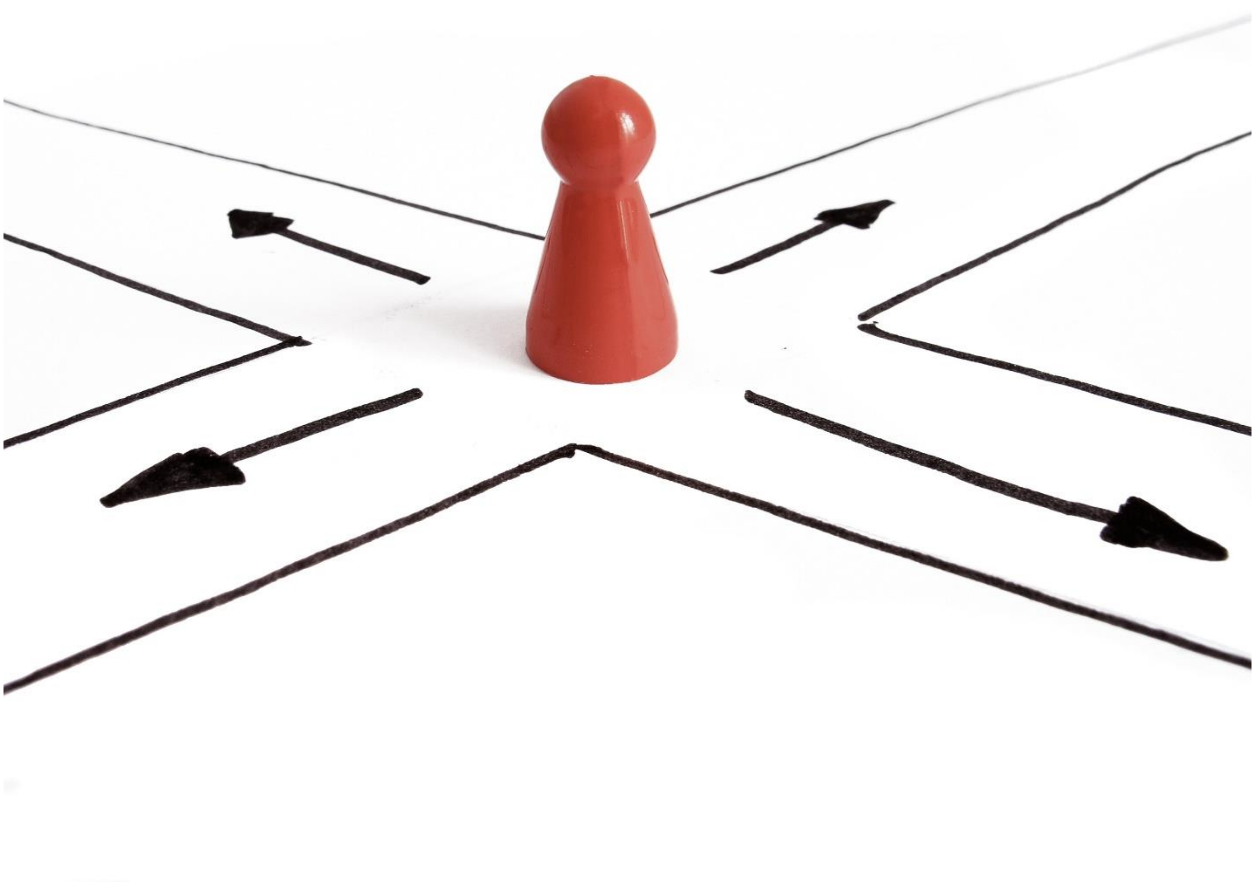
ALTERNATIVE STAFFING ALLIANCE
People-Based, Market-Driven

Weighing the Options:

Legal Structures for ASOs



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Introduction

The Alternative Staffing Alliance often receives questions from organizations and entrepreneurs about the appropriate legal structure for an alternative staffing business. There is no right or wrong legal structure, rather this decision should take into account the entity's business strategy, anticipated cost structure and profitability, capital sources, ownership and control of the enterprise, and other factors.

This paper provides a description and comparison of various legal structure options, and includes the perspective of several alternative staffing organizations (ASOs) we interviewed to understand the considerations behind their choice of legal entity. We would like to thank the seven ASOs who gave their time to respond to questions for this report and share information about their organizational structures.

