Journal of Business and Economics, ISSN 2155-7950, USA
June 2013, Volume 4, No. 6, pp. 495-501

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For-Profit or Not-For-Profit: An Outdated Choice

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Abstract: Worldwide, business is traditionally divided into two classes: for-profit and not-for-profit. While for-profits are focused on generating maximum financial returns for involved stakeholders, not-for-profits prioritize a mission usually involving a social cause. A wall actually exists between these two business types both organizationally and culturally. It is not considered good governance when for-profits become involved in social causes, and conversely it is considered unsavory when non-profits operate profit making businesses. For example, most people would be outraged if the church to which they donate cash on Sundays started using these contributions to open fast food franchises (even if the franchise helped with their "feed the homeless" efforts). This wall exists primarily to simplify taxation: for-profit businesses pay specific tax rates, and not-for-profits either are exempt from taxes or pay reduced rates. Unfortunately, this either/or corporate structure creates large disadvantages for society. Specifically, trillions dollars of assets invested in for-profit businesses cannot easily be tapped to solve social problems because for-profits can only breach the wall and support a social cause indirectly through grants or donations. Simultaneously, not-for-profits struggle to find annual funding and reliable revenue streams in order to keep their organizations liquid and accomplish their mission. This paper examines the current state of this either/or, profit/not-for-profit corporate configuration, discussing hybrid business structures as an alternative. Specifically (1) for-profit businesses focused on a social cause and (2) not-for-profit organizations operating to make a profit.

Key words: social business; L3C; tax code; not for profit
JEL code: K

1. Introduction

For about the past 100 years, businesses have been divided into two major categories: for-profit and not-for-profit. The objective of for-profit business is to maximize financial return to the business's stakeholders. Not-for-profits have the objective of accomplishing their mission which is usually to improve society or the human condition. These categories were developed, however, not to differentiate businesses by their objectives but as part of the tax code and they exist primarily to make its application easier. For-profit businesses pay a tax rate defined by the code and are free to operate their businesses as management sees fit. Not-for-profit businesses, on the other hand, avoid all or most taxes by agreeing to very specific management guidelines defined in the tax code. These guidelines focus the not-for-profit on a specific mission, do not allow most revenue or profit generating activities, and strictly limit or prevent any financial payments/returns to members of the not-for-profit.

These two categories of businesses are deeply ingrained in both the tax code and our culture with a legal and

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cultural "wall" between them. For example, culturally many people would be outraged to learn that their contributions to a not-for-profit church were being used to purchase for-profit fast food franchises even if the church had a mission of providing food to the homeless.

Limiting businesses to this either/or choice is restrictive and detrimental to healthy growth, a situation that can be addressed by creating new business structures.

2. Background

The current divide between for-profit and not-for-profit business has both pros and cons. The biggest advantage is that the appropriate tax code can be clearly applied to the correct business, and management stays focused. This was the original purpose and is still the best purpose of the divide. As time has passed, however, a number of disadvantages to the for-profit and not-for-profit distinction, the logical "wall" that exists between the two categories, have become clear. A for-profit business has difficulty using its profits to support a mission or cause except by giving one time grants or providing periodic contributions. Additionally, a not-for–profit business cannot develop revenue or profit making ventures or pay returns to investors in an attempt to have a more clearly defined revenue stream; the not-for-profit instead must exist each year based primarily on the generosity and gifts of strangers. The tax code is clear on this point, and the not-for-profit risks losing its 501c3 not-for-profit status by doing otherwise. As a result, these two categories create a situation where for-profit businesses have the money but cannot easily support a mission while the not-for-profits have clear missions but cannot easily get or generate the money needed. An example of this dilemma might be a not-for-profit that supports its mission and creates a website to teach teenagers about financial decision making: what is a mortgage, what is an interest rate, how does a credit card work, etc. Can the not-for-profit sell advertising on this website to generate revenue to pay for the website? The answer is unclear but "probably". Going further, can an investor agree to pay for the not-for-profit's website in exchange for receiving revenue from the advertising? The answer is again unclear but "probably not". In such an ambiguous case, the best approach would be to ask the IRS to issue a letter ruling before starting the website. Since this could take months, the not-for-profit either does not start the website or must find grants or donations that cover the cost, again slowing the process.

