CLIMBING THE ENTREPRENEURIAL LADDER

FIRST STEPS FOR THE NONPROFIT ORGANIZATION

Brad Caftel

SUMMARY

Many nonprofit organizations have devoted considerable time and energy to develop businesses that will earn profits, meet the needs of their client constituencies, or both. Such an approach can also make a meaningful contribution to overhead, thereby reducing dependency on grants. An entrepreneurial approach can have a positive impact on employment opportunities, management experience, cash flow, and dollar circulation within a low-income community. This article offers guidelines on planning the successful business.

Nonprofits have successfully started fee-for-service, businesses in such widely varied fields as publications, food services, sub-contracting, subassembly, laundromat, furniture manufacturing, health care, and property rehabilitation and management

Although many are successful, even the successful businesses are not funding panaceas. Nonprofits do not become "self-sufficient" from their businesses—nor should they be expected to. They must still rely on grants, fundraising and other non-business income.

Entrepreneurship is not a science. If an exact outline or cookie-cutter approach could be prescribed, the success rate of start-up businesses in the nonprofit and private sectors would be higher than the estimated 15 percent. Entrepreneurship places a high value on insight, imagination, and willingness to take risk. The quality of the management is often more important than the details of the business. The quality of the planning often distinguishes the successful businesses from those which do not meet expectations.

Despite the complexity of factors which make for successful businesses by nonprofits, some issues and broad themes are common: adequate attention to organizational development, appropriate opportunity identification, realistic feasibility studies and business plans, and adequate monitoring systems. This article focuses on organizational issues and processes for identifying business opportunities. For more information on the entire business development process, including legal, financing, and business planning issues, see the Law Center's three-volume series *Community Economic Development Strategies: Creating Successful Businesses*, or the new one-volume *Taking the Entrepreneurial Approach: A Resource Guide For Nonprofits*.

Entrepreneurship starts with the nonprofit organization's board of directors. Staff efforts at business planning are often wasted if they occur before board policy approval. The board should approve, typically by resolution, the concept of exploring business development before it examines specific business projects. Information on nonprofit business development might be distributed before the board meeting. These materials should describe the business development process, and the role of the board in that process.

The chart below describes the business development process that many nonprofits have successfully used. The process is viewed as a funnel with a series of screens. Opportunities flow into the funnel and are screened out by both an organizational analysis and a business feasibility analysis. Those few opportunities which meet organizational goals as well as generally

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Planning For Success

Internal Feasibility

External Feasibility

Business Planning

Structuring/Negotiating/Financing

Monitoring/Managing

Exit

accepted business standards are further analyzed by a business plan. Business plans which are convincing and realistic can be used to obtain financing and to establish monitoring standards. At the end of the funnel is "exit". Many businesses achieve their major positive financial impact when they are sold, refinanced, or attract other investors. If a nonprofit expects to exit a business, it should plan its exit at the time it plans its entrance.

The major difference between nonprofit and private sector business development is that the nonprofit enterprise is aimed at strengthening an institution with a charitable purpose. Its goals and values are expressed in its venture selection criteria (internal feasibility). Venture selection criteria guide the nonprofit as it looks for business opportunities compatible with its goals, and they provide a mechanism for quickly screening out those opportunities which are not consistent with its purposes for engaging in business development.

In other respects, nonprofit business development is very much like that of the private sector. Both face constraints of funding, technical skills, and experience; both face opportunities. Initially, a nonprofit may find that most opportunities do not meet its goals or are not feasible as businesses. For several months, the business development process may yield no results. This does not indicate failure. It is a natural part of the process of careful selection. It is estimated that private investment firms examine 75 to 100 opportunities in order to close three to five deals.

Avoiding the Pitfalls

Once the board understands the business development process, it might discuss the general strategic errors which other nonprofits—and in some cases the private sector—have made in their business planning.

