Profitable Solutions *for* Nonprofits

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The lure of the for-profit subsidiary

Are you blogging for ideas?

Move over, expense ratios
Evaluators broaden effectiveness measures

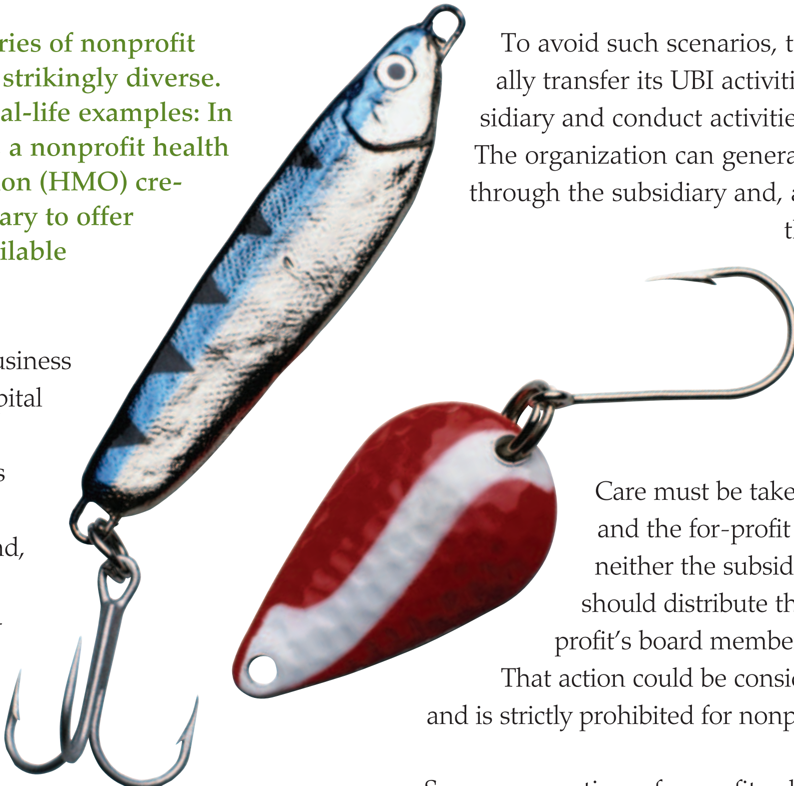
Newsbits

KATZ, SAPPER & MILLER
Certified Public Accountants

800 East 96th Street
Suite 500
Indianapolis, IN 46240

Phone: (317) 580-2000
Fax: (317) 580-2117

The lure of the for-profit subsidiary



For-profit subsidiaries of nonprofit organizations are strikingly diverse. Consider these real-life examples: In one part of the country, a nonprofit health maintenance organization (HMO) creates a for-profit subsidiary to offer health insurance unavailable through HMOs.

Elsewhere, a university business school starts a venture capital company to fund worthy startups and give students a first-hand look at what makes businesses tick. And, an investors association acquires a software developer to broaden its product line and add investor clubs and individual investors to its target market.

Sound interesting? In the wake of a severe recession — with a drop in public grants and private donations — for-profit endeavors can have a magnetic appeal as nonprofit survivors look for new sources of revenue.

WHAT'S THE DRAW?

What factors should a nonprofit consider before taking on the significant cost and responsibility of operating a for-profit company? You'll need, of course, to weigh the pros and cons of this strategic move.

Unrelated business income (UBI) is the top reason why nonprofits decide to create a for-profit enterprise. As a *nonprofit*, an organization can conduct a certain amount of revenue-producing activities unrelated to its mission, but it will pay tax on UBI profits. And if the IRS determines that your organization is pulling in too much gross revenue or net income, it could lose its coveted tax-exempt status. The same risk exists if the IRS decides that your staff is spending too much time on UBI activities.

To avoid such scenarios, the nonprofit can usually transfer its UBI activities to a for-profit subsidiary and conduct activities under that umbrella. The organization can generate after-tax surpluses through the subsidiary and, after paying tax in the subsidiary, use the profits (in the form of stock dividends) to fund activities that fulfill the nonprofit's mission.

