Public Charity Side Car

06 Apr 2020

Social Enterprise + Impact Investing

Client Alert

As corporations explore how best to address the current crisis—both health and economic—posed by COVID-19, many are looking to utilize their existing affiliated private foundations. Funded from corporate revenues, these foundations are able to make donations to the people and organizations that need the greatest support during the pandemic and ensuing recession. Unfortunately, foundation capital will, by definition, be limited, because foundation budgets usually represent an expense line on a company’s balance sheet. Therefore, funding will likely be reduced, as a result of either a reduction in overall revenues or a reduction in the percentage of revenues budgeted to enable companies to focus on current business and operational imperatives.

One solution that can be either neutral or accreting to a company’s balance sheet is the establishment of an affiliated public charity. The public charity can be a stand-alone 501(c)(3) tax-exempt organization (noting that the application and Internal Revenue Service (IRS) review time can be six to nine months, or longer given the current environment) or a project or non-profit corporation that is fiscally sponsored by an existing 501(c)(3) public charity. As distinct from a foundation, the public charity must have a diversity of funding so that it can meet the “public support” test, which means that the majority of funding should not come from the affiliated corporation. Two viable options for corporations to meet this test in the short term (avoiding months or years of fundraising) are:

- Securing philanthropic donations from a consortium of companies in an industry (e.g., retail, technology) or from private foundations; and/or
- Restructuring sales to customers and/or licenses to end-users such that a small portion of the proceeds few cents on the dollar from every purchase will be donated directly to the public charity.

The public charity can accept grant funding or public or corporate donations, purchase goods or services from the affiliated corporation at cost (or below fair market value) and then engage in charitable distribution of the goods and services to the “public” sector at a lower price (or for free). This will be particularly valuable now for corporations that find themselves with an oversupply and a public sector that has greater demand (with limited means to pay). The primary impediments to the public charity side-car are the inurement/private benefit rules that prohibit the public charity...
from being established to benefit the corporation affiliate or any for-profit entities. To protect against such claims, corporations must ensure that:

(1) the public charity is organized and operated for charitable purposes and avoids operating in a commercial manner;

(2) the public charity does not primarily serve the business purposes of (or compete with) the affiliated corporation;

(3) the flow of funds, IP, goods, and services between the two affiliated entities is documented by contract;

(4) all payments made by the public charity for resources, goods, or services provided by the affiliated corporation are at cost or below market (and all payments made by the affiliated corporation to the public charity are at or above market); and

(5) the public charity board has sufficient independence to ensure that its activities serve its charitable purposes.

A few current examples of this “hybrid” model are as follows:

• For-profit technology company with affiliated public charity that licenses technology solutions from the affiliated corporation (paying revenue-based royalties at slightly below market) and then on-licenses to entities in the public sector (governments, schools, relief organizations) at below-market rates.
• For-profit bookseller with affiliated public charity hiring staff from bookseller to provide events and lectures, some of which are held in the bookstore.
• For-profit software company that collects and aggregates data (including climate data) with its affiliated public charity, which in turn licenses the climate data and develops applications for use by NGOs in mitigating climate change.
• For-profit provider of meals with an affiliated public charity providing capital equipment to retrofit kitchens to allow them to accept delivery of the meals.

Summary of Additional Legal Issues and Best Practices

Functions of Entities.
The entities must maintain a clear distinction between the function of the non-profit and for-profit such that the purpose and activities of the non-profit do not primarily operate for the financial benefit of the for-profit. For example, the non-profit cannot function primarily as a product or service distribution arm of the for-profit. The
mission of the non-profit entity should be clearly defined and tailored to one or more of the charitable purposes set forth in Internal Revenue Code section 501(c)(3). [4]

Commerciality.

The public charity must avoid conducting its activities in a commercial manner, which would suggest that it is not primarily a charitable entity. Factors would include the extent and degree of free or below-cost distribution to targeted populations in need, whether it competes with for-profit commercial entities, its marketing and pricing practices, and the extent of its charitable-donation funding compared to revenue from goods or services.

Fiscal Sponsorship.

