

THE SOCIAL ENTERPRISE – DELICATELY PURSUING PROGRAMS & PROFIT

By Steve Sauer, ssauer@bkd.com

Speculation exists on the exact date of social enterprise’s inception; some cite the *Wilson-Gorman Tariff of 1894* as the earliest statutory reference to tax exemption in the United States. This thought stems from the Supreme Court declaring the law unconstitutional the following year with the next recorded mention 15 years later. It was a slow start for this particular legislation. While charitable, religious and social welfare programs had been in operation for millennia, there was no privileged tax treatment for them until well into the 20th century. It’s no wonder the advent of the social enterprise entity, another milestone in not-for-profit (NFP) history, also would have undefined origins and a discreet debut.

Fast forward to today’s ever-changing economic landscape: Generational effects are accumulating, social media is snowballing, the stock market and home values are swelling, interest rates are climbing, philanthropy is increasing, businesses are constantly transforming and reinventing and the number of newly incorporated NFPs and for-profits is growing, resulting in competition for both. NFP boards are seeking relevancy and self-sufficiency, and for-profit companies are pursuing competitive advantage and innovation. However, social enterprise claims to offer a proposition to both. As a result, this article seeks to explore the motivations and methodologies of the social enterprise entity.

MULTIPLE MOTIVATIONS

Many have drawn up a definition of social enterprise:

“An organization or initiative that marries the social mission of a non-profit ... with the market-driven approach of a business.”
– Social Enterprise Alliance

“A nonprofit venture that combines the passion of a social mission with the discipline, innovation and determination commonly associated with for-profit businesses.” – Nonprofit Good Practice Guide

“A business trading for a social purpose.” – U.K.-based Social Enterprise Coalition

To put it plainly, the Social Enterprise Alliance depicts this type of entity as existing in the space where NFP and business converge:



The common theme ascribed to social enterprise is total value creation or maintaining a triple bottom line—the summation of economic, social and environmental returns. While the traditional NFP solicits recurring funds to meet a social need and the traditional business generates a profit to benefit investors, the traditional social enterprise seeks a combination of both. At its core is a self-sustaining business often initially financed through capital or donations. The social enterprise’s profits are funneled into a social program while critically evaluating the effect of its footprints on the environment, employees, stakeholders and beneficiaries of its services. The social enterprise claims to be motivated by the creation of total value.

Social enterprise proponents assert that total value creation isn’t a one-size-fits-all approach. Rather, social enterprises operate on a continuum, as depicted by the Southern Colorado Better Business Bureau’s diagram below. Social enterprises generally tend to lean toward NFP or business. As a result, four relative types of social enterprise have emerged. For this article, we’ll examine the two bookends of the spectrum—social enterprise and benefit corporation—which are illustrated by two well-known entities.



The first is Goodwill Industries International, Inc. Goodwill was founded in 1902 in Boston by Methodist minister Edgar J. Helms. Helms collected used household goods and clothing and trained and hired the poor to mend and repair the used goods to be resold or given away. This business model continues today, and the NFP has grown into a \$5.6 billion organization as well as a provider of employment, training and rehabilitation for people of limited employability.

The second is Patagonia, Inc. started as a homemade rock-climbing gear business and quickly grew into one of the country’s most innovative, socially responsible outdoor outfitters. Patagonia’s mission statement is to “build the best product, cause no unnecessary harm, use business to inspire and implement solutions to the environmental crisis.” Not only does it invest a portion of profits in grassroots environmental groups of local communities, but it became an early pioneer in phenomenon such as organic, fair trade and living wage.

On one hand, Goodwill is an NFP organization that generates income from product sales to be reinvested in programs. Generally, this would be defined as a social enterprise (this term can be used to describe the sector as a whole or a specific tranche within the sector) and leans toward an emphasis on NFP mission and programs. On the other hand, Patagonia is a for-profit business that has been re-envisioned to benefit investors while using commerce to better the community and environment in which it operates (suppliers, vendors, personnel, customers, stakeholders). This is defined as a benefit corporation in the diagram and leans toward maximizing profits with a holistic corporate social responsibility business model. Both companies are long-standing archetypes of social enterprise, but they accomplish their status in unique ways.

You may ask, “If social enterprises like Goodwill were around before tax exemption was legal, why haven’t I heard more about this?” Kim Alter, founder of a management consulting firm specializing in social enterprise, recently addressed that question in her piece, “Social Enterprise Typology.” After identifying age-old social enterprise cooperatives and agendas in the U.K. and U.S., she writes:

“Yet it is only in the last 15-20 years that academics, practitioners, and donors have been studying and recording cases of nonprofits adopting market-based approaches to achieve their missions. The growing practice of social enterprise is fueled by nonprofit organizations’ quest for sustainability, particularly in current times when support from traditional, philanthropic, and government sources is declining and competition for available funds is increasing. Social enterprise enables nonprofits to expand vital services to their constituents while moving the organization towards self-sufficiency. Nonprofit organization leaders understand that only by establishing an independent means of financing can they become a going concern.”