- **The business development process can be time consuming.** Staff time must be committed, thus diverting staff from its other responsibilities. If staff cannot be freed from some of those responsibilities, a pre-development grant may be needed for a consultant or for temporary staff. Often, just as much time is needed to develop a small business as a large one.
- **Business development involves risk and possible business failure, although the experiences of other nonprofits can be drawn on to reduce risk.** The business process is not like the grant process. Grants are reactive, in which the funder determines what is needed, who is to be served and, often, how to serve them. Line item budgets leave little room for discretion. In a business, the nonprofit decides what to do and how to do it, and must react to changed circumstances. This requires a "mental shift" which not all nonprofits successfully make.
- **Nonprofits often confuse community need with market or demand.** The day-to-day activity of most nonprofits involves dealing with unmet human need. Businesses also focus on needs, but define them in terms of the price people will pay to have their needs met. Although a need exists, people may not be willing or able to pay enough to have that need met. Thus, not all unmet needs lead to good business opportunities. Many nonprofits overestimate the size of the market for particular goods or services because they focus on need rather than market demand.
- **Nonprofit businesses sometimes have too many goals.** In the private sector, earning a profit is the single most important goal. Nonprofits often attempt to accomplish more than is possible from a single business. They may seek to earn a profit, train employees, sell goods and services at an affordable price, meet a community

need, and build the nonprofit's asset base. Sometimes, the goals for a business are not clearly identified, and sometimes a business is inappropriate for the nonprofit's goals. For example, a nonprofit with employment and profitability goals should not expect that an affordable housing project will meet those goals. Nonprofits which are clear about their goals and aware that trade-offs are often necessary have found it possible to develop businesses that meet social goals while earning a profit.

• **Nonprofits often have a one-year funding mentality and insufficient working capital.** Businesses are not like the twelve month grant cycle for accomplishment of all results. Although businesses operate on cycles and have annual profit or sales goals, profitability might not be achieved immediately. Some businesses achieve break-even or profitability within the first year, but until then they will operate at a loss. Many nonprofits, accustomed to balanced budgets, are uncomfortable with this period of slow growth. Until the business covers its expenses from sales, working capital is needed. Most grant sources do not allow for working capital, and the concept is new to some nonprofits. Under-estimating working capital needs is a major reason for business failure.

• **Nonprofits often have unrealistic profit expectations.** Business profits generally average 7-10% of gross sales, less than commonly thought. To earn $10,000, a business needs $100,000 or more in sales. Profits which adequately support a self-employed person might not be enough to meaningfully contribute to a nonprofit's budget. It is important to identify businesses which can meet the nonprofit's financial goals.

• **Skilled management is critical to business success.** The most common causes of business failure are poor planning and poor management of matters within a manager's control. Private investment firms base their decisions more on the quality of management than on the product or service being sold. Likewise, nonprofit business success may depend more on management than on product or service. For nonprofits, the appropriate business manager may be very different from anyone else they have ever hired. Many nonprofits use the same recruitment, evaluation, and compensation systems for business managers as for their other personnel. Often, this does not work, for business management requires a different set of skills. A key feasibility issue is whether the nonprofit has or can hire an appropriate manager for the business.

• **Nonprofits sometimes do not resolve their disagreement over values, or even realize they have a disagreement.** It is easy to agree on "let's do a business and raise money." It may be less easy to agree on whether to charge market rates and to sell to anyone; whether to charge low-income persons at all; whether to adopt different wage scales for business staff and to hire and fire business staff like the private sector; whether to compete with the private sector; and whether it is "moral" to make a profit. These issues should be discussed and resolved early in the planning process.

• **Nonprofits sometimes rely too heavily on business plans prepared by outsiders or on other inappropriate technical assistance.** The staff that will be responsible for running the business should be fully involved in its planning. A consultant might be asked to provide specialized information when the need and expected results are clearly understood.

• **Nonprofits sometimes over-plan in response to the warning about the need for careful planning.** Once venture selection criteria are adopted, each opportunity can be quickly analyzed to determine its suitability and initial feasibility.

Forming a Venture Committee

Once it understands the business development process and the typical errors made, if the board desires to proceed, it is often helpful to establish a committee. The committee might include non-board members who bring added skills or expertise in business development.

The committee's first task is often to review a staff-prepared draft of venture selection criteria, or it might draft the criteria itself for presentation to and approval by the board of directors. The criteria might include statements concerning:

1. The relationship of the business to the nonprofit's mission.
2. How much profit is expected and by when.
3. How much money is available for investment in the business.
4. What type of business is preferred, if any (retail, service, wholesale, manufacturing, subassembly, real estate).
5. What stage of business is preferred, if any (start-up, buyout, co-ownership in business expansion).
6. Employment and training impacts (number of jobs, entry level, type of employee such as youth, women, elderly).
7. Willingness to co-own rather than to completely own the business.
8. Whether the business must be located in a particular neighborhood.
9. The desired impact on the community (for example, possible subcontracts with local business, community image, environmental soundness).

