



## Question One

We have developed some products that we are selling (*English learning books for adults*). What do we need to be aware of as far as taxes? And, we are getting sponsors for a guide we distribute nationally and are curious about tax laws regarding corporate sponsors for the guide? Thanks!

Lee Shainis, Executive Director, Intercambio Uniting Communities (*formerly Intercambio de Comunidades*)

## Answer

Congratulations on having developed products as a part of your non-profit's revenue strategy. Products that deliver on your mission and broaden your core programs allow for expanded reach to other communities, provide an opportunity for many more people to participate and help to build a diversified revenue stream leading to increased organizational sustainability.

If the products you are selling are directly tied to achieving your mission (and it sounds like they are), you will likely experience no additional income tax implications for your earned income stream, i.e. you will not be subject to Unrelated Business Income Tax (UBIT). The tests you should use to determine whether the revenue is taxable are explained by the Internal Revenue Service (IRS) as described at the URL: <http://www.irs.gov/charities/article/0,,id=96104,00.html>. The key in this situation is whether or not developing and selling these books is "substantially related" to the purpose of the organization. The IRS defines this term as follows:

"To determine if a business activity is *substantially related* requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related."

You will need to consider local and state sales tax requirements and be certain that the organization is licensed and paying appropriate sales taxes in the markets where your products are sold. Non-profits can choose to pass this sales tax on to their customers or choose not to (as many non-profits do at their annual silent auctions or other fundraising events). Either way, the organization is responsible for paying sales tax on all taxable sales.

In the case of sponsorships for the guide, again, you are probably in safe territory (i.e. not subject to unrelated business income tax) as long as the sponsorship offers "no substantial return benefit" (IRS Reg. § 1.513-4(c)(2)(ii)),\* to the sponsor. Sponsorship can be a complex topic for non-profits and must be carefully considered; however, sponsorship is also very common and an excellent way to build partnerships with businesses that are interested in supporting your organization and/or accessing your target market. Allowable sponsor benefits that do not constitute a "substantial return benefit" include:

1. logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities, or company
2. a list of the sponsors locations, telephone numbers, or internet address
3. value-neutral descriptions, including displays or visual depictions, of the sponsor's product-line or services
4. the sponsor's brand or trade names and product or service listings



## **Taxes on Product Answer** *continued from page 1*

Qualitative or comparative language can get confusing. A couple examples of a comparative or qualitative description include: “Sponsor A is better than local Company B” or “Sponsor X offers the most comprehensive products in town.” Furthermore, if the sponsoring corporation has control over the content, then it is considered advertising and this revenue is taxable. Another potential area of concern is if your sponsor would like to offer a discount or other special pricing to your constituency as indications of savings or value may also make the sponsorship subject to UBIT. That being said, each non-profit must determine whether UBIT is, in fact, something to avoid at all costs or whether the benefits of the sponsorship itself (the money, the relationship, the shared value of working with this company) outweigh the taxes that may have to be paid.

Again, congratulations on expanding your reach through product sales. Although the I.R.S. laws are complex, we encourage you not to let them discourage further earned income strategy development—there are many professional advisors in the area who can help you to navigate these waters effectively.

\*Under Reg. § 1.513-4(c)(2)(ii), for purposes of determining whether a benefit is a “substantial return benefit,” benefits are not treated as “substantial return benefits” if the aggregate fair market value of all the benefits provided to the payor in connection with the payment do not exceed 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit.

## **Question Two**

I’ve got a start-up question for the experts. Would accepting money from a medical marijuana enterprise established solely to benefit a nonprofit subsequently risk federal money being withheld?

*Anonymous (Board Member of a Boulder County non-profit)*

## **Answer**

There’s a first for everything and you have submitted a question we’ve never heard before!

But seriously, the answer to this question depends on how the transactions are handled and the independence of the entities. If the proprietor of an independent, licensed corporation that is approved by Colorado to sell marijuana makes money and then decides to give a non-profit organization some or all of its profits, then it is just like any other donation and should have no impact on federal grants. That corporation may or may not be able to deduct the donations as part of its tax return, but for the non-profit it is just another donation. On the other hand, if this marijuana-selling enterprise is owned by or operated by the non-profit, then the unrelated business tax (UBIT) issues discussed in other questions in this column come into play, and depending on the federal agency involved, may well have an impact on grants. For guidance on whether your non-profit can start a subsidiary for-profit medical marijuana enterprise, we strongly recommend you seek the advice of a legal professional and those familiar with managing grants for the particular federal agency involved.