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Overview

As social enterprises, alternative staffing organizations (ASOs) operate in the hybrid space between nonprofit and for-profit corporations. Successful ASOs strive to simultaneously manage competitive staffing businesses, and make a meaningful impact on the lives of the people they employ. Historically, the majority of ASOs have been structured as nonprofits, and tend to operate as programs within parent nonprofit organizations. Recently, though, the burgeoning social enterprise sector has sparked new corporate forms that allow for bottom lines beyond profit.

For-profit ASOs have increasingly entered the sector, taking a variety of forms, from traditional corporations and LLCs to Benefit Corporations and more. Much of the trend towards for-profit business structures is due to an increasing number of individual entrepreneurs entering the field. In other cases, nonprofit ASOs have created new for-profit entities to support their expansion strategy. Currently, of 67 known alternative staffing organizations, 72% are structured as nonprofits, and 28% as for-profits.

Given the variety of options, a key decision for new entrants to the sector is determining the best legal structure for their staffing business. Strategy is at the core of this decision, and there are many angles to consider.

Analysis

ASO startups face multiple decisions in determining their legal structure:

- If sponsored by an existing nonprofit, will they operate as a program within the parent organization, or create a separate entity?
- If creating a new entity, will it be a nonprofit or for-profit corporation?
- If opting to form a for-profit, is a traditional "C" corporation, LLC, or newer hybrid structure (e.g., benefit corporation, L3C) the best choice?

Addressing each of these decisions is strategic, and hardly straightforward. Tax status and implications are only one consideration. Legal structure will affect how an ASO can raise capital, and may influence how it attracts talent and positions itself in the market. For example, some business opportunities may flow more readily to nonprofit entities, particularly from other nonprofits or government agencies. Other business opportunities may offer procurement advantages to for-profit businesses that are minority or woman-owned. Still other potential business partners may favor for-profit entities, believing they are more professional and efficient than nonprofits.

The best legal structure for an ASO is the one that most closely reflects its long-term business strategy, from targeting customers and financing operations to cost coverage and long-term growth. As every ASO is unique in terms of its assets, competencies, relationships, and vision, there is no one-size-fits-all legal structure – just a set of several options with various tradeoffs.[1]

[1] Potential legal structures for a social enterprise include: traditional corporation, LLC, L3C, benefit corporation, nonprofit corporation, or program within a sponsoring nonprofit.

Considering Sponsorship

The majority of ASOs are sponsored by a parent nonprofit organization. Currently, of 67 known alternative staffing organizations, 81% are sponsored by nonprofit organizations, and 19% are "standalone," with nonprofit and for-profit entities in both categories. Operating the ASO as a program of a parent nonprofit may help the sponsor better fulfill its charitable purpose, as well as contribute additional revenue. Similarly, if an ASO expects grants and donations to be a major component of its startup and/or operating capital, then leveraging the fundraising connections and abilities of the parent nonprofit is advantageous.

If choosing to operate an ASO as a program within a parent nonprofit, there are no further considerations of legal structure – no new entity is created. In this case, the staffing business integrates operationally within the parent organization and its activities must be aligned with the parent organization's mission in order to protect the parent's tax-exempt status, and exempt the ASO's income.

If the sponsoring nonprofit opts to create a new ASO subsidiary, the new entity can be structured as a for-profit or a nonprofit. Typically when sponsoring organizations make this choice, the parent is the sole owner, and the same board of directors may govern both organizations.

One nonprofit parent organization, which operates its ASO as an internal program, reported having a lot of discussion about incorporating separately but not yet doing so "because it is a very time consuming process." For them, the primary driver in thinking about a separate structure is liability protection for the parent nonprofit. Another ASO, whose parent chose to form a for-profit subsidiary, said they wanted legal separation even if that meant paying taxes. As a separate entity, the ASO is "free to compete," and its business activities will not threaten the parent's nonprofit status in any way.

Program within Nonprofit	**Separate Entity**
Pros: • Ability to directly leverage organization's name and assets for raising capital, attracting customers and employees, providing administrative support, etc. • May be able to access more favorable workers compensation insurance through inclusion in Master Policy.	*Pros:* • Allows ASO to diversify beyond the nonprofit's core mission • If operating as a for-profit entity, allows for utilization of Work Opportunity Tax Credits, etc. • Limits liability for the parent resulting from the ASO's business activities
Cons: • Exposes parent to risks related to liability, insurance, and tax-exempt status • Customers may view ASO as nonprofit and expect price discounts or perceive lower quality service	*Cons:* • Adds time and expense to set up and maintain a new entity • Involves extra administrative burden, e.g., annual audit and corporate reporting

Raising Capital

Most businesses need to raise capital at startup to begin operations, and then later to fuel growth. How an ASO plans to meet its capital requirements should be factored into its choice of legal structure.