The venture selection criteria should be both idealistic and realistic. Businesses that meet goals which are set too low may do little for the nonprofit. If goals are set too high, all business opportunities might be eliminated. With experience and learning, the need to amend the criteria may become clear.

At this point, the board has learned about the business development process, made a commitment to go forward and allocated staff resources to the planning, formed a committee, discussed its values and goals, and approved a list of criteria. The next step involves a staff/committee/board listing of venture opportunities.

Characteristics of Successful Nonprofit Businesses

Nonprofits can pursue any business opportunity available to the private sector. Some businesses, however, appear to work for nonprofits while others tend not do so well. In general, nonprofits have not been successful with the kinds of businesses which, in the private sector, are managed by the owner. Nonprofits are always absentee owners with hired managers. Owner/manager businesses often require long working hours, are cash businesses with control problems, and have profit margins too low for both hiring a manager and returning profits to the owner. Most small retail stores fall under this category.

Nonprofits have had more success with businesses which in the private sector are managed by hired managers, especially those that are highly regulated. Many service businesses have this characteristic, including children's, elderly, mental health and transportation services.

Another characteristic of successful nonprofit businesses is that they are often highly structured and formal, with a considerable amount of published information available about them. This includes fast food, restaurant, and other franchises; coin-operated laundromats; and real estate. The systems required to operate such businesses are well understood and documented.

One other characteristic of successful nonprofit businesses is that they are often linked to a "captured," or low competition market. This includes sub-assembly and subcontract businesses in which the nonprofit provides services to one or two prime customers who guarantee a minimum level of work.

Some current trends in nonprofit business development are based on the "captured market" approach. In communities with a major institution such as a hospital, university, airport, power authority, military base, or dominant corporation, nonprofits have looked for business opportunities to supply the institution with a needed product or service. In communities with major development activities that involve public funds, nonprofits have looked for opportunities to participate.

Opportunities also come from analyzing spending patterns and identifying ways in which money can be captured before leaving a community. For example, must certain products or services be purchased from businesses located outside the community? Can the nonprofit successfully capture enough of this spending?

Finally, successful nonprofit businesses often build on what the nonprofit organization knows and does best. Such businesses use existing staff and assets, and can be identified by analyzing these resources. They often have a short start-up time, involve little capital investment, are low risk, produce quick returns, and involve the same market as the nonprofit's other activities. They tend not to generate large profits, but they do cover some of the nonprofit's overhead costs. Examples include becoming a paid fiscal agent, selling bookkeeping or management services, preparing and selling publications, renting excess space or equipment, and selling program services on a fee-for-service basis.

After analyzing opportunities for their "fit" with the venture selection criteria, the committee can present to the board those opportunities which it recommends for business feasibility analysis. In following this process, the nonprofit has separated its social and business goals, while keeping both in mind when making its decisions. This places businesses in their appropriate place as a tool that nonprofits can use to achieve their broader goals. ■

HYPOTHETICAL

LEGAL STRUCTURE ISSUES IN DEVELOPING NEW BUSINESSES

Anywhere Community Development Corporation (ACDC) is a nonprofit, tax-exempt corporation that provides child care, employment training, and meals programs to the low-income residents of Anywhere, U.S.A.

ACDC has raised $100,000 from individual contributions for a down payment on the purchase of a community building. It is considering the purchase of an 8,000-square-foot building for $500,000. The remaining $400,000 will come from owner financing at 10% for 15 years.

ACDC will use 4,000 square feet of the new building. The remainder of the space will be rented out. ACDC has identified several potential tenants, including its own business ventures (described below), other nonprofit organizations, and local small businesses.

The building comes equipped with kitchen facilities. ACDC is considering an expansion of its meals operations, perhaps by adding a catering operation. However, its analysis shows the need for $50,000 in additional equipment, inventory, and working capital. Also, no current staff member has catering experience.

ACDC has $25,000 unrestricted cash. It is considering making a $5,000 investment for bonding and equipment for a start-up janitorial maintenance business. The business is an outgrowth of its employment training program. The business would employ one permanent manager who will utilize several trainees on an as-needed, per-job basis. As trainees find other employment, new trainees are hired. The business will contract with government agencies like the public library and with private businesses. Some contracts are sole source, some are competitively bid. The business will charge market rates (cost plus).

