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Social Enterprise: A Legal Context

by Robert A. Wexler

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Introduction

Ten to 15 years ago, many in the exempt organization legal community viewed social enterprise as a mere trend, but now, social enterprise is a viable and intricate part of the exempt organization landscape. New social entrepreneurs continue to surface, and social enterprises continue to thrive. This article is a call to action to the exempt organization legal community to help further this important movement and to help change the law to accommodate new approaches to philanthropy. Although written for lawyers, this article is also intended for social entrepreneurs to help them understand the legal framework through which exempt organization attorneys will view their social enterprise business plans.

The first step in representing any new type of business or social model is becoming familiar with the culture of the movement and the language used by those involved. Exempt organization attorneys who represent this new breed of innovators need to develop a working knowledge of the new language of social entrepreneurs and become familiar with the many foundations, universities, and other entities that fund them, write about them, sponsor conferences about them, and bestow awards on them.

Ten years ago I would have been reluctant to indulge a social entrepreneur client who indicated her intent to establish an exempt organization to ''partner'' with other organizations and to make ''investments'' in ''social enterprises.'' I would immediately correct the client and instruct her not to use the word ''partner'' or ''partnering'' unless she really intended to set up a legally binding partnership under applicable state law. I would caution an exempt organization not to use the word ''investment'' to describe an outright grant, especially if the organization was a private foundation, because such language could trigger all kinds of problems under section 4944 (jeopardizing investments), when all the client really intended was a grant with conditions. Over time, however, I have become more flexible in not attempting to limit a client's use of the language of social enterprise, as long as the legal documents properly describe the legal relationship.

The second step in representing social enterprises is helping innovators work within a tax regime that is sometimes not flexible enough to accommodate these new ideas and new methods. Exempt organization attorneys who want to help social entrepreneurs need to think about how to use the established legal constructs in a way that encourages and fosters the creativity of those entrepreneurs. Ten years ago I would have been reluctant to advise a client to carry out substantial charitable activity through any vehicle other than a 501(c)(3) entity. My views have changed.

Also, recognizing that the current legal constructs might not be sufficient to accommodate the vision of social entrepreneurs, exempt organization attorneys might help social entrepreneurs think about ways to amend the Internal Revenue Code to support social enterprise activity. The United Kingdom has already moved to accommodate social entrepreneurs by offering a new type of legal entity called a community interest company, or CIC, which is discussed below.

This article first reviews how the social entrepreneurs themselves define what they are doing. Second, it considers why this movement has been strengthening over the last 10 or 15 years. Third, it describes how exempt organization attorneys might help give legal structure to social enterprise under existing law. This third section may be too basic, in places, for experienced exempt organization tax practitioners, but it might be useful for social entrepreneurs trying to understand how lawyers think about their business plans. Fourth, the article suggests that it may be time to follow the U.K. model and offer social entrepreneurs a new form of legal entity to carry out their important work.

I. Social Entrepreneurs and Social Enterprise — Who Are They and What Is It?

The social enterprise movement has done a thoughtful job of defining itself. Let us start by looking at the terms ''social entrepreneur'' and ''social enterprise'' from the perspectives of a professor, a foundation, and an association of social enterprises.

The Professor: Prof. J. Gregory Dees wrote ''The Meaning of 'Social Entrepreneurship'" in 1998 (reformatted and revised in 2001). (It is available at http://www.fuqua.duke.edu/centers/case.) Dees's article contains an extended and well-considered analysis of what it means

to be a social entrepreneur. Dees notes that entrepreneurs serve as the ''change agents'' for the economy (page 1), and he offers what he calls an ''idealized'' definition of the social entrepreneur as follows:

Social entrepreneurs play the role of change agents in the social sector by:

- Adopting a mission to create and sustain social value (not just private value);
- Recognizing and pursuing new opportunities to serve that mission;
- Engaging continuous innovation, adaptation, and learning;
- Acting boldly without being limited by resources; and
- Exhibiting heightened accountability to the constituencies served and for the outcomes created. (page 4)

The Foundation: The Skoll Foundation[1] was founded by Jeff Skoll, one of the entrepreneurs who founded eBay and who now produces thought-provoking films. It focuses on recognizing and funding social entrepreneurs with the Skoll Awards for Social Entrepreneurship and through funding the Skoll Centre at Oxford University. The Skoll Foundation Web site (http://www.skollfoundation.org) defines a social entrepreneur as ''society's change agent: pioneer of innovations that benefit humanity.'' The Web site notes that ''just as entrepreneurs change the face of business, social entrepreneurs act as the change agents for society, seizing opportunities others miss and improving systems, inventing new approaches and creating sustainable solutions to change society for the better. However, unlike business entrepreneurs who are motivated by profits, social entrepreneurs are motivated to improve society.''

The Alliance: The Social Enterprise Alliance sponsors conferences and otherwise represents the interests of social enterprises. It defines a social enterprise as ''an organization or venture that advances its social mission through entrepreneurial, earned income strategies.'' (http://www.se-alliance.org)

For purposes of this article, which examines the more complex legal issues involved in the movement, it is enough for us to consider social entrepreneurs to be those individuals who take the lead in forming and operating social enterprises. Social enterprises can be nonprofit or for-profit; tax-exempt or taxable, but there is usually some nonprofit, tax-exempt component. Social enterprises are enterprises because they use earned income or revenue-generating strategies, and they are social because they are doing something innovative to benefit society, not just to generate revenue. Often these enterprises seek to become self-sustaining, but they usually require help, especially in the early years.

Traditionalists will say that as there have always been nonprofit organizations involved in revenue-generating activities that benefit the community, so there have always been social enterprises, and the leaders of those enterprises have always been social entrepreneurs. Hospitals, schools, and low-income housing organizations, for example, are income-generating nonprofits that serve the community. But 21st-century social entrepreneurs are looking for new strategies to benefit society, strategies that might involve using both charitable contributions and private investment capital and that use the Internet and other new technologies. This is not to say that hospitals, schools, and low-income housing providers are doing anything wrong or are even uninteresting. It simply means that we have laws that have evolved and continue to evolve to deal with these more traditional institutions, while the laws related to the ever-changing world of social enterprises are significantly less well-charted.

The definitions of social enterprise and social entrepreneurship can seem abstract until we consider examples of the many social enterprises operating in the United States and abroad.

Technology: Many organizations are beginning to use innovative technology to benefit society.

Envirofit International Ltd. (http://www.envirofit.org) creates and distributes technologies that help developing countries address the health hazards of pollution. Envirofit is retrofitting up to two million two-stroke powered vehicles with cleaner, more efficient direct injection technology that eliminates 90 percent of hydrocarbon and 70 percent of carbon monoxide emissions from two-stroke engines.

