AN ASSESSMENT OF THE EFFICACY OF THE 501(c)(3) STRUCTURE
FOR ARTS ORGANIZATIONS IN THE UNITED STATES

A Thesis
Presented to
The Graduate Faculty of The University of Akron

In Partial Fulfillment
of the Requirements for the Degree
Master of Arts

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August, 2014
AN ASSESSMENT OF THE EFFICACY OF THE 501(c)(3) STRUCTURE FOR ARTS ORGANIZATIONS IN THE UNITED STATES

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Thesis

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CHAPTER I

A FUNCTIONAL STRUCTURE?

Is the 501(c)(3) still the best legal structure for organizations seeking to promote the arts? The 501(c)(3), not-for-profit organizational model has long been the leading model for organizations with the goal of social improvement. However, in recent years the birth of the “social entrepreneur” and several hybrid organizational models that allow for-profit entities to incorporate a social mission into their operational structure have begun to challenge the monopoly the 501(c)(3) has held over social enterprises. “The notion that nonprofits are the right — or even, better — vehicle for doing good in the world is no longer true. That may have been the case at one time, but today, ethical, well-run businesses with products that make life better are remarkable at improving lives at scale” (Chhabra).

In addition to an increase in 501(c)(3) alternatives, there has been a growing vocal concern over the effectiveness and
trustworthiness of 501(c)(3) organizations. An article in *The New York Times* interviewed social entrepreneur Saul Garlick and discussed his decision to turn his not-for-profit organization into a for-profit venture. Garlick said of not-for-profits that “Some are remarkable but far too many are disconnected [from the community] and dishonest” (Chhabra).

The main criticism of the 501(c)(3) model is that it leaves organizations at the mercy of donors causing not-for-profit organizations to spend more time and energy on raising funds than on mission related activities. Allen Bromberger, a lawyer experienced in not-for-profit financing, was interviewed in a *New York Times* article discussing the subject of hybrid models. He stated that “It is virtually impossible to grow a social enterprise in any significant way relying wholly on donated money, earned revenue and debt financing, which are the only sources of financing available to nonprofits ” (Strom). The sentiment that a “nonprofit” can not help but live up to its name begs the question: is the 501(c)(3) structure broken?

The purpose of this paper is to study the effectiveness of the 501(c)(3), not-for-profit structure for arts organizations in the United States of America. This will be achieved by studying the historical context in which arts not-for-profit organizations developed and
analyzing the main aspects of an arts 501(c)(3) structure including formation, taxation, revenue, management structure and structure adaptations. Finally, a benefit analysis of the 501(c)(3) structure as a whole will determine the advantages and disadvantages of the structure for arts organizations. Note that references to the Internal Revenue Service (IRS) website have been numbered for ease of identification.
CHAPTER II

HISTORY OF 501(c)(3), NOT-FOR-PROFIT CORPORATIONS

Religious, educational, charitable, scientific, or literary organizations; organizations that test for public safety. Also organizations that prevent cruelty to children or animals, or foster national or international amateur sports competition (IRS\(^1\)).

A. 501(c)(3) Tax Code Evolution

The term "501(c)(3)" refers to the Internal Revenue Service (IRS) tax code assigned to incorporated, tax-exempt, not-for-profit organizations. The roots of the 501(c)(3) structure began with the Wilson-Gorman Tariff Act of 1894, which established a flat tax of 2% on all corporate entities, excluding charities. While the Wilson-Gorman Tariff Act was declared unconstitutional two years later in 1896, the foundation was laid for tax exempt entities within the United States.

The Revenue Act of 1909 promised permanence for both the excise tax and for the existence of tax exempt entities. The Revenue Act of 1909 also established inurement, dictating that a charitable
organization may not be run for the benefit of an individual or private shareholder; this concept has been central to the identity of the 501(c)(3). The Revenue Acts of 1913 and 1917 updated the Revenue Act of 1909 by allowing individual donors an income tax deduction for charitable donations and the Revenue Act of 1936 expanded the charitable income tax deduction to corporate donors. Though the exact delineation of the modern 501(c)(3) did not occur until the current structure of the Internal Revenue Service was established with the Revenue Code of 1954, the essence of the 501(c)(3) legal structure was in place.

B. 501(c)(3) Arts Organizations In The United States

The roots of not-for-profit arts organizations began with the private art collections and parlor concerts of wealthy individuals and families. The tastes of the wealthy elite dictated the standards applied to the fine arts. The federal government was largely uninvolved with fine arts in the United States until Roosevelt’s public works projects, commonly referred to as Roosevelt’s “New Deal”. The public works projects established a network of state-sponsored performing bodies, making the arts more accessible to the general population and encouraging the growth of new audiences. Foundations evolved at a
similar pace as not-for-profit organizations. The wealthy families who had once been the sole benefactors of the arts became the creators of the first private foundations.

After WWII, the income tax became standardized and charitable donations became a popular income tax loophole for the rich, negatively coloring public opinion concerning foundations and not-for-profit organizations. However, increased regulation was introduced to curtail such practices and increase transparency. Researcher Peter Dobkin Hall had the following to say about increased regulations during the late 1950s and 1960s:

Despite these periodic outbursts of regulatory enthusiasm, funds from foundations, corporations, and new government programs (the National Institutes of Health, National Science Foundation, Nation Endowment for the Arts, and National Endowment for the Humanities, among others) continued to fuel the growth and transformation of nonprofit enterprises. Industries like the performing arts...which had been almost entirely for-profit in ownership before 1950, became dominated by nonprofit firms in the course of the next half century (Renz, and Herman 17).

