

PBPA Podcast Transcript

Balancing Act:

Diversifying Income Without Risking Your c3 Status

(28:16 minutes)



[00:00:00] **Sireesha:** Nonprofits are often drawn to the idea of being self-sustaining. Alternative revenue streams, like charging fees for services or partnering with for-profits can sound appealing as ways to diversify income, but public charities must maintain broad donor support and too much revenue from non- donation sources could even put their tax-exempt status at risk. In this episode of the PBPA Podcast, Amy Dosik joins us to answer common questions about social enterprise and what nonprofits need to know to stay compliant when exploring new revenue streams.

Hello and welcome to the PBPA Podcast. In each episode of the PBPA Podcast, we explore legal questions relevant to Georgia nonprofits. I'm your host Sireesha Ghanta, Counsel and Education Director at the Pro Bono Partnership of Atlanta. PBPA strengthens our community by engaging volunteer attorneys to provide nonprofits with free business legal services. We provide numerous free resources via our website, including articles and webcasts specific to Georgia nonprofits and their business legal concerns. We also provide direct legal services to our clients. For more information on client eligibility requirements, to apply to be a client or to access our vast learning center, visit our website at pbpatl.org. Before we jump into this episode's topic, keep in mind that this podcast is general information, not legal counsel, contact your attorney for guidance on your nonprofits' specific situation.

Amy Dosik is a tax attorney and self-professed nonprofit guru. She has been deeply involved in the nonprofit community of Atlanta throughout her career, including a CEO of Girl Scouts of Greater Atlanta, and as a board member of our very own PBPA.

Amy was named one of the 50 most influential nonprofit leaders by the Atlanta Business Chronicle is a member of Atlanta Rotary and a graduate of Leadership Atlanta. I'm so happy to welcome such a brilliant and experienced guest to join us on today's episode. Thanks for being here, Amy.

[00:02:34] **Amy:** It's my pleasure to be with you, Sireesha.

[00:02:37] **Sireesha:** So Amy, can we start off by talking about this general concept of “social enterprise”? What does this term really mean?

[00:02:47] **Amy:** Sireesha, social enterprise is a term that can mean different things to different people and encompasses a broad array of activities performed by both for-profit and non-profit businesses.

At its heart, social enterprise means some sort of business activity. That has its goal to both generate profit as well as have a positive social or environmental impact on the world. It can be conducted by a for-profit business. For example, many of our listeners may be familiar with the Newman's own brand of products. This is a for-profit company. Started by the actor Paul Newman, and they sell sauces and salad dressings and donate a portion of the pro profits back to various charities. , But many social enterprises are also conducted by not-for-profit organizations.

One of the most well-known ones is the Girl Scout Cookie Program run by my former organization. And so while the proceeds from Girl Scout Cookie Sales Benefit local Girl Scout troops and local Girl Scout councils, there's also an underlying educational purpose that ties to the Girl Scout's mission of promoting entrepreneurship among young girls. And so in addition to getting proceeds for their Girl Scout troops, girls also learn business skills like money management, goal setting, people skills, business ethics that help them be successful on their own entrepreneurial journeys later in life. And one fun fact is 50% of women business owners were Girl Scouts and participated in the good. Girl Scout cookie program. So, good news, it works!

[00:04:44] **Sireesha:** That is very true and as a former Girl Scout myself, and a Girl Scout cookie sales person, I learned a lot through that program. And I know a lot of our listeners have similar programs where they're trying to have workforce development programs or they're selling products. Maybe that might further their mission and also provide income. And so when we talk about these social enterprises, why does a 501(c)3 organization need to be so careful?

[00:05:17] **Amy:** You have to worry about unrelated business income if the type of goods or services you're providing compete with a for-profit business that does the same thing. And you know, you need to look at the goods or services or whatever it is you're doing as your social. Enterprise and say, does this implicate the unrelated business income tax rules?

Are we conducting this activity in a way that is competitive with for-profit businesses that do the same thing. And is the activity unrelated to the educational, charitable, or other purpose for which we have received our tax exemption? And so that's an analysis that should be done on the front end, before you go into that activity. Even if it is an unrelated business activity, so long as the activity's not substantial, you may still choose to engage in that activity and pay the tax on the activity if it is, overall deemed to be a good thing for your nonprofit to do with some legal advice from someone from pro bono partnership or a similar organization.