Care must be taken to keep the nonprofit and the for-profit separate. For instance, neither the subsidiary nor the nonprofit should distribute the proceeds to the nonprofit's board members or key employees. That action could be considered *private inurement* and is strictly prohibited for nonprofits.

Some see creating a for-profit subsidiary as a way to, in effect, pay for the next phase of a not-for-profit's growth. For example, the fictitious American Society for the Prevention of Cruelty to Ferrets (ASPCF) has a profitable publishing arm in the nontraditional-pets field, and draws over 15% of its revenue from the publishing operation. The nonprofit should create a for-profit subsidiary to handle its publishing activities — or it might risk endangering its tax-exempt status if publishing profits continue to grow.

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ARE THERE OTHER INCENTIVES?

Additional reasons why a nonprofit might want to launch a for-profit subsidiary involve internal flexibility and reduced risk in some areas.

More leeway in setting compensation. Let's say that the ASPCF wants to hire a nationally respected animal nutritionist to create a line of nontraditional pet food. With a subsidiary, one is able to attract and keep highly skilled employees in ways that are unavailable to tax-free entities — for example, through stock compensation and profit-sharing.

Better outlet for research. If the nonprofit conducts research, it would automatically have a commercial outlet for marketing its discoveries. Taking the ASPCF example further, if the organization developed a nutritionally balanced snack for pet lizards, it could market the snack via the subsidiary.

Reduced liability. Imagine, for instance, that a nonprofit leases to area businesses employees with criminal backgrounds and, thus, some risk of recidivism. The nonprofit may want to contain that activity within a subsidiary and thus protect itself from liability.

WHAT ARE THE DRAWBACKS?

Despite the potential pluses, running a for-profit subsidiary comes with pitfalls. The nonprofit shouldn't allocate too much of its resources to the for-profit or it will endanger its tax-exempt status. Additionally, the nonprofit must have a realistic idea of what taking on a for-profit endeavor will mean for the organization. Operating a separate entity has its own costs and complexities, such as management, personnel, tax, audit and other requirements. Ask yourself: Could the same function be done less expensively within your nonprofit?

THE ROAD TO SUCCESS

Nonprofit executives who've successfully created for-profit subsidiaries cite two key actions:

1. Hire employees with relevant corporate experience. Nonprofit employees — skilled and talented as they may be — often lack business experience and a profit-driven focus.

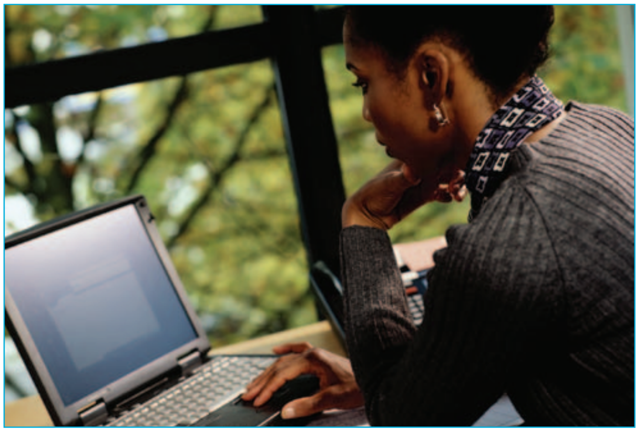
2. Maintain a management structure that's independent from the parent organization. A parent company's involvement in everyday decision making, they say, can be a recipe for failure.