Due in part to Johnson’s presidential initiatives which created programs that provided funding for the improvement of arts and cultural institutions, governmental funding of not-for-profit organizations increased during the 1960s and 70s. During this time period, the government was responsible for the majority of not-for-profit funding (Herman). However, with the establishment of The
National Endowment for the Arts (NEA), governmental arts funding began to change. The NEA was founded in 1965 with the goal of providing funding to the arts. The NEA focused on six specific areas of the arts, including visual arts, dance, music, theater, musical theater (including opera) and literature.

The role of the NEA in arts funding did not remain central in the budget of most arts organizations as another period of intensive not-for-profit review occurred during the 1980s and 90s. Important legislation concerning not-for-profits was introduced at a rate of around two acts per decade during the 1930s through the 1980s. However, during the 1990s the amount of legislation passed concerning 501(c)(3)s nearly doubled. Interestingly, the number of arts not-for-profits also exploded during the 1980’s and 1990’s. “Dance troops have grown from 28 in 1958 to over 400 [in 2000]. Opera companies with budgets of over $100,000 have grown from 29 in 1964 to 209 by 1989. Chamber-music groups, most formed in [the 80’s and 90’s], now number around 1,120” (Cherbo, and Wyszomirski 5-6). As the number of not-for-profit organizations increased, their reputation for poor management and stewardship of funds also increased. In 2011, the IRS was forced to rescind 501(c)(3) status from 275,000 not-for-profit organizations (not exclusive to arts organizations) because of a failure to complete required 990 forms (McRay).
Legislation introduced at the behest of for-profit organizations increased regulations and required transparency for not-for-profit organizations engaged in un-related business transactions at the same time that 501(c)(3) organizations began to receive heightened scrutiny in regards to lobbying activities.

At the same time that regulations were increased concerning 501(c)(3) organizations, the budget of the NEA was suffering severe cuts due to political outrage with controversial art funded by the NEA. The budget of the NEA was cut by 39% in 1996 and only began to recover in 2007 with a 20 million dollar increase (Bauerlein, and Grantham). Currently, the NEA operates with a budget of 159 million.

The current mission of the NEA includes “partnerships with state arts agencies, local leaders, other federal agencies, and the philanthropic sector” in addition to providing funding. In 2012, the NEA gave a total of 117 million in funding. The funds were separated into four categories: “creation of art, engaging with art, promoting knowledge and partnerships for the arts”. The “creation” category received 9% of the funds allocated to the programming budget, the “engaging” category received 47%, the “promoting” category received 4%, and the “partnerships” category received 40%. Programming represented 80% of the NEA’s yearly budget. The majority of NEA
funding went to its “engaging with art” and “partnerships for the arts”

Today, 40% of the NEA’s programming budget is spent on
“partnerships” at the state and regional levels. This means that state
level organizations like the Ohio Arts Council are responsible for
disbursing a large portion of NEA’s budget within their state. Most not-
for-profit arts organizations see very little or no funding from the
National Endowment. Large organizations like city orchestras and
museums also receive minimal funding from the NEA, but often feel
obligated to apply for funding because the receipt of funds act as a
stamp of approval for organizations.

In summary, the 501(c)(3) structure was created in 1894 with
the Wilson-Gorman Tariff act when the social elite were still hosting
concerts in their parlors. The evolution of both the legal structure and
the state of the American arts sector increased in complexity and
sophistication. The creation of the NEA introduced sustained support of
American arts at the national level, however, in recent years the
funding support of the NEA has transitioned to emphasize the creation
of state/regional and national partnerships, diminishing the amount of
funds available to individual organizations.
The passage of legislation concerning the 501(c)(3) structure increased to promote a higher level of not-for-profit transparency in the hopes of reducing mismanagement.
CHAPTER III

OVERVIEW OF THE 501(c)(3) STRUCTURE

A. Formation

The formation of a registered 501(c)(3) corporation begins at the state level with the registry of the entity’s name. Next, the organization must write and file Articles of Incorporation with the state. Articles of Incorporation list the purpose(s) of the organization, establish that the organization will be a not-for-profit, and include a list of board members. The original board of directors must contain at least three members: president, secretary and treasurer (Mancuso 22). After successfully completing and submitting the Articles of Incorporation to the state, the organization will be incorporated.

The newly incorporated organization may then obtain 501(c)(3) status, a process that occurs not on the state level, but on the national level. To obtain 501(c)(3) status, the organization must fill out Form 1023 and submit it to the IRS. The completed Form 1023 will contain
the board’s by-laws, the mission statement, and an outline of the programs/activities that the organization will engage in. In order to gain 501(c)(3) status the organization must also prove that it receives a substantial portion of its income from the public, or it will be considered a private foundation rather than a public charity. This can be demonstrated in many ways, including showing proof of contributions from individual donors, foundations, or the United States government (Mancuso 61-62). Additionally, the organization must contact the IRS to receive an employer identification number.

Once the 501(c)(3) status is attained, the organization should contact their attorney general’s office to learn about any further state requirements like Charitable Solicitations Registration, State Corporate Tax Exemption or State Sales Tax Exemption.

The process of applying for and successfully receiving 501(c)(3) status is complicated and requires familiarity with the process to achieve the swiftest results. The process is often accused of being confusing and expensive. Like all business ventures, an attorney should be consulted to ensure that the process is being completed accurately and legally.