A fiscal sponsorship could be an appropriate vehicle for a single charitable project or campaign for which the corporation seeks support from other funding sources. A fiscal sponsor may agree to support a project or campaign without requiring the creation of a separate non-profit. It also can support a non-profit while its tax exemption application is pending.

Tax Exemption for Public Charity.

To become a tax-exempt public charity, the non-profit must file a Form 1023 with the IRS. The non-profit must demonstrate that (1) it is organized and operated exclusively for charitable purposes, (2) it is not substantially engaged in commercial activities that do not primarily serve its tax-exempt purpose(s), (3) it is meeting the public charity “public support” test, and (4) it is not creating impermissible private benefit or private inurement to insiders or the for-profit. If the IRS determines private inurement has occurred, the individuals or corporation that benefitted and the public charity directors and managers can be required to pay substantial excise taxes, and the public charity risks loss of its tax exemption.

Disinterested Management.

The board of the charity should be sufficiently independent to ensure focus on its charitable purposes and activities. While the members of the boards of both entities may overlap, each board should include at least two and preferably a majority of members who are disinterested with respect to the other entity. These disinterested directors may form special committees to approve agreements or transactions between the entities, ensuring that they are negotiating and transacting with each other at an arm’s-length distance.

Inter-Entity Agreements.
The non-profit and for-profit entities may contractually share resources, services, IP, or personnel through inter-entity agreements that must be negotiated at an arm’s-length distance and must be able to be amended easily over time. These payments can include fair-market-value royalties paid pursuant to license agreements. Payments should be structured so as not to generate unrelated business income tax to the non-profit. The entities must track and document the flow of funds, the flow of services and resources, and the flow of intellectual property between them. Management should be required to report to the special committee on the flow of funds, services, and intellectual property on a quarterly basis to allow for amendments as the hybrid evolves over time.

Compensation to Non-profit.
The non-profit entity must receive at least fair market value for anything it provides to the for-profit; this is an important factor in ensuring the non-profit does not violate any private-inurement or private-benefit rules.

Employee Sharing.
Employees can be dually employed by both entities, but they must be compensated by each entity in accordance with the time worked for such entity. Employees can also be employed by one entity, then “leased” to the other entity, although such arrangements should be structured to avoid unrelated business income tax to the non-profit. The mindful structuring of employment arrangements for employees to work for/at both entities is important to prevent the “brain drain” effect in which employees of the non-profit will gradually shift into the for-profit because of higher salaries and equity incentives, leaving high employee turnover and low morale at the non-profit entity. Compensation for employees at the non-profit would be limited to some degree by the standard IRS reasonable compensation requirements. Also, any “disqualified persons” at the non-profit who are also or later employed by the for-profit may be subject to compensation restrictions. [5]

Executive Compensation Limits.
Compensation for executives of the non-profit is limited to a reasonable level as compared to other similarly situated non-profits. Directors and executives may be subject to penalty excise taxes if they receive excessive benefits from a non-profit. It is advisable to avoid sharing executives; if they are shared, any dual employment relationship should be negotiated by disinterested individuals, with the entities represented by separate legal counsel.

Maintenance of the Hybrid Structure.
The entities should consider engaging separate law firms, independent accountants, and different valuation experts (if needed) due to the multi-stakeholder negotiations inherent in this structure. It is also good practice to hire a sophisticated chief financial officer and finance team to manage the relationship and the flow of funds, assets, services, and resources.

[1] List of potential fiscal sponsors.

[2] There are two tests for public support, either of which a public charity must meet: (A) the organization receives at least one-third of its support in the form of contributions from publicly supported organizations, governmental units, and/or the general public; or (B) the organization receives no more than one-third of its support from gross investment income and more than one-third of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions.

[3] Careful attention should be paid to anti-trust considerations, which must be addressed in structuring the consortium and its funding mechanism.

[4] Options include charitable, scientific, educational, religious, literary, and public safety testing purposes. Charitable purposes include relief of the poor, the distressed, or the underprivileged, lessening the burdens of government, eliminating prejudice and discrimination, defending human and civil rights, and combating community deterioration or juvenile delinquency. See: https://www.irs.gov/charities-non-profits/charitable-organizations/exempt-purposes-internal-revenue-code-section-501c3.