SPINNING OFF

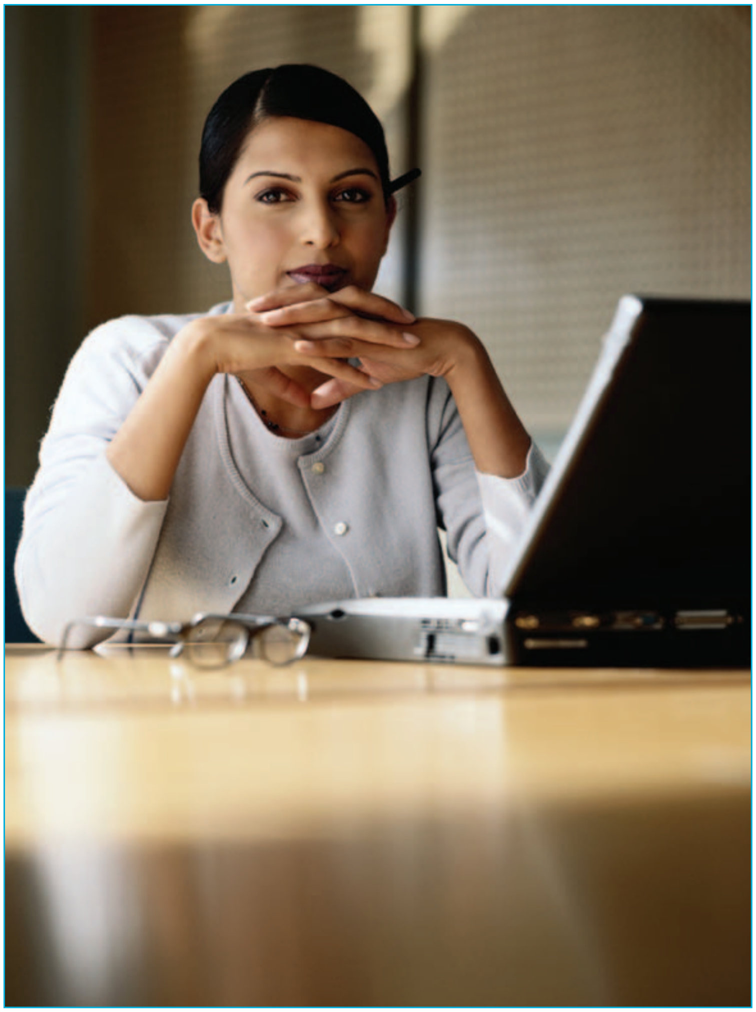
If your organization is considering creating a for-profit subsidiary, seek legal and tax advice at the onset. You'll need to decide, for example, if either of the most popular structures for nonprofit subsidiaries — C corporations and, to a lesser extent, limited liability companies — is right for your goals. Additionally, your CPA can help you conduct a feasibility study and, if your idea survives, form a business plan and work out how to capitalize your endeavor. ❃

Are you blogging for ideas?

In a nonprofit world — where funds for consultants are scant and trips out of the office hard to schedule — blogs enable you to learn from your peers about topics of mutual interest. Blogs, in turn, let you share your experiences and expertise with others.



The reality is, however, that not all blogs are equal in terms of quality and accuracy. No matter what you read on the Internet, vet the information thoroughly before relying on it to make significant decisions for your organization.



BLOGS GALORE

The most useful blogs target specific areas of expertise, including hospitals, colleges and universities, religious institutions, and other nonprofit sectors and interest subsectors.

Although many *individuals* use blogs as Web-based diaries, *professional* blogs offer focused, in-depth articles and often a way to solicit reader response. These blogs allow you to include many voices into a larger conversation. Here, for example, are a few blogs you may want to check out.

blog.givewell.org. The GiveWell blog offers a forum for nonprofits seeking advice from peers. For instance, it recently solicited ideas for helping a charity that distributes medical supplies to rural Africa. The organization sought suggestions for relating its story to potential donors and volunteers in a more compelling way. About a dozen professionals responded with detailed suggestions that included telling personal stories about the people who receive the medical supplies, equipping health care workers to videotape the recipients, and using less technical language on its website.

philanthropy.com. The *Chronicle of Philanthropy* sponsors several blogs on which you can read articles of interest and dialogue with the author and other bloggers. Current blogs include *Money and Mission*, which explores nonprofit finance; *Prospecting*, which offers fundraising tips; and *Profit and Purpose*, which examines the relationship between business and charity.

networkflip.com. The Future Leaders in Philanthropy (FLIP) blog enables bloggers to meet, learn, exchange ideas, and contribute to one another's success. Recent posts invited comment on how to make the "Causes" application on Facebook work for nonprofits and suggestions on how young nonprofit professionals can develop their careers.

CONSULTANTS' SITES

There are also dozens of blogs sponsored by consultants, including experts in fundraising, marketing, grant proposal writing, using social media and other areas. For instance, one blog has case studies on marketing topics. Another blog offers ideas in nonprofit branding.

You can find a listing of selected blogs at http://nonprofit.about.com. Type in "blogs we recommend" as a keyword phrase.