As previously stated, the concept of inurement is a central concept in the creation of a 501(c)(3). Inurement dictates that a charitable organization may not be run for the benefit of an individual
or private shareholder. The formation process is usually undertaken by the founder of the organization with help from his selected board members. Often, the cost associated with formation (filing fees, attorney, etc.) and the initial budget of the organization come from a personal investment made by the founder(s). As with any type of start-up, the founder of a not-for-profit is required to invest a lot of time, energy and capital to make their dream organization a reality. However, because of the concept of inurement, once an organization successfully gains 501(c)(3) status, the founder no longer has any ownership —the organization becomes its own entity that may not benefit any individual or shareholder. This means that the initial capital investment by the founder is lost.

In summary, there are two main obstacles when filing for 501(c) (3) status. Firstly, the process is lengthy, complicated and expensive. Secondly, the organization must be able to prove that it receives broad-based support —which may be difficult for start-up organizations that initially have very few sources of income. In addition to these obstacles, it is important to note that once incorporated, the original founder(s) relinquish ownership of the entity.
B. Taxation

As previously stated, Form 1023, once submitted and approved by the IRS, gives 501(c)(3) organizations federal and state tax exemption. However, 501(c)(3) organizations are still required to pay payroll taxes, worker’s compensation, and unemployment compensation (IRS\(^2\)). At the end of each fiscal year (different for each organization), 501(c)(3)s must file either Form 990, 990-PF, Form 990-N or Form 990EZ. Form 990-PF is filed only by private foundations. The amount of an organization’s income and assets determine the type of 990 to be filed. 990-N and 990-EZ are filed by organizations with lower incomes and assets. Form 990, or “long-form”, is the standard form most organizations submit. By law, 990s must be provided to the public. This practice ensures a level of transparency, an important feature for organizations that solicit donations from the public. 990s provide information on income, expenses, assets, program costs, board member and staff wages, governance changes, unrelated business income, and lobbying activities (Swords).

Tax exemption is perhaps the strongest advantage derived from the adoption of the 501(c)(3) structure. The federal government
functionally offers subsidies to the arts through 501(c)(3) tax exemption. As mentioned in the historical section of this work, arts organizations commonly do not receive much (or any) funding from the National Endowment for the Arts. Because of this, tax exemption is the main benefit that arts organizations can consistently receive from the federal and state levels. It is also notable that tax exemption is a characteristic unique to the 501(c)(3) structure. There are currently no other structures that receive this type of support from the government.

C. Revenue

Unlike other forms of corporations, not-for-profit corporations may not issue equity. Not-for-profits raise revenue through a number of sources: ticket sales and other earned income; foundation support at the national, state and local levels; endowments; individual and corporate donors; as well as unrelated business income.

For arts organizations, ticket sales and other earned income can represent a large percent of the budget. For example, during fiscal year 2011, earned revenue represented 42% of the Cleveland Orchestra’s total revenue. In addition to ticket sales, revenue can be earned through educational program fees, program sales, event
rentals and merchandise. Business income may be considered tax exempt as long as the activities are mission related. The line that delineates related from unrelated business income is thin; many of the intricacies have been developed in case law due to perceived not-for-profit abuses.

One of the most publicly known sources of income for not-for-profit organizations is the “special event”. Arts not-for-profits tend to gravitate towards these events especially because the arts industry lends itself well to entertainment and showcases. 501(c)(3)s often host large fundraising events with the goals of both raising money for the organization and also expanding and maintaining their donor-base.

Special event fundraising is often a double-edged sword; potentially losing money for the organization instead of raising funds. It is often the case that the direct (catering, entertainment, raffle prizes, etc.) and indirect (cost of event planner’s time, overhead) costs of hosting a special event decrease the net revenue of the event substantially. While special events are popular with arts not-for-profits, they are often not an effective model for raising funds.

Not-for-profit organizations also receive funding through grants from foundations at the federal, state, and local levels. While the focus of the National Endowment for the Arts has shifted from offering funding resources to arts not-for-profits to creating policies and
community connections that support the arts, many arts organizations still seek grants from the NEA (Cherbo, and Wyszomirski 20). At the state and local levels, arts organizations write grant proposals to support operations and programming. Grant writing is time consuming and therefore expensive. Often organizations do not have more than one development officer who is responsible for grant writing in addition to their other duties. This paradigm is common in arts not-for-profits; necessary tasks require more qualified or specialized human assets than are available to the organization. For this reason, arts organizations may hire professional grant writers who are familiar with the submission process. The main draw-backs to farming out grant writing to a professional are a lack of understanding of the mission and policies of the organization and cost. In addition to the initial costs of grant writing, receiving a grant means that an organization is responsible for reporting progress and funding usage back to the grantors.

The Foundation Center reports that 13% of grants from the FC 1000 Foundations (fiscal year 2011) were granted to arts and culture organizations. The 13% of grants awarded to arts and culture not-for-profits translates to a dollar value of $2,267,640,704, which is about 9% of the total dollar value granted to not-for-profits (Foundation Center 2013). So while grants still represent a substantial and
important source of funding for arts not-for-profits, there are many challenges associated with obtaining this type of revenue.