## Question Three

Our board has been interested in developing a social enterprise for several years but we don't know how to come up with a business that makes sense. Can you share examples of successful enterprises or tell us how other nonprofits figure it out?

Thank you, Anonymous (*Executive Director of a Boulder County non-profit*)

## Answer

Getting started is usually the hardest part. We suggest you start with your mission and goals. First, ask your board, "What is the purpose of the venture – to further your mission, create programmatic enhancements and outcomes, or to generate unrestricted revenue for your organization?" If you can identify specific goals it becomes easier to narrow down your opportunities. There are three general categories of social enterprise (*aka earned revenue strategies, social ventures, etc*):

- **Double Bottom line** - distinct ventures that incorporate program activities whose success is measured by program outcomes and generated revenue. Examples include:
  - Pest at Rest – a pest control company that trains formerly homeless men in pest management and generates revenue to support The Doe Fund's social service programs. <http://www.pestatrest.com/>
  - Greyston Bakery – a bakery that exists to support economic development in the community. <http://www.greystonbakery.com/>
- **Intellectual Property** - when a non-profit has a product or competency to sell that they have developed through their existing programs. Examples include curriculum or train-the-trainer services:
  - World Savvy – a global education non-profit serving youth - adapts curriculum and consults for non-profits to support others seeking to integrate global awareness into their offerings. They also offer professional development to teachers. <http://worldsavvy.org/>
  - Project Adventure – a wilderness education program that offers staff training for other professionals in the field. <http://www.pa.org/index.php>
- **Purely Revenue-Generating** - an earned revenue strategy is not necessarily mission-driven or brand aligned but rather developed to purely generate revenue. Examples include:
  - Girl Scout cookies
  - Churches selling steeple space for use as cell phone towers

To determine which, if any, social enterprise model is right for your mission and organizational goals ask specific questions relating to each of the above categories and apply the structure to your organization. The answers to these questions will dictate the type of business you create.

**Double Bottom line** – do you want your enterprise to incorporate your program? Are you looking to provide job training or work experience for your clients? Are you seeking to expand your program impact and generate revenue at the same time? Does your mission allow for this? If you decided to integrate a program component, how will you map out what that looks like? What will your priority be - mission/program or revenue?

**Intellectual Property** – do you have a product or service people want to buy? Is there something you do or produce already that is valuable that with the appropriate packaging and marketing can generate revenue? Perhaps a curriculum or product, such as artwork of the youth you serve, that has value?



## **How to Choose a Business Answer** *continued from page 3*

**Purely Revenue Generating** – Do you have extra space to rent out? Do you have an entrepreneur on staff or board who has a business idea that can benefit your venture? Do you have extra volunteer resources just waiting to be tapped? Have you identified a business gap in your local community?

These questions can be asked internally or with the assistance of an outside facilitator. If your organization has been ‘stuck’ for several years, as you say, it may be time to bring in an outside facilitator.

Other things to consider are whether you intend to add an earned revenue component to your parent organization or develop a separate entity. Will you utilize existing staff and infrastructure or will you need new resources? Do you have a funder who is interested in a mission-driven enterprise? You must compare your goals to your current resources to determine your capacity to proceed.

Finally, you must vet your idea within the context of the community/market in which you operate to determine if your business will be viable. (E.g. Is there a need for a landscaping business in Boulder? Will other organizations pay for a train-the-trainer training? Have we identified a sound financial case for this enterprise?) Like any business a social enterprise needs to fill a market need and needs to be well-researched in the context of the industry, competitors, market for your goods or services, operational and funding resources required. You should develop a complete business plan, being realistic about costs and revenues, and most importantly determining to what extent this new venture will draw away from the primary purposes of the organization in terms of time, talent, and focus. You’ll need to determine whether you have the requisite skills on your staff, and to try to make an accurate estimate as to what time and resources will take, and then evaluate whether these activities will distract from your primary mission.

## **Question Four**

I’ve just started a new job with an organization that started a business venture two years ago. At the time there wasn’t much thought given to the goals beyond making money to fill the gap in funding. We aren’t making much money and I’m not convinced this business is beneficial to our mission. How can I help my board create objective metrics that will allow us to judge the effectiveness or value of this business?