To try to bridge the gap between for-profit and not-for-profit worlds, the concept of "Program Related Investments" (PRI) was started many years ago. These specifically define an activity that drives positive social change but is structured to attract donations. A PRI is a combination of a grant and an investment that counts as a donation but allows the donor to receive a return on the investment (IRC 942 & IRC 945, 2006) A PRI attempts to blend not-for-profit purpose with for-profit finances and (1) must be charitable in its purpose (2) must not have income production as a significant purpose and (3) must not influence legislation. Examples might be investments in an industry that creates jobs for the disabled or low interest loans for a specific purpose such as student loans or home ownership (or the website example given previously). While the concept of PRIs is admirable, these are hard to design, difficult to implement and difficult to manage and monitor. Additionally, the IRS has not provided a clear enough understanding of PRI structure to comply with not-for-profit status. It is still best to get a letter ruling from the IRS or a strong recommendation from legal counsel before starting a PRI, both of which could take months and involve significant expense. Legislation has been proposed to attempt to streamline this process (Schock Aaron & Polis Jared, 2011) but has not yet been implemented.

3. Low Profit Limited Liability Corporation

Blending the not-for-profit purpose with the for-profit form and access to capital has been a topic of discussion previously (sometimes generally referred to as "social business") most notably by Professor Muhammed Yunus in his 2006 Nobel Peace Prize lecture:

> ". . . once social business is recognized in law, many existing companies will come forward to create social business. . . Unlike the non-profit sector where one needs to collect donations to keep activities going, a social business will be self-sustaining and create surplus . . . ." (Yunus Mohammad, 2006)

In an attempt to address this blending, a new concept of U.S. business structure called L3C was started, with Vermont being the first state to enact legislation in 2008 (Poulin Betty, 2008). The L3C is a hybrid not-for-profit/for-profit entity and is basically a low profit limited liability company. (The term L3C stands for <u>L</u>ow Profit <u>L</u>imited <u>L</u>iability <u>C</u>ompany.) Like a for-profit, it can have equity owners and can distribute its profits to stakeholders, but like a not-for-profit its primary purpose is to accomplish a charitable mission. However, although profit is allowed in an L3C structured business, this cannot be the primary purpose of the business.

The L3C is taxed like any other for-profit business and is not eligible for tax exempt status under the usual IRS Section 501C3. However, since the primary purpose is charity and the basic definition is "low profit," the tax payments should not be an issue. The L3C structure is trying to create a method for investment in companies doing charitable work that can provide some small return to investors, unlike a not-for-profit which legally cannot provide any return (or even a negative return when they need more money). By attracting investments from corporations and individuals and offering them a return on their investment, the L3C can be on more stable financial ground to cover its operating costs and obtain an equity cushion.

The promise of the L3C structure is that the not-for-profit can both accomplish its charitable mission and be self-sufficient by attracting outside investment and generating a consistent cash flow. Additionally, the need for private IRS rulings required for PRIs investments is eliminated.

The UK has a similar model named the "Community Interest Company" (CIC) while Brazil and Italy (and others) use a model called "Economy of Communion". These operate in a similar fashion to the U.S.'s L3C (Yunus Mohammad, 2006).

As a result, the three possible structures of businesses now can be thought of along a spectrum with the legal and cultural "wall" separating the groupings (Figure 1).

	← Tax Exempt →	← Taxable →	
Organization Type	Not-for-Profit (501 C3)	Low Profit Limited Liability Corporation (L3C)	Limited Liability Corporation (or similar) (LLL)
Purpose	Mission driven	Mission driven but financial focus as well	Financial and Business driven
Rate of Financial Return	No return or negative return	Low returns from 0% to 5%	Maximize return to investors usually over 5%
Financial Concerns	Grants and donations	Profits	Revenue and profit
Donor Tax Consideration	Grants and donations fully deductible by donor	Investments not deductible by donor	Investments not deductible by donor

Figure 1 Existing Choices of Business Structure

L3C legislation has now been enacted in 8 states with at least 7 more considering this type legislation (Morrisey John, 2012). About 1.5 million U.S. non-profit organizations are in existence (National Center for Charitable Statistics, 2013) but probably less than a few dozen L3C organizations have been started. While it is early and little data is available, the initial findings indicate that L3C structure implementation has been slow due to a number of issues.