Another common source of income for 501(c)(3)s are endowment funds. Endowments are investment funds created through individual, corporate, or foundation money, that have specific restrictions on how funds can be invested and withdrawn. Generally the restrictions on endowment funds require that the funds be invested conservatively and determine that only an agreed upon amount of the endowment, such as the interest or a percentage of the interest, may be withdrawn for use each year. Additionally, the donors to the funds may specify the purposes for which their donation may be used. Donations to endowment funds and individual and corporate donations to 501(c)(3) organizations are incentivized through charitable income tax deductions.

Like donations to endowment funds, the use of funds provided by individual donors can be restricted for a specific purpose by the donor. Funds designated to a specific purpose by donors can be less effective. For example, an individual donor interested in a small, struggling, theater company donates $10,000 for costumes. While the donation is generous, the theater company is still forced to cut two of its performances from the season program to make budget because while they now have a substantial costume budget, they can not meet
overhead costs. The remaining performances of the season have small casts and few costumes.

Disconnect between not-for-profit organizations and donors commonly occur. While many not-for-profit organizations are successful in having positive donor relationships, just as many are unsuccessful. Saul Garlick, quoted in the introduction of this work, changed the structure of his organization “ThinkImpact” from a not-for-profit to a for-profit entity. His frustrations with donors exemplifies the challenges faced by many not-for-profit organizations.

I find donors to feel owed some emotional reward that is intangible and constantly burdensome because as a nonprofit director you never know if they are really satisfied. Plus, each donor has a different need, from special projects to more colorful pictures. Investors, especially ones who believe in your vision, are pretty cut and dried about their expectations — deliver something great and do it in a way that is growing and eventually makes money (Chhabra).

In addition to donations, earned revenue fundraising, not-for-profits may also take on debt. A not-for-profit organization can utilize a line of credit to cover expenses when waiting for grants or other scheduled revenue streams. However, as with any financial venture, without prudence and due diligence, debt can cause trouble and bad press for an organization.

Not-for-profit organizations have many options available to them to bring in revenue. Because arts organizations are not reliant upon a
single source of revenue, they can be financially stronger and more resilient. Kevin V. Mulcahy summarizes this idea nicely in his work entitled “The Government and Cultural Patronage, A Comparative Analysis of Cultural Patronage in the United States, France, Norway, and Canada”. Mulcahy states that “the American system of cultural patronage is, in effect, much broader and stronger than may appear at first glance; similarly, the components of public culture in the United States are highly variegated and diversely supported” (Cherbo and Wyszomirski 139).

Having diverse options for generating revenue is both an advantage and a challenge for arts organizations. Each revenue option is associated with unique challenges best solved by specialized staff. Because of this, in large part the financial success of not-for-profit organizations are dictated by the management structure, skills, and expertise of its board members, staff, and volunteers.

D. Management Structure

Commonly, arts not-for-profit organizations have a management structure with three divisions. The three common divisions in an arts organization are the artistic department, administrative department, and the board of directors. Each of these entities is responsible for
different, but frequently overlapping functions.

Not-for-profit organizations feature a board of directors, administrative team, and artistic team that work together to further the mission of a not-for-profit organization in a previously agreed upon strategic fashion. However, it is more often the case that one or two “legs of the stool” function while the third does not. This leads to frustration, low-efficiency and mismanagement of the organization in general.

The board of directors is responsible for creating a vision of the organization that not only allows it to remain on-mission, but also relevant and competitive. The administrative and artistic staff are responsible for implementing strategies that allow the organization to execute the strategic vision. Outlined below are the basic functions of the artistic department, administrative department and board of directors.

The artistic department is responsible for yearly programming decisions. For an orchestra, the artistic director would be the primary conductor and the artistic staff would be his assistants, helping him to secure music, performers, performing rights, etc.. The artistic director is responsible for creating the artistic “vision” for the organization.

The administrative staff, depending on the size and purpose of the organization, may have several configurations. The basic functions
of the administrative department include development, marketing, sales, education and strategic management. Development departments cultivate donors (individual, corporate, endowment), write grants, host special events and are generally responsible for generating the funds necessary to run the organization. The marketing department advertises events, helps to establish sustainable community relationships, and creates a positive brand identity for the organization.

In addition to the development and marketing departments, arts organizations generally have a sales team. Box office, concessions and gift shop sales are all within the purview of a sales team. An education department is responsible for coordinating, staffing and creating educational programs (if education is a part of the organization’s mission). Finally, the administrative department is generally headed by a chief executive officer or chief organizational officer. These top administrative executives coordinate the movements both within the administrative department, and also between the administrative and artistic departments, and the board of directors.

The primary functions of the board of directors are to safeguard the mission of the organization and to serve as strategic management. The board of directors must be constantly aware of organizational weaknesses and strengths. Additionally, the board of directors is
responsible for ensuring the success of the organization by helping to fill the staffing gaps in the administrative and artistic departments. Start-up not-for-profit organizations tend to be particularly reliant upon board members, who for fledgling organizations often serve as both the board of directors, but more importantly, as the first administrative staff. Fully developed arts not-for-profits rely on their board members to assist with fundraising, strategic planning, and in providing important community connections.

A board of directors generally contains sub-committees for marketing, events, development/finance, and other relevant areas. In this way, the board of directors serves as a support system for the administrative staff. Additionally, the board of directors and the administrative team work as a system of checks and balances. Board members are required to execute due diligence—ensuring that the not-for-profit makes sound financial and managerial decisions.