Kickstart (http://www.approtec.org) is a nonprofit organization that develops and markets new technologies in Africa. These low-cost technologies are bought by local entrepreneurs and are used to establish small businesses. The U.S. branch of Kickstart helps fund these social enterprises abroad.

Beneficent Technology Inc. or Benetech (http://www.benetech.org) is a Silicon Valley-based organization. Its predecessor, Arkenstone, began by developing and selling inexpensive reading machines to the blind. Benetech now focuses on projects such as an Internet-based book-sharing community and technology-based human rights projects. Its founder, Jim Fruchterman, has won a number of awards, including a MacArthur Foundation award in 2006.

Job Training: Organizations continue to use job training to help the disadvantaged.

In 1971 Mimi Silbert began Delancey Street Foundation, which is not really part of this new social enterprise movement. Since the early 1970s, Delancey Street has been helping former felons and substance abusers learn the skills they need to rebuild their lives. Delancey Street has also developed more than 20 social enterprises run by unskilled workers. Those businesses include a restaurant, a moving and trucking company, a bookstore, a coffee house, and an art gallery.

Juma Ventures (http://www.Jumaventures.org) is a San Francisco-based organization that uses business enterprises to provide opportunities to young people who have traditionally lacked access to them. Juma operates, among other things, Ben & Jerry's ice cream shops and concessions at AT&T Park in San Francisco.

[1]Many of the organizations described in this article are valued clients of Silk, Adler & Colvin. All factual information about organizations, whether or not clients, is readily available on organization Web sites.

These businesses are all used for job training purposes and to make money for the organization.

Microfinance: Social entrepreneurs are using microcredit or microfinance to fight poverty in the U.S. and abroad.

Grameen Foundation USA (http://www.grameenfoundation.org) uses microfinancing to fight poverty around the world. It makes tiny loans and provides financial and technology assistance to small, self-starting businesses. The foundation maintains a relationship with the Grameen Bank of Bangladesh. Muhammad Yunus, the 2006 Nobel Peace Prize winner, began Grameen Bank in 1976. He discovered that poor women could break through poverty by taking tiny loans to start or expand businesses. Microfinance loans have become one of the best examples of how social enterprise can become self-sustaining and also do good.

The Acumen Fund (http://www.acumenfund.org) is another nonprofit venture fund that tries to solve the world's problems through entrepreneurial creativity, including microfinance loans.

It is important to also have a sense of who is studying and writing about social enterprise, who is funding it (business enterprises require seed capital; social enterprises require seed grants or loans), and what organizations are representing its interests. The list that follows is illustrative:

The Scholars

- Harvard Business School (http://www.hbs.edu/socialenterprise/) began its Social Enterprise Initiative in 1993. Jed Emerson and others have written articles and resource guides on social enterprise.
- The Center for the Advancement of Social Enterprise at the Fuqua School of Business at Duke University (http://www.fuqua.duke.edu/centers/case/) is also a leader in this arena. Dees, mentioned above, teaches and writes in this program.
- Stanford University houses the Center for Social Innovation (http://www.gsb.stanford.edu/csi/), which also publishes the *Stanford Social Innovation Review*.
- Oxford University's Said School of Business sponsors the Skoll Centre for Social Entrepreneurship (http://www.sbs.ox.ac.uk/skoll/).
- Columbia University Business School also offers a Social Enterprise Program (http://www.2.gsb.columbia.edu/socialenterprise/).
- New York University, Stern School of Business, sponsors the Satter Program in Social Entrepreneurship (http://www.stern.nyu.edu/berkley/social).
- Yale University School of Management offers the Program on Social Enterprise (http://www.pse.som.yale.edu/).

The grantmakers and award givers

Many grantmakers support social enterprise. A few examples are:

- The Roberts Enterprise Development Fund, or REDF (http://www.redf.org) was one of the first groups to identify and invest in entrepreneurial nonprofit organizations. REDF began by selecting some 501(c)(3) social enterprises and investing in them by offering conditional, recoverable grants to provide them with seed money. REDF also provided technical support to the entrepreneurs.
- The Ashoka Foundation's mission is "to shape a citizen sector that is entrepreneurial, productive and globally integrated, and to develop the profession of social entrepreneurship around the world." (http://www.ashoka.org). Ashoka provides fellowships for social entrepreneurs.
- The Draper Richards Foundation also provides fellowships to social entrepreneurs (http://www.draperrichards.org).
- The Schwab Foundation for Social Entrepreneurship offers the Award for Outstanding Social Entrepreneurs (http://www.schwabfound.org).
- The Skoll Foundation offers the Skoll Awards as second-round funding, in the form of grants, loans, or a combination of the two (http://www.skoll.org).

Other foundations and organizations, including the MacArthur Foundation, the Ford Foundation, the Gates Foundation, Google.org, and the Omidyar Network, also fund social entrepreneurship. While Ford, MacArthur, and Gates are traditional private foundations, albeit with cutting-edge programs, both the Omidyar Network and Google.org provide social enterprise funding through a combination of private foundations and for-profit entities, in part because they view the rules governing private foundations as too restrictive to accommodate social enterprise funding.

Representing and Educating Social Enterprises

Other organizations also provide resources through conferences, newsletters, and other vehicles for social enterprises. See, for example, the Social Enterprise Alliance (http://www.se-alliance.org), Social Venture networks (http://www.svn.org), Changemakers (http://www.changemakers.net), and Social Edge (http://www.socialedge.org). Social Venture Partners is a community of social investors, with different, geographically based chapters (http://www.svpi.org).

II. Why Has the Movement Grown So Quickly?

Academicians and social entrepreneurs have offered well-considered theories on the rapid growth of the movement. Having represented many social enterprises and social entrepreneurs, I believe social enterprise has evolved considerably in the last 10 to 15 years, primarily because of the following:

- During the 1990s a new generation of young entrepreneurs emerged, particularly in Silicon Valley. They had charitable notions and goals that were not steeped in traditional philanthropy. Some of them also had access to significant amounts of cash and stock, and they wanted to do socially useful work with that cash. To a more limited extent, this trend continues today.
- The Internet provided a platform for many entrepreneurs to become successful quickly, and it then provided a platform for innovative ways of thinking

about charity and social enterprise. The Internet was and is a technological catalyst for the social enterprise movement.
- People began to realize that U.S. dollars could go a long way in developing nations. Much social enterprise is conducted in developing nations.

III. Working Within the Law

How do we as exempt organization attorneys advise those who want to fund social enterprise and those who see themselves as social entrepreneurs?