BLOGGING RISKS

Blogging is a tool to be used appropriately. The risks of visiting (or sponsoring) a corporate blog are the same as with any public communication. Focus on accuracy, quality and perception. And remember, once something has been posted on the Internet, it may remain there forever.

Organizations should create policies to mitigate some of these risks and ensure that employees and board members are on the same page with their participation in blogging. Include these guidelines as a part of a broader set of protocols that address social media as a whole. Consider asking employees to:

- Place a disclaimer on their personal blogs indicating that the views of the author aren't necessarily the views of the organization, and
- Disclose their relationship with your organization when participating on other blogs to avoid conflicts of interest.

Your guidelines also could include specific information about types of content, publishing authority, media inquiries via the blog, and so on.

JOIN THE "BLOGOSPHERE"

If you're already engaged in blogging, remember to consider your sources carefully as you collect information. And if your nonprofit is only now starting to explore professional blogs, you're not too late — the Internet is a big place where change is a constant. ❃

Move over, expense ratios

Evaluators broaden effectiveness measures

Although still important to donors, the expense ratio — what a charity spends on administrative, overhead and fundraising costs vs. program costs — is now sharing the spotlight with other measurements as a way to judge an organization's effectiveness. Why did this trend to look beyond expense ratios come about and where is it headed?

EXPENSE RATIOS ARE EASY

The traditional appeal of expense ratios (sometimes referred to as "overhead ratios") is obvious. They're easy to calculate using data from nonprofits' financial statements or Form 990s. And they provide a standard metric with which to compare even wholly different charities. Watchdog groups vary somewhat in the expense ratios they advocate, but most agree that "effective" nonprofits spend at least 65% to 75% of their budgets on program costs.

Many nonprofit leaders, however, are coming to the conclusion reached by Perla Ni, founder and CEO of GreatNonprofits: "Overhead ratios … tell you nothing about the impact that the charity has and actually encourage charities to make decisions that make them less effective." Because watchdogs, donors, foundations and government regulators have placed such a strong emphasis on this single metric, many nonprofits have felt pressure to undertrack and underreport actual administrative and fundraising spending.

Some nonprofits have even neglected to make the organizational infrastructure investments that are essential to a charity's continued health and future growth. Ironically, pinching pennies to improve the appearance of fiscal responsibility can undermine an organization's long-term effectiveness.

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THEIR MERIT IS DUBIOUS

Some influential groups have begun to shift their emphasis on expense ratios to other areas. The Charities Review Council, for example, revised its Use of Funds (essentially, an expense ratio) standard to reflect that no one range is ideal for every charity and to encourage more infrastructure investment. And a coalition of charity watchdogs — including Charity Navigator, GuideStar and GiveWell — announced that it no longer believes that expense ratios or executive salaries provide meaningful data to determine a nonprofit's impact.

Kate Barr of the Nonprofits Assistance Fund declared in a blog post, "There is not a single, simple alternative method to evaluate the effectiveness of all nonprofits." She described how some of the newer charity watchdog groups, such as Philanthropedia and GreatNonprofits, instead rely on consumer reviews, expert panels and in-depth research.

Charity Navigator is phasing in a new system that rates charities based on transparency, governance, financial strength and outcomes achieved — with an emphasis on the last element. It expects to have its "three-dimensional" rating system completed by July 2013.

ACCENT ON OUTCOMES GAINS STEAM

Many nonprofit professionals have advocated placing less emphasis on "outputs" — such as the percentage of funds spent on programs — in favor of "outcomes" — a program's measurable impact in the community. This means, for example, that, instead of assessing a literacy organization based on its expense ratio, a prospective donor might focus on how the charity recently expanded its classroom facilities and library, enabling it to improve the English reading, comprehension, and conversational (for non-native speakers) levels of 300 more individuals per month.

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For *your* public to understand the impact of your spending, you need to craft a clear and compelling message. Start by developing a method of measuring your success appropriate to your mission — for example, by the reduction in teen pregnancy rates over time in target communities where the nonprofit has sponsored educational, counseling and media messaging activities. Track these results and explain them clearly in the "Summary" section on your Form 990 and in marketing materials.