The balance of power between the artistic director, administrative director, and board of directors is determined by the organization’s bylaws. The bylaws lay out the operating policies for the organization. They contain information such as the rules for board quorum, lay out procedures to guard against conflicts of interest, establish board committees, and dictate hiring procedures. The bylaws explain precisely how the administrative staff and board of directors
interact, stipulating how and when reports on finances, programs, etc., are to be presented.

Unfortunately, in many arts organizations, the duties of both the artistic department and the administrative department fall to a single person, or to a small number of people. Under-staffed not-for-profit organizations may struggle to accomplish the many diverse tasks necessary to execute the organization’s strategic mission. As shown in the previous section, “revenue”, arts organizations utilize many different revenue streams to meet budget demands to support their missions. This section, “management structure” highlights how it can often be impossible for short-staffed organizations to successfully utilize all revenue options open to them.

Many not-for-profit organizations also have problems attracting and retaining engaged and helpful board members. The popular phrase “Give (money), Get (money), or Get off” has evolved from a culture of unhelpful, or simply not present, board members.

E. Liability

Not-for-profit organizations have limited liability, which means that generally individuals are not held personally liable for improper actions; rather, the corporate entity is held responsible. However, there
are a few exceptions in which a board member could be held personally liable. If it is determined that a board member or staff member has not acted with proper duty of care, loyalty, or obedience, they may be found legally liable. The consequences for a breach of the duties of care, loyalty or obedience vary from state to state. However, unless the party at fault has been “grossly negligent,” generally, legal action is still not taken against an individual (Davidson, and Murdock).

It is important to note that while limited liability is a coveted protection, the 501(c)(3) structure is not the only legal structure that offers this type of protection to organizations. All C-corps, S-corps, B-corps and some LLCs and L3Cs offer limited liability protection.

All five of these elements—formation, taxation, revenue, management structure, and liability define the characteristics that distinguish 501(c)(3)s from other legal structures. The 501(c)(3) legal structure is unique from other legal structures in its formation process, taxation standards, and method of generating revenue. It shares the feature of limited liability with the c-corp, s-corp and LLC. Arts organizations have management structures organized to work with the 501(c)(3) structure. 501(c)(3)s have both unique structural elements, and elements shared with other legal forms.
CHAPTER IV

501(c)(3) STRUCTURAL ADAPTATIONS

The introduction of hybrid organizations have recently gained popularity and sparked the interests of social entrepreneurs as an opportunity to circumnavigate cumbersome aspects of the 501(c)(3) model. These hybrid organizations leverage the positive attributes of both for-profit and not-for-profit entities to achieve social change. However, 501(c)(3) organizations began embracing the idea of utilizing aspects of for-profit business structures for the benefit of a social cause in the 1980s and 1990s. The two most common 501(c)(3) adaptations borrowed from for-profit-practices are the use of unrelated business income and fiscal sponsorships.
A. Unrelated Business Income

The IRS states that unrelated business income is defined as "a trade or business that is regularly carried on and is not substantially related to furthering the exempt purpose of the organization" (IRS\textsuperscript{3}). A not-for-profit organization may engage in an unrelated business, though federal law stipulates that the unrelated business income should not exceed 30% of the non-profit’s total income (McRay).

Unrelated business income (UBI) is taxable unless it meets the qualifications of certain exemptions. The most common exemptions are those having to deal with investment income and property. In addition, unrelated business income resultant of volunteer labor, certain bingo games or donated merchandise, are tax exempt. Perhaps the vaguest of the IRS exemptions is the “Convenience of Members” exemption. The IRS describes this exclusion as “[any trade or business that is carried on] primarily for the convenience of its members, students, patients, officers, or employees” (IRS\textsuperscript{4}).

The above listed exemptions garner criticism from for-profit entities who find themselves offering similar (or duplicate) services without tax exemption. In a response to abuse, 501(c)(3)s are required to supply the public with Form 990-T, the Exempt Organization Business Income Tax Return, in addition to requiring the
public availability of 990 Forms (Bishop, and Patton). As seen with other abuses related earlier in this work, implementing additional paperwork to curb improper use of tax exemption for unrelated business is the initial policy response. Why not adjust the policy instead?

B. Fiscal Sponsorship

In its most basic form, a corporate fiscal sponsorship is a donation agreement between a not-for-profit organization and a corporate entity. Basic corporate sponsorships are generally comprised of corporate donations of time, money and volunteers, in exchange for previously agreed upon benefits from the not-for-profit organization. An example of a not-for-profit benefit to a corporate entity would be a museum offering free admission to employees of a corporate fiscal sponsor on a specific date. However, there has been an increase in the utilization of the corporate sponsorship, and a trend of developing corporate sponsorships into strategic partnerships (Crutchfield, and Grant).

Beyond a basic corporate sponsorship agreement, a well-matched strategic partnership can provide positive marketing, financial benefits in the form of increased sales, and a boost in brand visibility
and loyalty for both the corporate entity and the not-for-profit. A strategic partnership increases the level of association between the for and not-for-profit entities. An example of this type of relationship is the partnership between the Environmental Defense Fund and McDonalds in the late 1980s. The strategic partnership between for and not-for-profit entities resulted in a massive reduction in packaging waste produced by McDonalds. By switching from polystyrene containers to packaging made with recycled fiber, “McDonald’s would go on to reduce its packaging waste by 150,000 tons over a ten-year period (Crutchfield, and Grant 135).

