often more of a business decision than a legal decision.
- It is possible to combine these approaches, e.g. a 501(c)(3) organization with a for-profit subsidiary, or a corporation with a charitable arm, but this poses added administrative burdens.

TAX-EXEMPT SOLUTIONS PLLC

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Contact Details

Benjamin Takis
700 12th St. NW
Suite 700
Washington, DC 20005
www.taxexemptsolutions.com
btakis@taxexemptsolutions.com

Heather Batzel
641 S Street NW
Third Floor
Washington, DC 20001
www.BatzelLaw.com
hbatzel@batzellaw.com

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