ACDC is also considering providing day care on a sliding scale fee basis each weekday both before and after its government-subsidized child care activities. Charges will be set at cost for low-income families, rising to prevailing market rates for others. ACDC estimates that 50% of the children served will be from low-income families. Profits from the fees charged to other families will be used to expand ACDC's child care and other social service activities.

ACDC is concerned about preserving its tax status, protecting itself and its assets from liability, and promoting opportunities for diversifying income and raising new revenues to support additional businesses. It asks for a response to the following questions:

1. a. Should the community building be owned by a separate corporation? For-profit or nonprofit? What are the factors involved in reaching a decision?

   b. Should the catering, janitorial maintenance, and/or day care businesses be separately incorporated? How many corporations? For-profit or nonprofit? What are the factors involved in reaching a decision?

2. If ACDC forms more than one separate corporation, what is their appropriate corporate structure? What are the factors involved in reaching a decision?

3. How can ACDC insure that a separate corporation will be treated as a separate legal entity?

4. What board structure should ACDC adopt for its separate corporations?

5. Some of ACDC's employees will spend time on one or more of the businesses. Assuming a business is separately incorporated, what staffing options are available, and what are the advantages/disadvantages of each?

6. How is income earned by a separate corporation transferred to ACDC? How is such income treated by ACDC?

7. What is the responsibility of the ACDC Board of Directors in making decisions concerning these activities? What liability do they face, and how can they protect themselves from liability?

Business Activities of Non-Profit Organizations

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INSIGHT
Center for Community Economic Development

Helping People and Communities Become and Remain Economically Secure

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Introduction: Insight Center

The Insight Center for Community Economic Development (formerly NEDLC) is a national research, consulting, and legal organization that develops and promotes innovative solutions that help people and communities become, and remain, economically secure.

Insight Center Program Areas

Economic Security
Savings and Asset Building
Early Care and Education
Workforce Development
Legal Services

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501(c)(3)'s –The Three Major Principles

- Organized and operated exclusively for charitable purposes
- Activities do not benefit any private person or interest

unless the private benefit is incidental to an organization's exercise of its charitable activities

- Assets are irrevocably dedicated to charitable purposes

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Basic Concept - Charitable Purposes

Rule: Organized and operated exclusively for charitable (exempt) purposes

- Every organization has one or more charitable purposes
- Business activity can further charitable purposes if substantially related to accomplishing such purposes
- The organization may engage in activities unrelated to its charitable purpose only if the unrelated activities are insubstantial in relation to its total activities

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Substantially Related

- An activity is related to exempt purposes only when the activity has a substantial, causal relationship to achieving the organization's exempt purposes.
- Activities must contribute importantly to accomplishing the organization's exempt purposes to be substantially related.
- To be exempt, an income-producing activity must be of a size and extent reasonably in proportion to its contribution.

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Social Purpose Ventures

- Business-like activities that qualify as charitable and tax exempt because they are related to an organization's exempt purpose and conducted in a manner that includes a charitable aspect.

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Identifying Social Purpose Ventures

Does it operate like and compete with commercial businesses?

Does it have a "donative element"?

- Fees/prices charged to members of charitable class are subsidized
- Primary purpose
  - Job training for disadvantaged vs. income generation
- Scale
  - No larger than reasonably necessary for charitable purpose

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Is This a Social Purpose Venture?

An organization was formed to operate a low-price grocery store in a low-income neighborhood and to provide job training. The store is operated in a manner similar to commercial stores, but charges lower prices by taking less profit. About 4% of the store's revenues are used to provide job training to 'hard core unemployed' community residents.

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Not Related

The operation of the store, in itself, is not a recognized charitable purpose

The job training activities are charitable, and require the operation of the store

But - the scale of the store's operation is <u>larger than reasonably necessary</u> to carry out the job training program

-Rev. Rul. 73-127

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A Social Purpose Venture

An exempt organization operates a retail grocery store to carry out the job training portion of its therapeutic program for emotionally disturbed adolescents.

The training program is operated to provide vocational rehabilitation and to help the teens become self-supporting.