As stated previously, a strategic partnership increases the level of association between two organizations. The outcome can be positive as with the example of the Environmental Defense Fund and McDonalds, however, the outcome can also be detrimental to one or both organizations if their missions and goals do not match. In an effort to secure a lucrative corporate partnership, a not-for-profit could be tempted to engage in a project or activity that does not directly support their mission. An example of mission shift to work with a corporate partner would be an organization with a core mission of increasing literacy of at-risk youth partnering with a sporting goods company to provide after-school sports classes for at-risk youth. While the 501(c)(3)s target population (at-risk youth) are being served and
presumably helped by this type of programming, the core mission of the not-for-profit is not being furthered. This type of mission shift can be both small and large and is often referred to as “mission drift”.

Additionally, a 501(c)(3) must be wary of potential unfavorable public perception of a corporate sponsorship. In the example of the partnership between the Environmental Defense Fund and McDonalds, many criticized the Environmental Defense Fund for working with McDonalds. Because of the popular perception, especially amongst environmentalists, that McDonalds was the “enemy”— critics felt that the Environmental Defense Fund was compromising their standards for corporate dollars. While this particular partnership was very successful, 501(c)(3)s must consider every aspect of a potential partnership. The reputation of both organizations—positive and negative—will reflect on the other if a partnership is made.

The many benefits offered by fiscal sponsorships and strategic partnerships are also accompanied by challenges. The risks include mission drift, community perception that the 501(c)(3) has “sold-out”, and the challenges associated with unrelated business income restrictions. Partnerships between two organizations that are not compatible often lead to dissatisfaction for both parties.
CHAPTER V

501(c)(3) STRUCTURAL ALTERNATIVES

As mentioned previously, hybrid organizational structures have recently gained momentum and popularity within both the business community and with the public. Examples that showcase an increased public interest in business-propelled social change are the successful “go green” and recycling campaigns.

Beyond cause marketing and the 501(c)(3) adaptations adopted by traditional 501(c)(3) organizations, hybrid organizations seek to solve some of the issues inherent and produced by the 501(c)(3) structure. Below are descriptions of the L3C, B-corp, and B-corp certificate. These three alternatives were chosen because like the 501(c)(3), to utilize these structures an organization must place social or environmental issues at their core. In this way, these three organizations are the 501(c)(3)’s closest relatives.
A. L³C, Low-Profit Limited Liability Company

A Limited Liability Company (LLC) is a business structure allowed by state statute. Each state may use different regulations. Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a corporation, partnership, or as part of the LLC’s owner’s tax return (a ‘disregarded entity’) (IRS⁵).

Legislation legalizing the low-profit limited liability company structure, or L³C, was passed into law by the first state, Vermont, in 2008. According to founder, Robert Lang, the purpose of the structure is “to encourage commercial capital markets and market rate investors to invest in solving social problems” (“What is the L³C?”). The L³C is considered a variation of the LLC, or limited liability company. Because of this, L³Cs formed in Vermont, or any of the other nine states and two Indian Nations (Michigan, Crow Indian Nation, Wyoming, Utah, Oglala Sioux, Illinois, Maine, Louisiana, North Carolina, Rhode Island) where L³C legislation has been successfully ratified, may operate in any part of the United States (“The L³C - Background & Legislative Issues”).

Like LLCs, L³Cs utilize an Operating Agreement—a document that stipulates how the organization is run. The main difference between the Operating Agreement of an LLC, and the Operating
Agreement of an L3C is that the purpose listed in an L3C’s Operating Agreement must be consistent with the mission requirements for the formation of 501(c)(3) organizations.

Also consistent with established guidelines for LLCs, the L3C can be taxed in a variety of different ways, depending upon the state in which it is formed. L3Cs can either be considered partnerships or corporations based on the “number of associates, an objective to carry on business and divide the gains therefrom, continuity of life, free transferability of interests, centralization of management, and liability for corporate debts limited to corporate property” (Harris, Henring, and Stevenson). Depending upon which of the aforementioned characteristics the L3C selects, it will either be treated as a partnership with a pass-through tax structure, or as a corporation subject to double-taxation.

The founders of the L3C structure hope to create and pass legislation that would make L3C organizations automatically approved to receive Program Related Investments (PRIs) from foundations. If legislation like this were approved, the L3C structure would enable organizations to accept investments from venture capitalists and from foundations. While the L3C structure has been built to accommodate future PRI legislation, it does not yet exist.
The main goal of the L3C is to solve the funding conundrum faced by most 501(c)(3) organizations. 501(c)(3) organizations, by definition, can not have investors. The L3C structure can hypothetically receive funding from investors and foundations. The other major benefit of the L3C structure is that it requires much less paperwork overall to start and continue. A problem resultant of the 501(c)(3) structure is large amounts of paperwork required by the IRS to curb abuse of the 501(c)(3) model. Either because of its newness, or because the structure is less easily exploited, the L3C model is accompanied by a significantly less demanding paperwork load.

B. B-Corp, Benefit-Corporation

Benefit corporations [are required to] have a corporate purpose to create a material positive impact on society and the environment; are required to consider the impact of their decisions not only on shareholders but also on workers, community, and the environment; and are required to make available to the public an annual benefit report that assesses their overall social and environmental performance against a third party standard (Benefit Corporation Information Center).

Just as the L3C structure has its roots in the LLC structure, the B-corp structure shares its foundation with C-corps and S-corps. Because of this, a potential B-corp can choose whether it will be taxed as a C-corp or S-corp. B-corp legislation has passed in Arkansas, Arizona, California, Colorado, Delaware, the District of Columbia,
Hawaii, Illinois, Louisiana, Massachusetts, Maryland, Nevada, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, Vermont and Virginia (Benefit Corporation Information Center).