But if that activity starts to become substantial, as mentioned in the introduction, you may need to be concerned about whether that activity endangers your tax exempt status. So, substantial is a relative term of art. There's no numerical test, but if it engages a substantial portion of your resources, your employee's time, or generates a substantial portion of your revenue, that's when you need to start looking at. Is this an activity that endangers our tax exempt status.

And then the third issue that it implicates is one that often falls beyond the wayside until it's too late, and that's sales tax. If you are selling just about any good to the public, it is probably going to be subject to sales tax, unless it falls under a specific exemption in the official code of Georgia. And even many services are subject to sales tax. So rentals, if you're renting, either facilities or equipment, those can be subject to sales tax as well. So some services are also subject to sales tax. So that's something to be looking at on the front end if you're gonna engage in social enterprise to make sure that you are registered. To collect and remit sales tax with the Georgia Department of Revenue. Because whether or not you charge that sales tax to customers, you will be liable for that sales tax and be needing to take it out of your pocket on the backend, which is an expense that you probably did not budget for.

So in summary, UBIT, tax exempt status and sales tax are three issues to have front of mind before you engage in any social enterprise.

[00:08:27] **Sireesha:** Thank you for mentioning that about sales tax. And for any of our listeners, if you would like more information on it, we have a great webcast that goes into more detail. I will include a link to that in the show notes. And what types of social enterprises are considered unrelated under the unrelated business income tax rules.

[00:08:53] **Amy:** The first thing I would look at is how closely the social enterprise lines up with the tax-exempt purposes for which you received your exemption from the Internal Revenue Service. And, using another example that many folks are familiar with, let's look at Goodwill Enterprises. So most of you have probably shopped, or donated to a Goodwill Enterprise, um, thrift store. Selling used goods is not an inherently charitable activity. However, one of the charitable purposes of Goodwill Enterprise is workforce development and job creation for disenfranchised folks who may be coming out of a drug or alcohol program or were formerly homeless or may have had some other issue that life has thrown their way. And so when you look at who is staffing the Goodwill stores and their purpose of giving disenfranchised individuals job skills, that also has a very strong, substantial connection to their tax-exempt purpose.

There's also a UBIT exception when you are selling goods that were primarily donated. And that's often known as the thrift store exception. So even without the workforce development and job creation exempt purpose, if you are doing something that falls under a UBIT exception, like selling goods that have almost all been donated, then you don't have to worry so much about UBIT.

[00:10:38] **Sireesha:** And now let's talk about the "U" in UBIT- unrelated. How can a nonprofit determine if its social enterprise is substantially related or if it's unrelated to its exempt purpose?

[00:10:53] **Amy:** So I would say, the first sort of line of questioning is- is the activity in furtherance of the exempt purposes for which the organization received its exemption? Back to the Girl Scout Cookie program. The primary exempt purpose of Girl Scouts is to build life skills, leadership and character in girls. And so when you look at the cookie program, all of those skills are advanced by the entrepreneurial or sales activity itself. And so along with selling cookies at a cookie booth, girls are also earning badges where they do activities to teach them about business ethics, budgeting. And so if there is a strong connection between the social enterprise activity and the organization's exempt purpose, there is less of an opportunity that the IRS is gonna come in and say that is an unrelated business activity.

On the other hand, if you are primarily an educational institution and somebody donates a spaghetti factory to you and you continue just producing spaghetti that sold in Publix and Kroger, that's probably not an exempt activity that has a strong causal relationship, to your exempt purpose.

[00:12:26] **Sireesha:** Thank you for that clarification to help our listeners kind of get better understanding on what would be considered substantially related. Now my next question has to do with exceptions or exclusions to UBIT. And you mentioned one when you were just talking about goodwill. Are there any others that nonprofits might qualify for?

[00:12:48] **Amy:** Yes. I'll mention the two we've already talked about, where there's a substantial relationship between the social enterprise and the nonprofits exempt purpose. That's probably the biggest category to try to fit under. There is also a donated goods exception, so if you are reselling goods primarily, all of which have been donated at no cost to you.

There is also an exception where substantially all of the work of the activity is done by volunteers. So, if you are a school PTA and you're selling chips and sodas at a concession stand at high school football games, workers at the concession stand are volunteers. That is gonna get out under the volunteer exception. However, that business still would have to register to pay sales tax., So don't let sales tax come back and bite you. Even if you don't have a UBIT issue, you might still have a sales tax issue.