Imagine two clients, one of which is husband and wife (H&W), both age 40-something. They tell the attorney proudly that they have built a technology company that they have just taken public. They say they want to become social entrepreneurs and to invest $50 million in a to-be-formed charity that will fund social enterprise projects. They are not interested in being traditional philanthropists, and they believe the expertise they have developed in building their company will be directly applicable to the skills they will need in funding social enterprise. They want to help create self-sustaining projects that solve important social problems, and they want to do so in a way that has not been done before.

The unprepared attorney might have various reactions. One experienced lawyer might think, ''You are reasonably young; you know nothing about philanthropy; why don't you follow Warren Buffet's recent example and give your money to someone who has been doing this kind of work effectively for a while?'' Another lawyer might think, ''I have no idea what H&W just said, but these folks can obviously afford to pay; how do I move this forward?''

Having heard some version of this introduction before, our attorney tells H&W he is interested in working with them. He suggests that the three of them talk first about what has already been accomplished. Then he can help H&W access some of the resources that they will need to develop a more coherent charitable/business plan. The attorney says they can discuss some of the possible legal structures, which might involve a 501(c)(3) organization, a for-profit corporation or limited liability company, a 501(c)(4) organization, or some combination of any of the above.

The attorney makes it clear, however, that he does not want H&W to start by conforming to what 501(c)(3) private foundations have done. Rather, he wants them to figure out what they want to do and then he will work with them to develop legal structures to best accommodate their ideas.

The second new client, S.E., is also in her 40s. She has a strong medical practice, but now wants to help indigent children get better medical care, particularly in poor and developing countries. S.E. has some ideas of how to better manufacture and distribute medical devices and vaccines and of how to get care to the people who need it. She needs a legal vehicle to accomplish her work, and she needs funding. She considers herself to be a social entrepreneur but is less concerned about what scholars think that term means than about getting her work done. She believes some funding will be available from foundations and maybe also from private investors. S.E. says she has also considered ways of manufacturing medical devices and distributing them to middle-income and wealthier individuals in the United States. She believes that because she will be manufacturing medical products for distribution to the poor, she might as well also sell them at market value to those who can afford to pay to help subsidize her charitable endeavors.

The attorney discusses the different legal options of establishing a 501(c)(3) charity to raise funds and a for-profit corporation or limited liability company to attract investors. He notes that sales of medical equipment and devices at market value may generate taxable income, rather than exempt income.

How do all of these new ideas and this new language fit within the legal framework of the section 501(c) tax exemption?

A. Husband and Wife

It is clear that H&W do not want to be social entrepreneurs themselves; rather, they want to fund social entrepreneurs and social enterprises. In the next meeting with H&W the attorney will want to address the most important issue: What type of legal entity should H&W establish, or affiliate with, to accomplish their goals? H&W might be duly impressed when the attorney offers the following choices:
- The entity could be a new entity or an existing entity;
- The entity could be a for-profit or a nonprofit;
- If the entity is a for-profit, it might be a corporation or a limited liability company, each having advantages and disadvantages;
- If the entity is a nonprofit, it could still be either taxable or tax-exempt. Although unusual, a taxable nonprofit corporation can be ideal in some situations;
- If the entity is tax-exempt, it could be a section 501(c)(4) social welfare organization or a section 501(c)(3) charity;
- If the entity is a section 501(c)(3) charity, it could be a private foundation or a nonprivate foundation;
- If the entity is not a private foundation, it could be a publicly supported charity or a supporting organization; or
- H&W could use a donor advised fund or a field of interest fund at an existing public charity, most likely a community foundation.

The attorney cannot tell H&W what he recommends until he finds out what characteristics are most important to them. He might ask the following questions:

1. Gathering Information

Do H&W expect a personal financial return in addition to a social return on their investment? Social entrepreneurs often refer to the combination of a social return on investment and an economic return on investment as a double-bottom-line return. If H&W expect a financial return on their investment, the attorney should steer them toward a for-profit model. The attorney might suggest that H&W invest in one of the emerging types of investment partnerships that focus on double-bottom-line investing, in the microfinance arena (for example,

Gifts by Individuals During Life	Amount of Deduction for Gifts to Public Charities (or private operating foundations)	% Limitation on Gifts to Public Charities (or private operating foundations)	Amount of Deduction for Gifts to Private Foundations	% Limitation on Gifts to Private Foundations
Cash	Face Value	50 percent	Face Value	30 percent
Publicly traded stock held for more than one year	Fair Market Value	30 percent	Fair Market Value	20 percent
Real estate held for more than one year	Fair Market Value	30 percent	BASIS	20 percent

investments discussed at http://www.shorebankcorp.com). H&W could also set up their own venture capital fund that is geared toward promoting double-bottom-line products and services. If H&W are not interested in a personal financial return, the attorney should steer them toward a nonprofit vehicle, and probably a tax-exempt vehicle.

What tax benefits do H&W expect or need? If H&W are interested in a charitable contribution tax deduction, the attorney should consider a section 501(c)(3) organization because there would be no deduction for a contribution to a for-profit entity or even to a section 501(c)(4) social welfare organization. A 501(c)(4) organization generally pays no taxes on its income, but it is also ineligible to receive tax deductible charitable contributions. H&W hopefully understand by this point that the world of 501(c)(3) organizations is further divided between private foundations and, for lack of a better phrase, public charities, but H&W may be less clear on the advantages of making contributions to a public charity.

What type of property are they planning to donate to the entity? The attorney would inquire about their overall adjusted gross income in relation to the proposed gift and their tax deduction needs. A contribution of $50 million is sizable and certainly enough to warrant setting up a new organization. H&W need to understand that tax deductions will be more limited for gifts to a private foundation in two ways. First, property other than cash or unrestricted publicly traded stock will be deductible only at basis. Second, gifts of cash to a private foundation are limited to 30 percent of the donor's AGI, while gifts of cash to a public charity are deductible against 50 percent of the donor's AGI (20 percent and 30 percent, respectively, for gifts of stock). If H&W plan to deduct $50 million in donated unrestricted publicly traded stock in one year, and if they make no other contributions that year, they would need $166,666,667 in AGI to deduct the entire gift to a public charity, but they would need $250 million in AGI to absorb the entire gift to a private foundation. In either case, the unused portions in one year can be carried forward for up to five years. The chart at the top of this page, with the following additional notes, illustrates these concepts:

- The amount of deduction not used in the year of gift can be carried forward for up to five years.
- Publicly traded stock generally refers to unrestricted stock and, in the case of the private foundation, to qualified appreciated stock described in section 170(e)(5).
- Most other property that is not listed above is deductible at basis only.