*Anonymous (Executive Director of a Boulder County non-profit)*

## **Answer**

The first step in evaluating the impact of a business venture is to carefully evaluate the program’s true costs and expenses associated with the enterprise, being very careful to make sure that the accounting presents a true and accurate reflection of all costs. (*See the answer to Question 4 for more detail.*) Only when you understand the true and total costs can you evaluate whether you are making money and how much. This additional revenue then has to be qualitatively compared with what else the organization could do with the personnel and other resources devoted to this effort, and what programs would have to be reduced or eliminated in order to make up for the loss of revenue from this earned income venture. These questions are judgment calls and deserve serious consideration. However, until there is consensus that the excess revenue is accurate and reflective, these discussions are premature.

## **Evaluating the Impact of an Earned Income Venture** *continued on page 5*



## **Evaluating the Impact of and Earned Income Venture** *continued from page 4*

Once you are confident in the accounting, we suggest you start to develop metrics by revisiting your organization's mission and goals. If it is true the business venture is not making money, and you haven't given us any indication that you believe it could make money in future, then its inherent value must lie within its activities.

Your organization exists to fulfill a specific mission and this venture must support that mission in some way. We would challenge you to dig deeper into the organization's mission statement by listing values that support the mission and behaviors that support those values. The behaviors are the most detailed descriptions of how you achieve each value and these behaviors are where we suggest you focus on creating objective metrics. An example for a homeless shelter: If a value is to build self confidence with those you aid, then one behavior may be providing occupational education. One could create an objective metric to measure the success of that behavior by tracking the number of educational hours per month and subsequent new employment.

So, once you have determined that you have accurately identified the business venture's costs, your next steps would be to work with your board to list values and behaviors that support your mission. Spend time developing easy to track metrics that will help you and your board measure success. Finally, revisit this business venture regularly to see if the organization's core mission, values, and behaviors are represented and effective.

### **Question Five**

We are about to start a small earned income business and are trying to figure out how to include it in our financial reports. The board and some of our funders are worried that they be able to easily identify the expenses and income. Do you have any suggestions?

Anonymous (*Treasurer of a Boulder County non-profit*)

### **Answer**

You ask about an often overlooked but important detail – good for you! Based on the wording of your question, we are assuming this social enterprise is a part of your current business, not incorporated as a subsidiary. Please let us know if our assumption is incorrect.

There are no special requirements for reporting revenue or expenses associated with earned income activities (although the organization may have to file an additional form (990-T) at the end of the year). There would be absolutely no difference in *the statement of financial condition* (balance sheet). However, you could present the *statement of activities* (Profit & Loss statement) differently to specifically show the earned income and associated expenses as unique line items to help the Board and funders better understand the impact of these activities. The statement of activities could list this set of activities with expense and revenue compared to a projected budget and therefore be able to track the impact of such a program.

While revenue and expenses can be shown on a statement of activities, one should ask a lot of questions to determine if the expenses which are shown accurately reflect the “real” costs associated with such a program. Cost accounting is not a hard science, but rather an art. Numbers can be represented differently to prove a point depending on what a given individual may want to conclude. The challenge will be to define your associated expenses in a reasonable and realistic manner.

## **Financial Reporting for Earned Income Ventures** *continued on page 6*



## ***Financial Reporting for Earned Income Ventures*** *continued from page five*

Since expenses are a function of how you do your cost accounting, there is a need to convince the Board or others that this has been done from an accurately representative approach. This means that the costs of space are allocated in a fair manner; that the personnel costs are truly indicative of the percentage of time various personnel actually spend on these earned income activities; and that all other direct and indirect costs are appropriately included in the calculation of expenses for such a program. If a person had a specific objective and wanted to develop and grow an earned income effort, the desirability of such a program could be enhanced by lowering the costs of personnel by suggesting that a lower percentage of time was spent on this project than might be accurate, thus making a program look like it is more profitable, or *vice versa*. Since there is no way to absolutely clarify these issues by looking at financial statements, it is important to clarify the methodology used in the cost accounting for such programs. By being totally transparent, the Board or funders will have greater confidence in the relative contribution that an earned income program might have.