And then another one is what's known as the passive income exception. And so where the income stream that you get is primarily passive, that's coming back to you. And so that's most of your forms of investment income. So interest, annuities, capital gains where that's the sort of income you earn from investment accounts. Most of that coming back is going to be passive.

[00:14:16] **Sireesha:** Would it be taxable if a nonprofit organization is collecting fees for services? For example, providing discounted rates for mental health therapy for kind of this demographic group that the organization generally serves.

[00:14:34] **Amy:** So in general, the same analysis is going to apply whether the business is selling a product, selling goods, or performing services.

And so there you have to look at- is the service provided in a charitable manner. And it's the same analysis as it would be if you were selling cookies or spaghetti. And so, is there a strong causal relationship between the service provided and the not-for-profits exempt purpose, and is the service being conducted in a charitable manner? Healthcare services like mental health counseling, are not inherently charitable in their nature because there are many private psychotherapists or counselors that are in private practice that are for profit that are not organized as nonprofits. And so, then you really have to look into the "how" of the service and how it's being provided. Are some services provided for individuals who are indigent and don't have the ability to pay? Is there a sliding scale based on income? Does the organization take Medicaid and Medicare? Those are all of the types of things you would look at to determine if the services being provided in a charitable manner or in a way that is more akin to how a for-profit business would operate.

[00:16:07] **Sireesha:** I like that there's a consistent question that nonprofits need to be looking at - is it substantially tied to our exempt purpose or not? My next question is more big picture. About the board of directors. What role should board of directors play in approving or overseeing social enterprise?

[00:16:30] **Amy:** That's a great question and I'm glad you mentioned the board because any strategic. Decision is really a joint decision between the organization's leaders and its board. So one of the three primary duties of a nonprofit board of directors is governance, and that includes oversight of the budget and also oversight of the major.

Programs and activities of an organization. So anytime a nonprofit is going to engage in a new activity or social enterprise, the board should be at the table from the very beginning, and ask questions like: is this consistent with our nonprofit purpose and the reasons why we exist? Or are we doing this just to try to earn extra revenue? Is this in line with our strategic plan and our, the goals we've set together for our organization. And then if you determine that the answers to those questions are "yes", then I think you need to look at some of the issues we talked about earlier in this podcast.

So does this social enterprise raise the possibility of needing to pay UBIT? If so, how much is it still a good idea to do it? And do we envision that the activity could grow so large that it could endanger our tax-exempt status? And sometimes nonprofits will have somebody knowledgeable on their board who can help them vet that issue. Or if they have somebody from a large law firm on their board, there may be someone at the law firm that can help them with that expertise. If not I strongly recommend that the nonprofit reach out to Pro Bono Partnership [of Atlanta] or someone else with that expertise to be able to help them so they know what they're getting into on the front-end and they understand what all their rights and responsibilities are with that new business enterprise.

They also probably need to ask: Does the activity they're thinking of engaging in require any sort of special license or permit. So if you're gonna get into providing childcare, there's all sorts of licensure requirements that exist for both for-profit and not-for-profit organizations that provide childcare for a fee or if you're gonna do something like a charitable raffle, in many counties you need a permit to do that.

And so you also wanna ask the questions beyond UBIT of might this activity require you to do, to be compliant with the law and make sure you have those answers so that you're making a decision about that activity fully informed.

[00:19:19] **Sireesha:** Those are great points there, Amy. Now I'm going to throw another fuzzy term at you, Amy: cause marketing. I hear it often among our nonprofit audience, and I wanted to get an understanding of how does this relate to our conversation thus far? Are there legal considerations around cost marketing with for-profit organizations? And what are those legal considerations?

[00:19:47] **Amy:** That's a great question Sireesha. Cause marketing is probably as fuzzy, if not a fuzzier term than social enterprise, that can mean various things to various people.

One of the types of cause marketing that many of our listeners today might be familiar with is where a nonprofit is asked to promote a business in exchange for a percentage of proceeds from that business, either on a particular occasion or on an ongoing basis. Here, many of the issues that can be implicated are similar to social enterprise. Primarily UBIT is the issue to be concerned about. And here you would wanna look at the nature of the extent and the ongoing term of the relationship between the business and the nonprofit that benefits from that cause marketing. In general, if a nonprofit organization engages in advertising services to promote a for-profit business, advertising is one of those types of activity that the IRS is going to consider per se a UBIT activity. However, there are ways to do cause marketing that do not promote UBIT. And here the line is between acknowledging the business and promoting the business.