Do H&W expect to raise other funds? Entrepreneurs often believe they can encourage their other newly wealthy friends to join in and support their cause. Sometimes this involvement means an investment in a new LLC that the entrepreneur may establish. Usually, support means a charitable contribution to a 501(c)(3) organization. The attorney would explain to H&W that it is much less likely, for a variety of reasons, that H&W's friends would contribute to a private foundation than to a public charity.

If H&W decide that they absolutely need a public charity to take full advantage of their deductions and to encourage their friends to donate, they would consider several possibilities, none of which, in my experience, will typically appeal to folks like H&W.

First, H&W might consider setting up their own publicly supported charity. It can, of course, be more difficult to encourage others to contribute to a private foundation than to a public charity, but it might be extremely difficult for an entrepreneur to muster a level of public support that would enable a charity to satisfy the public support tests of sections 509(a)(1) and 170(b)(1)(A)(vi), especially beyond the initial start-up phase. To meet the technical tests for public support, H&W, who are contributing $50 million, would need to raise at least $25 million from other donors — none of which contributed much more than $1.5 million — or they would need to find some existing public charity donors, which is unlikely. The alternative 10 percent facts-and-circumstances test is less likely to be useful for a foundation that H&W closely control.

Second, H&W could consider establishing a section 509(a)(3) supporting organization. A supporting organization has two distinct disadvantages from the standpoint of most social enterprise funders. H&W could not control the supporting organization, which is usually a deal-stopper for entrepreneurial-minded donors. Also, the supporting organization would have significant limits on its ability to make grants to fund social enterprises, particularly foreign social enterprises.

Third, H&W could consider a donor advised fund or field-of-interest fund at a community foundation. H&W would not control those funds, which would also have limited ability to make grants to noncharities and to foreign organizations. Though a donor advised fund is a great vehicle for more traditional charity, it may not be as useful for H&W's less traditional grants.

	Community Foundation DAF	Supporting Organization	Private Foundation	501(c)(4)	For-Profit LLC or Corporation
Tax benefits	Maximum deductions	Maximum deductions	Deductions with limits for gifts to a PF	No deductions	No deductions
Control	None, but can make advice	None, but can have a board seat	Can control, but accountable to AG and IRS	Can control, but accountable to AG and IRS	Total control is possible, with minimal accountability
Outside funding	Other donors possible	Other donors possible, but less likely	Other donors not likely	Unlikely since not deductible, but possible	Other equity investors posssible
Limits on grants	Must be for charitable purposes, and further limits on recipients	Charitable purpose, plus specific limits on recipients under 509(a)(3)	Limited, and expenditure responsibility for some grants	Grants must be to promote social welfare	Not limited
Limits on loans and investments	Must be for charitable purposes	Charitable purposes and limits on recipients	Program-related investments with expenditure responsibility	Must be to promote social welfare	Not limited
Halo effect	Maximum	Mixed	Strong	Limited	None

How important is the halo effect of having a charity? H&W may want to live, work, and play in the world of philanthropy by establishing a recognized foundation that borrows their name. They may want to attend conferences with other private foundation leaders and have their name associated with a foundation that will endure over time. Many social entrepreneurs are not at all concerned about being associated with the traditional private foundation world, but some are. This is an intangible issue that may affect the structuring decisions, and the attorney should explore it with H&W.

Do H&W want control? Entrepreneurs who have built their own businesses often demand complete control over the charity that they fund. Unless H&W will establish a for-profit company, there is no substitute for the control available through a private foundation. It is difficult for a donor-advised fund or a supporting organization to offer the operational flexibility, let alone the control, that the entrepreneur wants. A 501(c)(4) is a tax-exempt vehicle that H&W could control, but of course it could not offer H&W or other donors a charitable contribution deduction.

2. Recommending a Solution

In the end, the organizational choice of H&W depends on many of the factors that we usually discuss with a wealthy client who wants to set up a charity. Consider the chart at the top of this page. In all likelihood, the charitable contribution deduction will be of some consequence to H&W, so we can assume they will want at least part of their planning to include a 501(c)(3) entity.

It is also possible for some individuals like H&W, with access to a great deal of charitable capital, to elect to form both a charity for more traditional activity and to use an LLC or corporation for social enterprise funding that is difficult under section 501(c)(3). They can then make traditional grants from the 501(c)(3), but make less traditional investments, loans, and grants from the for-profit entity. Indeed, this type of dual giving approach may become more popular if the code is not adjusted to take into account the changing goals of social entrepreneurs.

Like many wealthy donors, H&W will likely reject any vehicle that does not place them squarely in control. For this reason, a community foundation and a supporting organization, though they can be excellent vehicles for many, do not usually accommodate the entrepreneurial grantmaker. H&W probably will decide to form a private foundation to house at least some of their social capital.

What about using a section 501(c)(4) organization? A (c)(4) might be an interesting choice for a donor who does not need a charitable contribution deduction; wants to be able to proclaim publicly that he operates through a nonprofit, tax-exempt organization; does not want to be subject to the constraints governing private foundations; wants to have control; and wants his assets to be permanently restricted for social welfare purposes, without private benefit. H&W might consider a (c)(4) for a portion of their assets, but they probably will want a private foundation to take advantage of a charitable contribution deduction.

3. Understanding the Consequences

Though entrepreneurs are typically comfortable with the level of control and the tax deductions offered by a private foundation, they are often frustrated by the limits imposed by sections 4945 and 4944. Those limits cause some individuals who want to fund social enterprise to give up a charitable contribution deduction in favor of maintaining more flexibility over grants and program-related investments (PRI).

H&W want to fund social enterprise in the U.S. and abroad. Section 4945 requires expenditure responsibility for all grants to nonpublic charities or the foreign equivalent of public charities, and sections 4944 and 4945 require PRI treatment for loans and equity investments. An attorney can usually find a legitimate way to fashion a loan or equity investment in a deserving project as a PRI, but the required restrictions often run contrary to the

entrepreneurial spirit of the funder. It is essential that H&W understand the limits. Also, but less often, the section 4941 self-dealing rules and the section 4943 excess business holding rules might cause problems, particularly if H&W were to donate significant shares in their own company.