Social enterprises have a history of being inspired by both mission and money, benevolence and business and programs and profits. However, according to Alter, it would appear it simply took the above economic changes to cast this industry to a wider audience.

METICULOUS METHODOLOGIES

Social enterprise proponents claim that while the basic principles behind these entities are relatively simple, the practical considerations, variables and methodologies that affect their legal form and social function can be complex. Some of these complexities tend to have unique qualities and patterns resulting in several key generalizations. The chart below developed by the Leaffer Law Group summarizes some key attributes and how they generally apply to the bookends of the social enterprise spectrum.

	Attribute	Social Enterprise	Benefit Corporation*
Fundamentals	1) Primary objective or reason for being	To address a social need	To generate socially-responsible profits
	2) Organizational structure	Integrated within an existing NFP, a separate department, or a separately incorporated entity altogether	Separately incorporated entity
	3) Tax structure	Nonprofit corporation, association or single-member LLC filed under 501c(3) or (4)	Business corporation, partnership, multi-member LLC or low-profit limited liability company (L3C)**
	4) Initial funding needs	Low to moderate start-up costs to be funded by donors or debt	Higher start-up costs to be funded by capital or debt
Stakeholders	5) Initial (and/or contingency) funding sources	Primary – donors, interested in one-time (vs. recurring) start-up gifts Secondary - debt	Primary - capital Secondary - debt
	6) Financial motivations of initial funding sources, above	Primary - social returns only (though expectation is that these may take several years to accumulate) Secondary – fixed income (interest)	Primary – both financial and social returns (though expectation is that these may take several years to accumulate) Secondary – fixed income (interest)
	7) Level of required transparency	Greater transparency - via IRS Form 990	Limited transparency*
	8) Exit strategy	Continue in perpetuity or transfer assets to other NFP	Virtually unlimited - continue in perpetuity, sell, merge, dissolve

The information contained in this chart is presented for informational purposes only. Applying specific information to your situation requires careful consideration of facts & circumstances. The information presented in this chart was largely developed by the Leaffer Law Group in Denver, Colorado at www.leafferlaw.com.

* The term “benefit corporation” not only describes a specific tranche within the sector, but it also refers to a certification by B Lab for companies adhering to standards for social impact, accountability and transparency. For more information, see <https://www.bcorporation.net/>.

** L3Cs are not recognized in all states, including Colorado.

As a result of these patterns, social enterprise enthusiasts recognize these entities possess some inherent benefits and cautions. Note that while these also are relative generalizations, they help to provide a clearer picture of social enterprise range.

	Social Enterprise	Benefit Corporation
Pro's	Leverage the mission to induce tax-deductible "investments" from donors	Least regulated and greater privacy for internal operations
	Profits are generally tax-exempt (see con, below)	Share risk/rewards with owners
	Social impact built into the structure	Unlimited access to capital, means of operations, transferability
Con's	Highly regulated and transparent	Must maintain fiduciary duty to owners to maximize profits
	Certain profits may be subject to unrelated business taxable income or UBIT (see pro, above)	No tax exempt status
	Limited access to capital	Social impact depends on leadership, not structure

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As enumerated above, there are several considerations that affect the mechanics of the social enterprise. However, one of the primary questions generally relates to how it will earn, retain and use income: Will earnings be taxable or tax-exempt? Is the enterprise expected to produce sufficient funds to finance the program, or is additional capital or traditional philanthropy anticipated? Will profits be solely used for the mission, or will a portion be carved out and distributed to owners? A significant consideration for social enterprises pursuing tax-exempt status relates to whether profits qualify as unrelated business income. While there are a number of modifications, exclusions and exceptions to the definition, UBIT is the tax NFPs pay on the net profits of an unrelated business, meeting these IRS requirements:

- It's a trade or business (it exists to churn a profit)
- It's regularly carried on (its business shows the frequency and continuity of a for-profit business)
- It's not substantially related to furthering the exempt purpose of the organization

An unrelated business must meet all three requirements, though the third item is the most significant and subjective. To be substantially related, the activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes.

CONCLUSION

In November 2016, social entrepreneurs and other social enterprise enthusiasts gathered to educate participants and engage efforts for ongoing work in Malaysia. The Malaysian Global Innovation & Creativity Centre (MaGIC) organizes the MaGIC Accelerator Program Social Enterprise Track to equip social enterprises to address local and global issues. Their key observations:

- Social enterprise revenues are steadily growing.
- Impact investing (for both individuals and venture capitalists) is now “a thing.”
- Entrepreneurial spirit (a must for social enterprises) needs further development.
- It’s not about ideas anymore, it’s about execution.
- Social enterprises are dominating prime Malaysian industries, such as energy, environment, education, arts/fashion and food and beverage.
- Corporate mentors (sponsors) remain important.
- Partnerships between social enterprises are increasing.
- The general public lacks sufficient education about social enterprise.

Social enterprise is called the fourth sector, joining businesses, NFPs and governments in seeking to address current social issues with new organizational structures.

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