And so it may be that your PTA will get 10% of the proceeds from restaurant sales at a particular restaurant on one Tuesday night. There, I would not be so concerned about that, because it's one day a year and so the activity is limited in scope and duration. It does not compete with a for-profit advertising firm. It can get out under any number of different UBIT exceptions. Either a de minimus exception, or the fact that it's not conducted in a way that competes with for-profit businesses 'cause it's only one night a year.

However, the types of things that I would begin to be more concerned about is an ongoing relationship where 10% of the proceeds from the sale of a particular product, were going to go back to a nonprofit all year long. And so if you are the nonprofit that's benefiting from that product, what you can do is you can make your constituents aware of that arrangement and acknowledge that

arrangement. And so there, the type of language is, "thank you to XYZ corp, from the sale of the ABC widget. And 10% of the proceeds from the sale of ABC widgets are gonna go back to our nonprofit. "However if that language also has what's called a "call to action", where you ask your constituents or members of the general public to patronize that business, you know-, go to Bob's restaurant, buy the widget -when there's a call to action that calls on that listener to do a particular thing, in patronizing the business, then that acknowledgement turns into advertising and probably is going to be UBIT. So that 10% of the proceeds coming back to you is going to be deemed to be advertising income rather than some sort of sponsorship income that is not subject to UBIT.

[00:23:32] **Sireesha:** For any of our listeners who are interested in getting, even more insight into cause marketing, we do have an article on the topic and so I'll include this article, "Maximizing Impact With Cause Marketing" in the Show Notes.

So far, Amy, you have helped us to understand UBIT and how social enterprises could create taxable income for a nonprofit and maybe even potentially threaten the tax-exempt status of an organization if that income is beyond a certain threshold. What if a nonprofit decides, okay, I'll just create a separate legal entity and that separate entity will manage my social enterprise, and then I don't need to worry about UBIT. Is that an option?

[00:24:20] **Amy:** It is, but like many questions in the nonprofit world, the answer is, it depends. It depends on what kind of entity you create and what the nature and extent of that activity is in, in the separate legal entity.

So some of our listeners may be familiar with single member LLCs, and they're super simple to create. In some cases they don't even have their own employer ID number. However, they're considered a part of the nonprofit itself. And so everything that that single member LLC does is deemed to have been done by the nonprofit itself. So dropping an activity into a single member LLC generally will not protect you from UBIT.

However, if you use a non pass through entity like a C-Corp, in most cases, that may be a way to insulate the activity from tainting the parent organization, with UBIT. However that C-Corp will pay tax just like any other for-profit business. And so, like many things in the nonprofit world, this is one of those things you wanna ask on the front end and make sure that you are selecting the correct type of entity depending on the nature and extent of the activity that you're gonna be engaging in.

[00:25:49] **Sireesha:** And for any listeners who are looking for more information on options for structure, I'm going to share a webcast on the topic. It is a very complex topic and would definitely be one that an organization should seek legal counsel on.

Amy, this has been such great information so far. I wanted to ask you one last question to close out. In your opinion, if a nonprofit remembers one thing from today's episode, hopefully they'll remember everything. But what is the one takeaway you definitely want them to keep in mind about social enterprise?

[00:26:31] **Amy:** I would say that one takeaway is make sure that you are consulting with someone knowledgeable about these issues. Either a referral from the pro bono partnership or someone on your board, and asking all of these types of questions around UBIT, exemption and sales tax that we've gone through today, so that you know what you're getting into before you begin the activity

because it's a lot easier to set it up correctly on the front end than to try to unwind something that's been going on for six months or a year.

Sireesha: Thanks for talking us through all these considerations, Amy. I know that now some nonprofits are grappling with funding cuts and are particularly interested. In alternative revenue streams, the guidance that you have shared today will help them better understand UBIT and best practices for 501(c)3's engaging in social enterprise.

Amy: Thank you, Sireesha. It was my pleasure to be with you today.

Sireesha: We hope that you found this episode of the PBPA Podcast to be informative and helpful. We add new episodes every month with short conversations about general, yet important legal information for Georgia nonprofits. Remember that this is not legal counsel. Talk to your attorney about your organization's specific concerns. Thanks for tuning into the PBPA Podcast. And to all nonprofits listening out there, thank you for all the good work you continue to do in our community.