WORK ON IT

Your funding sources might still want to review your expense ratios before awarding or renewing a grant. But don't let the evaluation of your program's effectiveness stop there. Your financial advisor can help you develop metrics that will demonstrate how well your organization is fulfilling its mission.

Then be proactive in telling your story. Not only are real-life examples of program outcomes compelling, but the reporting of the results — not just dollars spent and activities conducted — strengthens an organization's position for fundraising and public trust over time. ❃

Newsbits

ELDERLY GET INCENTIVE TO MAKE IRA DISTRIBUTIONS TO CHARITY

Here's something that could potentially interest your contributors 70½ or older: Thanks to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, these seniors can make tax-free charitable distributions to your organization directly from their IRAs. While they don't get a contribution deduction, they don't pay tax. And they can treat these as IRA distributions toward their minimum distribution requirement for either 2011 or 2010.

To receive the tax break, the contributor must:

- Make the donation in 2010 or 2011,
- Give less than $100,000 in IRA distributions each year to a charity eligible to receive tax-deductible contributions, and
- Make the distribution directly from the IRA to the charity.

Additionally, the charity can't be a 509(a)(3) supporting organization. With this year's April 18 deadline approaching, the time to make a solicitation to this elder audience is now. ❋

ADVICE FOR AVOIDING IRS SCRUTINY

Linda Lampkin, a director at the Economic Research Institute, suggests several steps your nonprofit can take to reduce the chances of an inquiry in 2011. At the top of the list is making sure that what's reported as compensation on your nonprofit's Form 990 matches what's reported to other federal agencies. Recent changes to Form 990 allow these comparisons.

She also suggests confirming that income taxes and other payments related to employees — Social Security and unemployment compensation — are correctly reported and transmitted to the proper agencies. Lampkin's report was published on the ERI website in January. ❋

GIVING ONLINE RISES

While charitable donations, in general, slumped again last year, some of the largest not-for-profits reported an increase in *online* donations. Network for Good, which accepts donations for all U.S. charities, said it received 20% more online gifts in 2010 than it did in 2009. And fundraising software developer Convio reported that online donations to its 1,300 clients shot up more than 40% over the previous year.

Are the increases the result of more generous donors — this would be an exception to recent giving patterns — or do the upticks reflect a surge in popularity for online giving? Either way, to ensure your nonprofit can participate in the upswing, make sure your organization is able to efficiently process funds online this year.

Network for Good further suggests that you prioritize *recurring* giving in your online fundraising. The organization (which reports that 20% of its online gifts are repeats) suggests giving donors the option of making a recurring donation every time they enter a gift amount. ❋

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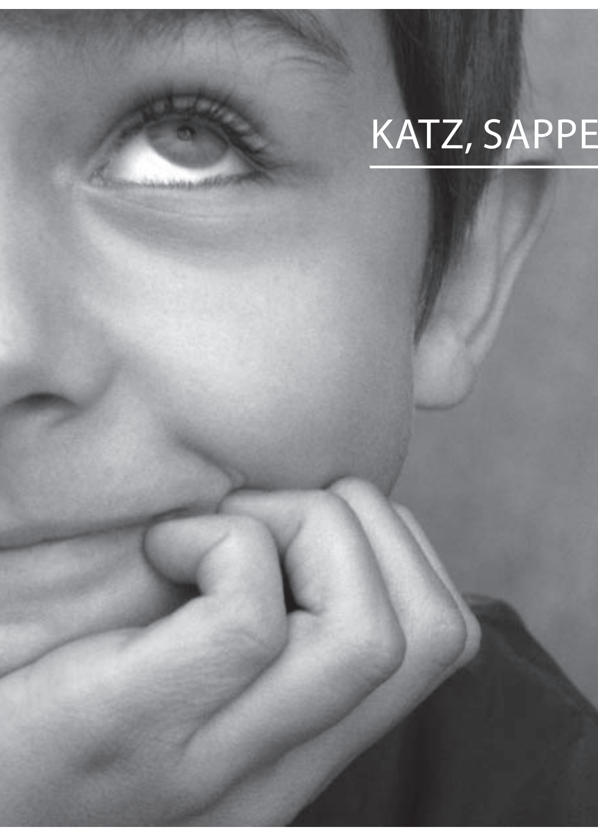

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