Before establishing a private foundation, the attorney would want to ensure H&W really understand the limitations that a private foundation would impose. It is likely that even after explaining the rules, H&W will be frustrated over time by the limitations that the private foundation rules impose, but at least the attorney will have done his job by ensuring that H&W understand the rules of the game before it is played. Materials explaining the private foundation limitations are available from the Council on Foundations (http://www.cof.org) or even on the author's Web site (http://www.silklaw.com). But how are those rules likely to influence the goals of H&W? The attorney will explain at least the following:

a. Section 4940. Section 4940 requires a 2 percent tax on the foundation's net income, including most capital gains, but the tax can be reduced to 1 percent in some situations. This tax is not likely to impose any significant burden on H&W's foundation that would not apply to any other private foundation. If H&W want to reduce their tax from 2 percent to 1 percent, they should set up a spreadsheet with their accountant to understand how to satisfy this test on an ongoing basis.

b. Section 4941. Section 4941 greatly limits the foundation's ability to engage in any transactions with H&W or their family or any business owned by H&W. The attorney should ask H&W to explore any possible problem areas, including any equipment-, personnel-, or space-sharing arrangements that H&W contemplate between the foundation and H&W or any compensation or fees that H&W expect to receive from the foundation. In all likelihood, H&W will not find the self-dealing rules troublesome because H&W are not looking for any personal benefit from the foundation.

c. Section 4942. Section 4942 requires that the foundation pay out at least 5 percent of the value of its assets that are not used for charitable purposes in some combination of grants, PRIs, or direct charitable activities, including foundation administration. Do H&W understand that they will need to make grants and other qualifying distributions of at least $2.5 million a year based on a $50 million corpus?

H&W also must understand the implications of section 4942 for PRIs. They should understand that a PRI loan or equity investment will be a qualifying distribution that counts toward the 5 percent payout requirement in the year made, but that the amount will come back to increase the payout requirement in the year it is repaid.

Unless there is an ongoing and consistent PRI program, large, long-term loans or equity investments can cause problems. Suppose the H&W foundation, with a $50 million asset base, makes a PRI loan of $20 million in year 1. The H&W foundation, which is required to pay out approximately $2.5 million a year (5 percent), has now made a $20 million qualifying distribution in year 1 that can be carried forward for up to five years before it expires. In year 8, the $20 million PRI is repaid and now adds an additional $20 million payout requirement. However, the H&W foundation is unable to use any excess qualifying distribution carryforward from year 1 (because the carryforward expired in year 5), so it must now make another significant grant or PRI in year 8 to satisfy its section 4942 obligations. For that reason, it might make sense to plan a consistent PRI program that does not overly burden the H&W foundation in a particular year.

d. Section 4943. Section 4943 limits the foundation's ability to hold more than 20 percent of an active business, when combined with the interests of H&W and their family. This provision is usually no more of a problem for a socially active foundation than for any other private foundation.

e. Section 4944. Section 4944 requires that any investments that the foundation makes either qualify as prudent investments or as a PRI. H&W should understand how PRIs work. Most of the PRIs that H&W will suggest to counsel over the years won't be covered by the basic examples in the section 4944 regulations. H&W foundation and legal counsel will need to work together to structure PRIs that work from a business, charitable, and tax law standpoint. As a basic matter, however, the attorney can explain to H&W that an investment must meet three requirements to qualify as a PRI:

- the primary purpose of the investment must be to accomplish an exempt purpose;
- the production of income or the appreciation of property may not be a significant purpose of the investment; and
- no electioneering and only limited lobbying purposes may be served by the investment.

Assuming that H&W are not interested in lobbying or political activity, the attorney will want to explain the first two requirements. This will be important to H&W, who are likely to do much of their work through PRIs.

To satisfy the primary purpose test, the investment, whether it is a loan or equity, must significantly further the foundation's exempt activities. Second, the investment must be such that it would not have been made but for its relationship to the foundation's exempt activities. The PRI recipient can be noncharitable so long as the purposes of the investment are within section 170(c)(2)(B).[2] How can H&W understand when an activity, particularly a loan or investment in an enterprise that is not a 501(c)(3) or foreign equivalent, significantly furthers the foundation's exempt purposes? To H&W, anything they propose furthers the foundation's purposes, or they would not propose it.

The somewhat dated regulations contain 10 examples of investments involving noncharitable recipients, 9 of which qualify as PRIs. In the first five examples, private foundations that loan funds to business enterprises to increase economic opportunities for minority or low-income persons and prevent community deterioration are described as making PRIs.[3]

The IRS has ruled in at least one private letter ruling that a foundation's investment in a for-profit business

[2]Reg. section 53.4944-3(a)(2)(i).
[3]Reg. section 53.4944-3(b), examples 1 through 5.

enterprise still met the primary exempt purpose test and qualified as a PRI.[4] Although the foundation operated ''much like a venture capital organization,'' its equity investment was intended to encourage the creation of jobs and economic development in underdeveloped and disadvantaged areas, and therefore it furthered charitable purposes.

In other rulings, the IRS has approved section 501(c)(3) status for organizations formed to make low-cost or long-term loans to business enterprises to combat community deterioration in economically depressed areas, demonstrating that loans to businesses may serve a charitable purpose in the nonprivate foundation context.[5]

Similarly, the IRS has treated as PRIs loans made to taxable nonprofit mutual benefit or cooperative corporations controlled by member charities, even though the services provided by the borrowers were not inherently charitable. For example, the IRS approved as a PRI a loan to a noncharitable cooperative organization that provided communication technology and related services to member nonprofits at the lowest possible cost, enabling its section 501(c)(3) members to use their charitable funds more efficiently.[6]

In other instances, the IRS has ruled that a charity may promote charitable purposes through activities that are not themselves inherently charitable.[7] And, of course, assisting in the administration and operations of charitable entities is also a proper PRI activity.[8] Some of the activities that H&W propose may be similar to these examples, but some may not.

No significant purpose of the investment can be the production of income or the appreciation of property. This requirement can be particularly confusing to social entrepreneurs who anticipate a double-bottom-line investment that does good while making money.

The regulations point out that the IRS will consider whether investors solely concerned with profit would be likely to make the investment on the same terms. However, that an investment produces significant income or capital appreciation is not, in the absence of other factors, conclusive evidence that income or appreciation was a significant purpose of the investment,[9] and it therefore does not preclude the investment from being a valid PRI.

Example 3 of reg. section 53.4944-3(b) discusses a situation in which a private foundation purchases shares of common stock in a business enterprise on the same footing as other stockholders. It concludes that ''the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.''

Following that example, the IRS has approved PRIs consisting of the purchase of shares of common stock in for-profit corporations on the same terms as would apply to commercial investors. In LTR 8549039, a private foundation was permitted to purchase voting stock in a private company formed to transform a blighted area into a marketplace. The corporation sought to raise a minimum of $15.5 million, with minimum subscription amounts of $100,000. The IRS recognized that it was a civic investment and that the corporation's failure to raise the necessary capital would end the entire endeavor. The IRS found that the investment in corporate stock was ''quite speculative'' and provided ''no assurance that it will result in the return of a stockholder's capital investment,'' and it concluded that the foundation's desire to invest was ''motivated by . . . charitable purposes, and not by any significant expectations of economic gain.''