All store employees are emotionally disturbed adolescents who participate in the therapeutic program. The adolescents are paid for working in the store.

The grocery store is operated at a level to utilize only the number of adolescents residing at the facility.

- Rev. Rul. 76-94

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Is This a Social Purpose Venture?

An organization is operating a hot dog stand.

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Is This a Social Purpose Venture?

- ABC operates a halfway house for recovering alcoholics and a furniture production business.
- The furniture is produced by halfway house residents participating in a transitional program.
- The transitional program is designed to help the residents develop self-discipline and regular work habits.
- Residents participate in the program for a short time, until they develop the skills and confidence needed to secure regular employment.

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Yes, the Activity is Charitable

- The residents produce the furniture as part of a bona fide training program focused on the development of particular skills.
- Participants remain in the program for a limited time to develop the skills, rather than becoming permanent employees.
- The business activities are no more extensive than necessary to carry out the charitable activity.

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Substantial Unrelated Activity

What is unrelated?

- Activity that is not charitable
- Charitable activity that does not further the organization's specific exempt purpose

What is substantial?

- IRS has not defined

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What if the Activity is Unrelated?

The organization may engage in unrelated activity, without jeopardizing its tax exemption, as long as the activity is not a substantial part of its overall activities.

The organization may have to pay unrelated business income tax (UBIT), IRC Sections 511-513. Avoids unfair competition with tax-paying businesses.

The organization may decide to establish a for-profit subsidiary to carry out the non-exempt activities.

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UBIT – Three Part Test

Business Activities

- Like a commercial business
- Purpose is the production of income

Regularly carried on

- Frequency or continuity similar to a commercial business

Substantially unrelated to the organization's exempt purpose

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Deductions and Exceptions

Tax applies to net income

- Direct costs of earning income are deductible

Exceptions to UBIT include:

Businesses operated for the convenience of patients, students, etc., such as campus book store

Businesses for the sale of donated goods or that are operated primarily by volunteers

Passive income such as rents and interest

Unless from debt-financed property or controlled entity

Sales

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How Much Unrelated Business Can You Do?

An insubstantial amount

How measured:

- Amount of staff time or other resources expended on exempt versus non-exempt activities
  - Ex. Textbook publishing by educational institution
  - IRS looked at scope of exempt activities and determined exempt activities were commensurate with organization's resources and did not revoke exemption

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Identifying Unrelated Activity

Determine charitable purpose

Review the corporate documents:

- Articles – statements of purpose
- Bylaws – statements of purpose
- Tax exemption application
- Determination letter

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It's Unrelated – Now What?

If charitable:

- Describe on Schedule O of Form 990
  - Non-filers send a letter within 4 ½ months after end of fiscal year

If not charitable:

- Determine if substantial
- Consider establishing a for-profit subsidiary

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For-Profit Subsidiaries: Overview

Why form a for-profit subsidiary?

How does a tax-exempt organization form a for-profit subsidiary?

How does the for-profit subsidiary relate to its tax-exempt parent?

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Why Establish a Subsidiary ?

- Protect organization's tax-exempt status
- Insulate organization from liability associated with the business
- Obtain financing from conventional sources
- Attract staff and board members with business experience

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Forming a For-Profit Subsidiary Corporation

Formation

- Articles of Incorporation filed with DCCA
  - Include number and classes of stock authorized
- Parent nonprofit receives ownership interest (stock) in exchange for contribution of money or other assets
- Stockholders appoint directors
- Directors adopt bylaws

Operations

- Directors and officers control the business
- Stockholders elect and can remove directors

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Parent-Subsidiary Relations

The nonprofit and the subsidiary each have their own Boards of Directors and officers, with separate meetings, minutes, accounts, books and records

- There can be overlap but the Boards shouldn't be the same
- Directors and officers have separate duties of loyalty

The nonprofit is not involved in the day to day management of the subsidiary

- As shareholder, it appoints and removes directors

Transactions between the nonprofit and subsidiary should be documented and on market terms

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Transfers Between Subsidiary and Parent

Profits are returned to parent as dividends

- Taxed at subsidiary level
- Tax-free to parent

Parent can provide services to subsidiary under market rate contracts

- Agreements for space and services are common
- May be taxable as unrelated business income (UBIT)
- Must be negotiated and priced like arm's-length transactions, but typically are at cost

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Questions

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