The major benefit offered by the B-corp structure is that an organization can make decisions based on the potential ramifications to society and the environment in addition to the company’s bottom line. This allows the organization to attract investors who want their investments to both generate money and benefit society. It is also important to consider that investors prefer to invest only in C-corps. While it is easy to convert an S-corp into a C-corp to attract investors, it is much more difficult and costly to convert an LLC to a C-corp (Walker).

As an alternative to utilizing the B-corp structure described above, many businesses are electing to apply for the B-corp certification. The certification allows organizations that already exist to retain their current structure, but certifies that the organization will “voluntarily meet higher standards for accountability, transparency, and performance” (Why B Corps Matter). Businesses like Warby Parker, Patagonia, and Ben & Jerry’s have the B-corp certification.

B Lab, the not-for-profit organization that created the B-corp certification, is also responsible for pursuing the ratification of B-corp structure legislation in the United States. B Lab maintains that
“government and the nonprofit sector are necessary, but insufficient to address society’s greatest challenges” (Why B Corps Matter). B Lab hopes that the B-corp structure and B-corp certification inspire a community of businesses to help make the world a better place.

The major benefit of the B-corp or B-corp certificate is that it gives a corporate entity usually a slave to the “bottom-line” leeway to make more socially responsible decisions. It is important to point out that currently, all for-profit entities may apply for foundation funding in the form of PRIs—L³Cs do not hold that advantage exclusively. However, PRIs are complicated and expensive to obtain and are therefore seldomly used by any type of organization.
CHAPTER VI

ANALYSIS

Arguments both supporting and contesting the functionality of the 501(c)(3) structure can be divided into two main categories: benefits and challenges. Benefits and challenges are either inherent to the 501(c)(3) structure, or are simply resultant from how the structure is utilized. The benefits and challenges that are inherent are necessarily present in every organization while the benefits and challenges that are resultant of how the structure is utilized, may or may not be present in every organization. While arguments listed in the previous sections of this work have not been delineated as either one type or the other, the following analysis will make this distinction and its implications clear.
A. Arguments Supporting the Functionality of the 501(c)(3) Structure

The 501(c)(3) organizational structure offers arts organizations many advantages. The 501(c)(3) structure is capable generating revenue from many different sources. This enables organizations to not be reliant upon a single source of income. 501(c)(3) arts organizations may generate revenue through ticket sales/earned income, foundation support at the national, state and local levels, endowments, individual donors, unrelated business income and fiscal sponsorships. The loss of a substantial grant offers a setback for a not-for-profit, but the revenue stream as a whole is protected by the diversity of revenue sources.

Not-for-profit organizations also receive major benefits from the national government. The United States government subsidizes arts activities through tax exemption for 501(c)(3) organizations and tax deductions for donors to arts organizations. These advantages are essential for most arts organizations, and can only be taken advantage of if the organization is incorporated as a not-for-profit.

Both the ability to utilize several different forms of income and national level support in the form of tax exemption are benefit inherent to the 501(c)(3) structure. These benefits are unique to the 501(c)(3) structure which means that other organizational structures,
including the hybrid organizations discussed previously, can not receive these benefits.

In contrast, the benefits offered by the management structure common to arts organizations are resultant of the 501(c)(3) structure. Board members, who usually serve on the board for free, provide varied expertise and can serve as a support system for chronically under-staffed administrative departments. The administrative and artistic departments and the Board of Directors can serve as a system of checks and balances, helping to ensure that the organization maintains its mission focus, budget, and legal obligations. Because the benefits offered by the management structure usually found in 501(c)(3) art organizations is resultant-from and not inherent-to the structure, arts organizations may or may not take advantage of these benefits.

Additionally, the 501(c)(3) structure provides limited liability to its members. The corporate veil protects private assets of the founder, board members and employees. This benefit is inherent to the 501(c)(3) structure but not unique to it; liability protection is available to other forms of corporations including C-corps, S-corps, and some LLCs. However, alternative arts structures that do not utilize a corporate structure are more vulnerable in this respect.
Beyond corporate donations, corporate strategic partnerships allow not-for-profit organizations to harness the power of for-profit organizations. These partnerships provide positive marketing and increased brand visibility for both partners. This boost in visibility can lead to increased funding, and the introduction of new audience/patron segments. Additionally, 501(c)(3)s can generate additional income through unrelated business practices. In this way, the 501(c)(3) structure can maximize its legal structure—benefitting from both the strengths of for, and not-for-profit structures.

501(c)(3) alterations like corporate partnerships and unrelated business income ventures can be utilized by any 501(c)(3). However, to do so requires expertise and staff hours that many organizations may not have. So while the ability to utilize these adaptions is open to all 501(c)(3)s, only certain organizations have the capabilities to take advantage of them.

The public perception of 501(c)(3) organizations serves as both an advantage and a disadvantage. While the perception of not-for-profits has been marred by corruption and mismanagement, 501(c)(3) organizations are still associated with community service and “doing good”. This positive perception is reflected in the ability of arts organizations to utilize volunteers, a benefit largely exclusive to 501(c)(3) organizations. Volunteer labor allows organizations access to
expert advice, lowered labor costs and also serves as a way to develop potential donors. Public perception of not-for-profit organizations is often an unconscious association. But either positive or negative, I personally believe that an organization has the ability to overcome public perception with their actions.