In LTR 199943944, a foundation provided seed money to start-up businesses to promote economic development in underdeveloped and disadvantaged areas. The foundation's criteria for selecting its investments required that each project be based in a depressed economic area with high unemployment and have the potential for creating quality employment for underemployed and unemployed individuals. The for-profit business in which the foundation invested signed a written agreement requiring that a percentage of its employees be members of the previously unemployed or underemployed targeted group. The IRS found that the foundation's equity investment in the business was intended to promote economic development and create jobs, and the fact that the investment might be profitable did not affect its charitable nature.

In LTR 200136026, a private foundation proposed to invest in a for-profit corporation formed to finance and promote the expansion of environmentally oriented businesses that would contribute to conservation and economic development in economically or environmentally sensitive areas. The corporation had dual goals of providing a rate of return for investors and demonstrating a clear environmental benefit through each investment. Only companies that met environmental guidelines were eligible for investment. The corporation also created an advisory committee to scrunitize each investment that included representatives of public charities interested in preserving the environment. The foundation represented that the rate of return alone would not compensate for the speculative nature of the investment and overall risk associated with the corporation's unique investment characteristics. The IRS determined that although the foundation expected a financial return, the investment was made directly to accomplish the foundation's charitable goals and thus qualified as a PRI.

Several other private letter rulings have approved PRIs in which noncharitable organizations were also investing on the same terms. In LTR 8710076, a $10

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[4]LTR 199943044.

[5]Rev. Rul. 74-587, 1974-2 C.B. 162; Rev. Rul. 81-284, 1981-2 C.B. 130.

[6]LTR 8445096.

[7]*See, e.g.*, reg. section 53.4944-3(b), Example 10 (financing the construction of housing for low-income families is a charitable activity, although building houses is not inherently charitable); *accord*, LTR 8923071; LTR 8728053 (financing the construction of a research center for an exempt organization is a charitable activity, although research is not inherently charitable).

[8]*See, e.g.*, Rev. Rul. 67-149, 1967-1 C.B. 133 (providing financial assistance to section 501(c)(3) organizations by receiving and disbursing income on their behalf is an exempt activity); LTR 8708067 (lending money to an exempt organization to create an endowment for it is a section 170(c)(2)(B) charitable purpose).

[9]Reg. section 53.4944-3(a)(2)(iii).

million limited partnership was established with a taxable general partner, and limited partnership interests were offered to a small group of private foundations and private individuals. The limited partnership was created to go beyond informational services and to provide financial support to actual enterprises seeking to demonstrate that privatization of human services is a viable concept. A private foundation's $600,000 investment in the partnership was approved by the IRS as a PRI.[10] PRI loans to for-profit limited partnerships are also a common mechanism for private foundations to support low-income housing and economic development in blighted areas.[11]

H&W must be willing to have each PRI independently reviewed by the foundation's program staff and by legal counsel. The process can be cumbersome but is necessary for this level of activity.

f. Section 4945. Section 4945 limits the ability of the foundation to make distributions to individuals and to organizations other than public charities. If the foundation wants to make grants to individuals for scholarships or fellowships in the form of prizes and awards or for specific projects, it will need to have the IRS preapprove those grantmaking procedures under section 4945(g).

If the H&W foundation wants to make grants, loans, or equity investments in organizations that are not public charities or that are not the foreign equivalent of a U.S. public charity, it must exercise expenditure responsibility, which requires adequate staffing to review and monitor the projects. Basically, expenditure responsibility requires (1) a pregrant inquiry, (2) an appropriate written grant agreement, (3) grantee reporting to the grantor, (4) reporting of the grant on Form 990-PF, and (5) follow-up with the grantee if the grantee fails to use the funds correctly. The attorney should explain to H&W that many foundations engage in expenditure responsibility grants, but they must follow the rules. Sometimes entrepreneurial funders want to give their grantees maximum latitude to carry out their programs without the burden of cumbersome reporting and other limitations. H&W have to understand upfront what they are getting into.

B. S.E.

S.E. is a true social entrepreneur. She knows what she wants to do, but does not know how to fund her vision. Her primary concern should be what type of entity to establish to maximize her ability to accept money and to operate without restrictions.

1. Gathering Information

To what extent does S.E. plan to solicit private equity versus grants? If S.E. intends to raise charitable contributions, she must form a 501(c)(3) charity. If S.E. intends to seek private equity, she will need a for-profit vehicle. If she is interested in both charitable contributions and equity investments, she may have to consider a hybrid vehicle involving both a charity and a for-profit, although U.S. law is not particularly amenable to this combination. Because there is no true hybrid vehicle available in the United States, she would have to set up two organizations that would operate side by side, while avoiding potential state law self-dealing issues and excess benefit issues under the code. For wealthy individuals such as H&W, operating a for-profit and a charity side by side can be less burdensome because the for-profit could provide the charity office space and personnel without the need for reimbursement. For S.E. it may not be financially feasible for a struggling for-profit to subsidize a charity, and there may be potential cost-sharing problems related to joint operations. These issues can generate potential excess benefits under section 4958 if not handled properly.

Are S.E.'s proposed projects consistent with section 501(c)(3)? We need more facts. The attorney must get a specific charitable/business plan from S.E. The attorney does not want section 501(c)(3) to limit S.E.'s vision, and S.E. should understand what she can and cannot do within a section 501(c)(3) entity.

The attorney explains to S.E. that under section 501(c)(3), to qualify as a tax-exempt charitable organization, an entity must be organized and operated for one or more of the exempt purposes listed in section 501(c)(3), and it must refrain from inurement, electioneering, and substantial lobbying.

The attorney explains to S.E. that her charity will satisfy the organizational test because its articles of incorporation or certificate of incorporation will contain all the necessary language and none of the prohibited language. The attorney then learns that S.E. is not interested in lobbying or political activity or in any private benefit, private inurement, or excess benefit transactions. We are left with the operational test of section 501(c)(3).

Section 501(c)(3), taken literally, requires an organization to be operated *exclusively* for exempt purposes. The regulations, however, add some flexibility to what is known as the operational test. They make clear that a charity may qualify as such if it is operated *primarily* for exempt purposes. An insubstantial part of the charity's activity may be devoted to nonexempt purposes.[12] Thus, a charity may operate a trade or business whose conduct is not related to the achievement of its exempt purposes without losing its charitable status under the tax law.