The first is the potential for grants and donations to be shifted from the traditional not-for-profits into L3Cs. Donors may prefer to make donations into an L3C that will become self-sufficient (and potentially not need additional funding in the future) rather than making grants each year to a traditional not-for-profit organization. Additionally, a donor may prefer to have the potential for a return on their L3C investment rather than the usual grant/donation to a not-for-profit. This makes it less likely that not-for-profits would start an L3C organization. The second is that while L3Cs have a charitable purpose, they are essentially for-profit start-up organizations. Any start-up organization, whether not-for-profit or for-profit, requires an entrepreneurial spirit, drive, and determination and even with this, traditional for-profit startups have a high failure rate. It is logical to assume that L3Cs will have a similar high failure rate thus further reducing their attractiveness. Thirdly, the management of an L3C must have a unique blend of skills: understanding the aggressive management objectives of a for-profit business but also the not-for-profit objectives of accomplishing a charitable purpose. Such a management person may be difficult to find, although retired business executives trying to make a contribution to society, could be good candidates for these jobs. Fourth, it is not clear who is to start an L3C: a not-for-profit business extending its charitable purpose or a traditional for-profit business attempting to do more charitable work. Murky tax guidance should not drive not-for-profits to use possibly less efficient for-profit L3C structures instead of conducting mission related activities directly (Molk Peter, 2012). Lastly, legislation is being enacted at the state level with each state producing slightly different wording and implementation requirements. The Federal government and the IRS have not yet endorsed L3C as a federal corporate form and need to provide guidance on the use of L3Cs with PRIs.

4. Proposed New Organizational Structure

The creation of L3C organizations by state governments makes it clear that the discussion is beginning to move toward finding common ground in territory between the traditional for-profit and the traditional not-for-profit. The current system of for-profit businesses providing grants and donations “over the wall” to not-for-profits has limitations that reduce the ability of private sector dollars to help solve/address societal problems. L3C organizational structure tries to bridge this gap by operating on the for-profit side of the wall. To overcome some of the limitations and issues previously mentioned, a similar organizational structure is needed that operates on the not-for-profit side of the wall instead of on the for-profit. While an L3C is a for–profit business focused on a charitable purpose, it is time to discuss the opposite concept: a not-for-profit business that can make some profit without jeopardizing its tax exempt status.

Managing a not-for-profit business efficiently revolves around a number of key items including the issue of money: getting enough grants and donations to sustain the organization and allow it to accomplish its mission. (Private foundations are somewhat different in that these are required by the tax code to use 5% of their net asset value annually for charitable purposes). The not-for-profit in most cases does not have a defined or predictable revenue stream. In good economic times, donations may be robust but in difficult periods, grants and donations can drastically decrease (Figure 2).

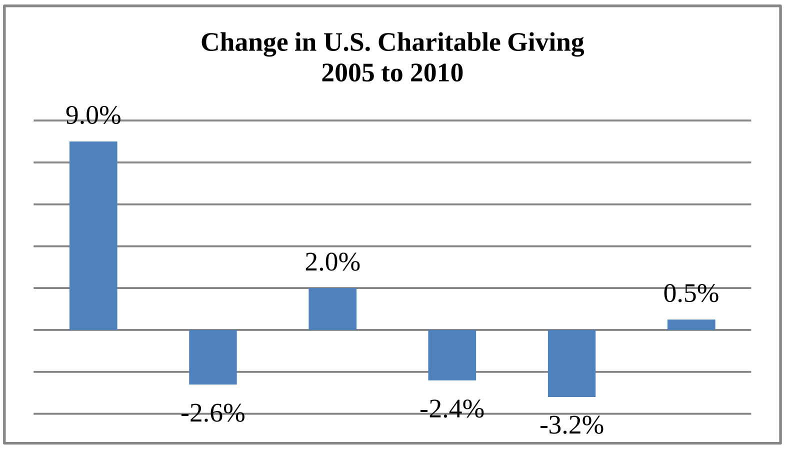

Figure 2 Change in U.S. Charitable Giving

Source: Giving USA Foundation (Hall Holly, 2012)

It is difficult to manage any type of business when revenue swings widely and is unpredictable.

The addition of a profit making business into a not-for-profit organization would provide a predictable stream of "profit" that the not-for-profit could use to accomplish its mission. This is not that dissimilar from a private foundation that invests heavily in corporate bonds and uses the interest gained to further its charitable purposes. In this case, however, it is the not-for-profit that is actually owning or investing in the business generating profits.