B. Support for the Argument that the 501(c)(3) Model is Not Functional

One of the major criticisms of the 501(c)(3) structure is that organizations are forced to spend more time on fundraising than on any other activity. To some extent, this criticism is true. It is advantageous for an organization to have several different sources of revenue, however, the ability to optimize each type of revenue source (ticket sales/earned income, foundation support at the national, state and local levels, endowments, individual donors, unrelated business income, and fiscal sponsorships) demands specialized staff who have the time and resources necessary to properly pursue each type of revenue source. Additionally, many organizations end up feeling “trapped” by donor expectations or by foundation guidelines.

The L3C structure was created to specifically combat this issue. The L3C structure is relatively untested but regardless of its worth, its
existence proves a level of community frustration with the state of constant fundraising in the not-for-profit sector.

Many arts organizations feel that they must devote all of their staff time to fundraising, rather than furthering their mission. As discussed in the introduction of this work, organization leaders may feel beholden to donors in a way that they would not if they worked with investors rather than donors.

While the demand for specialized staff without the budget for specialized staff plagues many businesses regardless of their structure, the 501(c)(3) structure can be extremely vulnerable when short-staffed. Human assets are key to the success of not-for-profit organizations and without them, the organization will struggle.

Regardless of the size of the not-for-profit organization, boards of directors and organizational staff have a reputation for inefficiency or for mis-managing organizations. The primary drawback of this negative perception is that not-for-profit organizations seek donations which requires some level of public trust. It is important that current and potential donors are able to trust in the competence of the not-for-profit organization, and that trust is eroded with every story reported that highlights the managerial or operational iniquities of not-for-profit organizations. Secondly, this perception of mismanagement
has been the impetus for the creation of hefty not-for-profit regulations.

While increased transparency through heightened scrutiny can be viewed positively, it demands the maintenance of better records (financial, program related, employee, etc.) and a considerable amount of paperwork—both of which demand increased staff time and procedural knowledge.

The above listed issues with 501(c)(3) organizations are common challenges faced by many, but not by all organizations. These challenges are not inherently caused by the structure, rather, they are reactions to the structure. Because they are not inherent, the challenges can be navigated.

Two challenges inherent to the 501(c)(3) structure are a complicated application process and the founder’s loss of initial investment and ownership of the organization after incorporation. The challenges associated with applying for 501(c)(3) status include a complicated application process and a considerable cost relative to other potential legal structures. While creating any type of organization demands time and capital, the IRS applies increased levels of scrutiny to 501(c)(3) applicants because unlike any other type of structure, the 501(c)(3) is tax exempt and receives donations
from individual and foundations. These activities demand a higher level of scrutiny.

Secondly, once formed, a not-for-profit organization is no longer “owned” by the founder. This means that a founder may dedicate his/her life’s work to a social cause and be instrumental in the success of the organization, but he/she cannot be the sole beneficiary of the not-for-profit. Obviously, inurement is necessary to protect the assets of a not-for-profit organization, but loss of ownership and the limits to the amount that a founder can benefit from the organization are both incentives for forming another type of structure.

Interestingly, most of the disadvantages associated with the 501(c)(3) model are not inherent to the structure. However, the not-for-profit culture is, in my opinion, diseased with the idea that a 501(c)(3) charitable organization is not a business. This idea permeates culture at its most basic form of unconscious expression—speech. In the United States, 501(c)(3)s are referred to as “nonprofits”. The idea that 501(c)(3)s must not make a profit or that top 501(c)(3) leaders should not have salaries that match the level of their for-profit cousins are widespread and generally accepted, both inside and outside of the not-for-profit world. While these ideas are born from the truth that the 501(c)(3)’s core is necessarily focused on the mission, they are
dangerous because they vilify organizations that are fiscally stable and prosperous.

C. Conclusion

The strengths inherent to the 501(c)(3) structure include tax exemption, limited liability, and the ability to utilize diverse revenue streams. The strength resultant from the 501(c)(3) structure is the strong support system that can be created within 501(c)(3) organizations through management structures. The weaknesses inherent to the 501(c)(3) structure include the complicated and costly application process, the founder’s loss of ownership over the 501(c)(3), and the intense scrutiny and regulations faced by not-for-profit organizations. The weaknesses resultant from the 501(c)(3) structure include the copious amounts of time that must be spent on fundraising and the vulnerability of organizations that function without the necessary qualified board or staff members. Public perception of 501(c)(3) organizations serves as both a potential strength or weakness.

The argument that the 501(c)(3) structure must be functional because thousands of organizations use it everyday is logically unsound—but does point to an important fact not yet considered. A
system is not functional simply because it is used, however, because
the 501(c)(3) structure has been utilized in the United States for over
100 years, case law and legal familiarity with the structure exists; the
same is not true for recently developed hybrid organizations.

Overall, in my opinion, the strengths inherent to the 501(c)(3)
structure both out-number the weaknesses inherent to the structure
and overpower them in importance. However, the weaknesses
resultant from the 501(c)(3) structure are too serious to ignore. Again,
these weaknesses are resultant-from and not inherent-to the
structure, and can therefore be overcome by a thoughtful, well-
organized 501(c)(3). Their widespread existence indicates that the
501(c)(3) structure could benefit from some updating. The existence
of hybrid structures shows interest in the reformation of the processes
required of organizations that wish to promote social, cultural, and
environmental change in the United States. It may be time to update
how we go about changing the world.
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