What makes the operational test especially challenging is that there is no single legal standard for whether an activity is consistent with section 501(c)(3)'s operational test. The law has evolved different rules and different tests for different types of activities, particularly revenue-generating activities. In analyzing whether an income-generating activity is an appropriate exempt activity, the IRS and courts have examined a variety of factors, many of which ultimately result in a test: Does the activity appear more like a commercial or an exempt activity? As

[10] *See also* LTR 9016078 (purchase of a large equity interest in a holding company affiliated with a for-profit enterprise, to develop business in a depressed area) and LTR 8807048 (investment in construction of low-income housing, accomplished through limited partnerships with for-profit corporations).

[11] *See, e.g.*, LTRs 9112013, 8923070, 8923071, and 8637120.

[12] Reg. section 1.501.(c)(3)-1(c)(1).

the U.S. district court recently said, does the activity have a ''commercial hue''? (*Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C 2003).)

The attorney would explain to S.E. that the more an activity fits within the realm of activities that have traditionally been recognized as charitable, the more likely the activity is to generate exempt income. The less the activity resembles a traditional charitable endeavor, the more scrutiny the IRS will apply. For example, it is relatively easy for hospitals, schools, and activities that have traditionally been exempt to qualify for exemption as long as they do not improperly benefit insiders, do not discriminate, and provide an appropriate level of service to those who cannot afford to pay. On the other hand, the tests are more difficult to satisfy in areas such as publishing, fee-based management, or consulting services.

Most of the projects that S.E. is proposing are likely to be ''charitable.'' Going back to basics, the regulations tell us that the term ''charitable,'' as used in section 501(c)(3) in its generally accepted legal sense, can include activities that might also be described as educational, religious, or scientific. The term includes: (1) relief of the poor and distressed or of the underprivileged; (2) advancement of religion; (3) advancement of education or science; (4) erection or maintenance of public buildings, monuments, or works; (5) lessening of the burdens of government; and (6) promotion of social welfare by organizations designed to accomplish any of the above purposes or to: (a) lessen neighborhood tensions; (b) eliminate prejudice and discrimination; (c) defend human and civil rights secured by law; or (d) combat community deterioration and juvenile delinquency.

To fit within the established rules of section 501(c)(3), S.E.'s activities would have to aid the poor and distressed by providing needed medical and technology items at a substantial discount, probably below cost. Based on S.E.'s goals, it should be possible for her activities to qualify as charitable under section 501(c)(3). Because she wants to provide medical equipment and vaccines to the poor for free or substantially below cost, this is a fairly easy analysis.

Are any of S.E.'s activities outside the scope of section 501(c)(3)? S.E. said she was considering selling some of her products at market value to middle-income or wealthy individuals in the U.S. to subsidize her other activities. It is important to explore with S.E. the extent and scope of these noncharitable activities. The attorney should explain that any section 501(c) organization with unrelated business income (UBI) pays unrelated business income tax on that income at the regular corporate tax rates.[13] Sometimes an entrepreneur with a great idea wants to sell an item at a deeply discounted rate to the poor and distressed but then sell the same item at market rates to individuals who can afford them. The latter activity may be unrelated; it is not enough that the market sales will bring income to support the below-market sales.

A section 501(c) organization generates UBI when it recognizes net income from a trade or business that is regularly carried on and that is not substantially related to the organization's exempt purpose. Selling medical devices to middle-income and wealthy persons at market value will normally generate UBIT.

None of the typical UBIT exceptions is likely to apply to S.E.'s market value income. Under the UBIT rules, income that otherwise is subject to UBIT is excepted from UBIT if:

- the income is interest income, dividends, and annuities (section 512(b)(1));
- the income is from royalties (section 512(b)(2));
- the income is from rents derived primarily from real estate and a limited amount of personal property leased with the real estate (section 512(b)(3));
- the income is from the sale of capital assets (section 512(b)(5));
- the income-generating activity is conducted for the convenience of members, students, patients, or employees (section 513(a)(2)). (This exception typically applies to venues such as college bookstores or museum or school cafeterias);
- the income-generating activities are conducted entirely by volunteers (section 513(a)(1));
- the income is from the sale of donated merchandise (section 513(a)(3)); or
- the income is qualified corporate sponsorship payments (section 513(i)).

How much of S.E.'s activity is likely to generate UBIT? The attorney explains to S.E. that organizations must have a core activity that is exempt in nature. If an organization operates a legitimate exempt activity, it may also operate even a substantial unrelated trade or business without losing its exempt status as long as its primary purpose and activity is exempt (reg. section 1.501(c)(3)-1(e)).

If an organization operates a core exempt activity, how do we know the amount of unrelated activity that is permitted? Organizations are sometimes concerned that if they generate too much money from an unrelated business activity, they will lose their exemption as described under section 501(c)(3). Organizations sometimes say they believed that if their UBI exceeds a percentage, such as 25 percent or 33 percent, they will automatically lose their exemption. The good news is that there is no automatic percentage rule.

Rev. Rul. 64-182, 1964-1 (part 2) C.B. 186, sets forth the ''commensurate in scope'' test, which is still followed today. This ruling stands for the principle that an organization may receive a significant amount of UBI (whether taxable or nontaxable under an exception) as long as it carries out charitable programs that are commensurate in scope with its financial resources. In that ruling, the organization presumably received 100 percent of its income from renting real estate, but it engaged in grant-making activities that were commensurate in scope with its financial resources.

Other rulings expand on this concept to suggest that we do not look entirely at the percentage of income from an unrelated activity, but at the full scope of operations of the charity. How much time is the charity spending on its

[13]Section 511.

exempt activities in relation to the time it is spending on generating income from investments and nonexempt activities? [14]

A leading treatise on the taxation of exempt organizations explains the test well:

> If the tax-exempt organization carries on one or more activities that further exempt purposes, such as operating a museum, hospital, school . . . and also conducts a clearly commercial activity, such as operating a restaurant, a determination must be made as to whether the effort expended to carry out exempt purposes is commensurate in scope with the organization's financial resources. This requires an evaluation of the time and effort undertaken by the organization in the conduct of the exempt activity or program, the impact of the exempt activity or programs, how the organization holds itself out to the public, and the use of net after-tax UBI. (Footnotes omitted)[15]

As a practical matter, if it is a close call as to whether an unrelated activity is beginning to overshadow the exempt purposes and activities of the organization, the attorney would likely recommend dropping the business activity into another organization, usually a for-profit corporation.

2. The Solution

Eventually it becomes clear that S.E. really has no plan to sell anything at market value and wants to focus on her charitable mission; she just wants to keep the market value option open. Because she wants to obtain charitable contributions and grants to get started, in hopes of becoming self-sustaining at some point, she will need to establish a section 501(c)(3) public charity or she will need to find a very accommodating existing charity to work with her.

S.E. will find that matters become more complex when she begins to work abroad because she must check the local laws of each area in which she plans to distribute medical aid. She may have to work with local charities or set up her own organizations in different countries. She may find hurdles in transferring currency abroad and in working within nations that the U.S. government considers hostile. There are a number of nontax issues she must consider.