There are two ways to actually think about the implementation of this idea. First, this new organizational structure could be a discrete new form of not-for-profit 501c3 organization. Let's say we call it a low-profit 501C3 (LP-501C3). Of course, such a discrete organization would not prevent some of the problems mentioned above with the new L3C organization. Specifically, the new LP-501C3 would be a startup organization separate from the main 501C3 and thus more difficult to manage and probably slow to roll-out. However, having a separate business structure may be more desirable from the perspective of the IRS (Figure 3).

	← Tax Exempt →		← Taxable →	
Organization Type	Not-for-Profit (501 C3)	Proposed Low Profit Not-for-Profit (LP-501C3)	Low Profit Limited Liability Corporation (L3C)	Limited Liability Corporation (or similar) (LLL)
Purpose	Mission driven	Mission driven	Mission driven but financial focus as well	Financial and Business driven
Rate of Financial Return	No return or negative return	Low returns from 0% to 5%	Low returns from 0% to 5%	Maximize return to investors usually over 5%
Financial Concerns	Grants and donations	Grants and donations and investments	Profits	Revenue and profit
Donor Tax Consideration	Grants and donations fully deductible by donor	Grants and donations fully deductible by donor Investments not deductible	Investments not deductible by donor	Investments not deductible by donor

Figure 3 New Proposed Option to Existing Choices of Business Structure

Instead of having a discrete separate organization, the second method to implement would be to allow existing 501C3 organizations to begin operating low profit businesses as their management decides. Such entities would have a faster roll-out because 501C3 management can begin creating low profit activities within their existing organizations that support their current missions without the need for a new legal structure. This creates a mixed environment within the not-for-profit, some activities being operated "traditionally" with grants received and money spent. Other activities would be operated to make a low profit that would be rolled back into the organization to accomplish the mission and also paid out to investors. Essentially, this changes our view of how to manage the application of taxes from a legal entity view (are you an LLL or a 501C3 or a L3C?, etc.) to an activity based view. Is the purpose of your activities solely to make money or to make money to support your charitable mission? Malani and Posner argue that activities, not initial legal entity structure, should govern the tax treatment of charitable undertakings (Malani Anup & Posner Eric, 2007).

To make this possible, several important changes need to occur in the way we think about not-for-profit organizations. Probably the most important requires a change in the restriction that not-for-profits must not distribute profits to managers or stakeholders. There already exists an exception to this no distribution rule with Program Related Investments (PRI). Although this mechanism is cumbersome at present, it could be streamlined to have an automatic approval feature for certain types of preapproved investments in charitable missions without the lengthy IRS review process. More likely instead, however, would be regulation that limits and directs the amount that a not-for-profit could pay out to investor/donors. This regulation might stipulate that a maximum of 30% of profits can be paid out with 70% remaining within the not-for-profit to support its charitable mission. EOCs in Italy and Brazil successfully use a similar type of profit sharing approach within their organizations (Sertial Heather, 2010).

As a hypothetical example of this structure in application, suppose it costs your local symphony $100,000 to stage its three concerts this weekend: Friday night, Saturday night, and Sunday afternoon. An investor/donor could agree to provide a $100,000 investment for this weekend to cover the symphony's costs in exchange for all the monies collected from ticket sales. The symphony thus has its $100,000 costs covered and the risk of ticket sales has now passed to the investor/donor. If ticket sales are only $80,000 for this weekend the investor/donor takes the loss instead of the symphony. However, if ticket sales are $120,000 this weekend, the $20,000 profit is split 30% to the investor/donor and 70% to the symphony. This type of charitable investment thinking should be a regular course of business that not-for-profits may use without the need to form new legal structures like L3C or LP-501C3 or to have PRIs pre-approved.

5. Conclusion

The creation of the L3C structure represents a step forward in closing the gap between for-profit and not-for-profit businesses, possibly bringing closer the huge financial resources of for-profit business and the financial needs of not-for-profit charitable organizations. While there are issues with L3Cs that have slowed acceptance, a long overdue dialog has started about the best ways to harness the power of the US economy, as defined by for-profit businesses, and to better apply this power in helping to solve societal issues. This creation of the L3C structure should, however, be the first and not the final step in finding a workable mechanism. Other, possibly more expedient ways can be developed.

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