3. Consequences of Success

If S.E. does decide to move forward with her market-level sales of medical devices to the middle- and high-income, she then must consider whether to carry out this unrelated business activity within her charity or whether to establish a for-profit entity to carry out the activity. The attorney should review at least two options with S.E.: keeping the activity within her charity or forming a new subsidiary.

a. Option A: Keeping the unrelated activity within the existing charity

Keeping the unrelated activity within S.E.'s existing charity has at least two advantages:

- Business activities can freely use the charity's name and goodwill, as well as tangible assets and human resources, without the complexity of entering into licensing, rental, or resource sharing agreements between two entities.
- If S.E. terminates the business activities, any appreciated assets used in those activities belong to the charity.

The option also has potential disadvantages:

- If the charity already has substantial UBI, and new activities will be so substantial that exempt activities of the charity appear secondary to the unrelated activities, the charity's exempt status will be in jeopardy.
- The taxable activity may appear inappropriate for the charity from a public relations standpoint.
- Any potential liabilities associated with new activities will be liabilities of the charity.

b. Option B: Forming a subsidiary

The advantages of forming a for-profit corporate subsidiary are as follows:

- If properly implemented, it eliminates the risk to the charity's exempt status.
- The subsidiary enables S.E. to raise funds from outside investors.
- This option eliminates possible confusion in the public eye concerning the charity and its activities.
- If properly structured and operated, this option provides insulation from liabilities arising from new activities that are now localized in the subsidiary.
- Dividends received from the subsidiary are not taxable as UBI (although dividends are also not deductible by the subsidiary).

The following are disadvantages of a separate subsidiary:

- Because these market-rate activities are unrelated to the charity's exempt purposes, investment in the new corporation must satisfy a prudent investment standard. This must be a sensible use of the charity's resources.
- There are greater start-up and ongoing expenses in maintaining two separate corporations.
- If the charity owns more than 50 percent of the subsidiary, any income from rents, royalties, or interest from the subsidiary to the charity will result in UBIT.
- On eventual dissolution of the subsidiary, transfer of any appreciated assets to the charity will constitute a deemed sale of the assets, taxable at the subsidiary level.

There are, of course, other practical and legal issues that must be addressed before the charity would establish a subsidiary. In the end, the attorney will likely advise S.E. to begin a new section 501(c)(3) public charity. If she decides she needs outside investors to operate an

[14] *See* LTR 200021056 (this ruling reached the correct result through some unusual reasoning); *see also* TAM 9711003 (charity retained exemption when 95 percent of its income was UBI); *see also* LTR 8038004.

[15] *Taxation of Exempt Organizations*, Hill and Mancino, Warren, Gorham & Lamont of RIA, pp. 21-17 through 21-18, updated regularly.

unrelated activity that will be significant in size compared to her charitable activities, she might consider a subsidiary.

Ultimately, though, the hybrid entity that S.E. dreams about, an entity that could receive grants and also have investors, does not exist under U.S. law.

IV. Changing the Law

There is no single or perfect way to form a social enterprise or to fund a social enterprise under U.S. law. It can be cumbersome to design a social enterprise under the dense and unaccommodating passages of the code. And because of abuses, both actual and perceived, in the charitable sector, Congress seems more intent recently on curbing the ability of charities to operate (see, for example, the Pension Protection Act of 2006) than on trying to accommodate new approaches.

Typically, when Congress wants to encourage community development and social enterprise, it does so by enacting limited tax credits such as the low-income housing tax credit (section 42) and the new markets tax credit (section 45D). These credits are good vehicles to encourage for-profit institutions to invest in housing or other community development projects. Low-income housing and new market tax credit transactions are, arguably, a form of social enterprise, but they are limited in scope, amount, and flexibility. The rigidity of state nonprofit laws coupled with a code that is better suited to traditional philanthropy than to cutting-edge ideas makes it difficult for social entrepreneurs and social enterprises to work as effectively as they could in the United States.

In the United Kingdom, the law tried to accommodate social enterprise. The community interest company (CIC) is a new type of legal entity established by the U.K. government as part of the Companies (Audit, Investigations and Community Enterprise) Act of 2004, which became effective July 1, 2005. CICs are created specifically to benefit social enterprises. For more information, see http://www.cicregulator.gov.uk.

CICs are limited companies under U.K. law, a form that is already familiar to U.K. investors and legal counsel. However, a CIC must include the words ''Community Interest Company,'' ''CIC,'' or ''Community Interest Public Limited Company'' in its title, presumably so its status is clear to the public.

A CIC must apply for CIC status from the government by satisfying a broad community interest test. Its purposes and activities must be such that a reasonable person might consider them to be carried on for the benefit of the community. The community served by the CIC does not have to be located in the U.K, suggesting that a CIC might even be a tool that a U.S. social entrepreneur might consider.

As with a typical U.S. public benefit corporation, the underlying assets of a CIC are subject to an ''asset lock.'' They are permanently dedicated to community and/or charitable purposes. This way, socially motivated investors can have greater confidence that their investment will not be used for unintended purposes. Unlike public benefit corporations, however, a CIC may pay dividends to its shareholders, subject to a dividend cap. The dividend option allows investors to receive some return on capital, even though they will never receive their original investment back.

The CIC does pay taxes on its income, and investors do not receive a contribution deduction for contributions to a CIC, which may make CICs less useful than they otherwise might be.

The United States might also consider adopting a new form of entity that allows for private investment with a social benefit purpose. For example, consider a new type of section 501 organization with the following characteristics:

- The entity would be formed as a nonprofit corporation with members, under state law.
- Members could receive limited current income in the form of dividends, which could be capped.
- Memberships could be transferable.
- Members would have no right to a return of their initial investment, which would be forever dedicated to public or social benefit purposes.
- Because the purposes of the entity go beyond that which section 501(c)(3) permits, the members would not be entitled to a charitable contribution deduction.
- As with a 501(c)(4) social welfare organization, the income of the organization would be tax-exempt, although members would pay taxes on dividends. In this way, the U.S. model could differ from the U.K. model, which is subject to tax.
- The assets would be limited to public benefit and social benefit purposes, but not subject to all of the current 501(c)(3) limitations.
- There would be clear prohibitions on self-dealing and excess benefit transactions.
- The entity would have to be eligible to receive private foundation grants and PRIs.

Of course, there are many ways to change the laws to establish new forms of hybrid entities. To be credible, those entities would have to contain strict prohibitions on any excess benefits to insiders. There is already much discussion and speculation about whether it's time for a new hybrid entity. I for one believe the time has come!