If you plan to raise capital from…	Then, consider a…
• Grants and donations	• Nonprofit corporation
• Equity and traditional debt	• Traditional or benefit corporation, or LLC
• Program-related investments from private foundations	• L3C*

Grants & Donations: If an ASO is likely to rely significantly on grants and donations to support ongoing operations, structuring as a nonprofit corporation is likely the best option. Most grants are not available to for-profits, nor are donations tax-deductible. Further, ASOs with parent organizations that are strong fundraisers can directly benefit from selecting a nonprofit status and following suit. A nonprofit sponsor can also use grant funds to capitalize a for-profit staffing subsidiary, and some have done so. In this case, the extent to which the enterprise is expected to need grant support for startup only or on a continuing basis is a key consideration.

At the same time, overreliance on grants can pose long-term challenges to sustainability, when conditions limit funding opportunities. One ASO that recently transitioned from a nonprofit to an LLC said that writing grants and seeking donations was a distraction, and that time is now better spent focusing on generating revenues from customers. Another commented that relying too heavily on grants and donations ran counter to their message to temporary workers in terms of earning income and working towards personal financial sustainability.

Equity: If an ASO plans to seek equity investment in the company to fuel growth, they must select a for-profit structure, such as a corporation or an LLC. A nonprofit cannot issue shares or sell membership interests, as it exists for a charitable purpose and cannot have owners. The ability to offer equity paves the way for partnerships with venture capitalists, independent investors, and even top executive staff.

Debt: Nonprofits may have a more difficult time securing bank financing, especially at startup, due to often heightened standards by loan officers in demonstrating business viability. For-profit structures, particularly corporations, are well understood and normally have an easier time securing debt financing. Additionally, social impact investors may be interested in extending debt financing to for-profit and hybrid entities, versus making grants, in order to earn a modest return on and recover their assets.

***Program-Related Investments (PRIs):** Private foundations are required by the IRS to distribute at least 5% of their net investment assets annually. Often, funds are given in the form of grants, but foundations may also make program-related debt or equity investments (PRIs), which hold the potential for return. PRIs must be invested in charitable organizations or business ventures for a charitable purpose. In the mid-2000s, social enterprise advocates created the L3C, a low-profit business operating for a charitable purpose, specifically to attract PRIs, but lack of clarity from the IRS as to its treatment of PRIs in L3Cs has greatly constrained growth of such investments. While foundations can get a private letter ruling or opinion of counsel for protection, these additional requirements often deter action.

Winning Clients

Selecting the most appropriate legal structure also depends on an ASO's customer strategy. As potential employer clients may perceive nonprofit and for-profit staffing providers differently, it is important that an ASO considers their structure in light of who their customers will be, and what they will value. For example, a nonprofit structure may benefit ASOs planning to secure set-aside contracts with government entities, or do business with nonprofits or other entities that prefer to source from charitable organizations.

On the other hand, some potential clients may believe that a nonprofit staffing company is not able to serve them as well as a for-profit. One ASO interviewed for the report believes that employer clients often perceive candidates from a for-profit staffing company to be of higher quality than workers from a nonprofit. Given these perceptions, some clients may see hybrid entities as business suppliers that are both effective and socially responsible. Customers that have traditionally purchased staffing services from traditional for-profit staffing firms may be more willing to shift their sourcing to a hybrid legal structure, like a benefit corporation, than to a nonprofit.

Delivering Supportive Services

The decision of whether worker support services will be delivered internally or externally is a strategic concern related to legal structure. ASOs generally strive to be competitive on price with traditional for-profit staffing companies in their market. At the same time, a key difference between ASO and traditional staffing company business models is the provision of supportive services to job seekers, and market billing rates typically fail to cover these additional costs. As a solution, some ASOs cultivate partnerships with nonprofit entities that focus on supporting workers (with job readiness training, counseling and other training and/or social services), while the ASO itself offers a very limited range of support (mainly, informal coaching). If the ASO intends to deliver comprehensive support services in-house, structuring as a nonprofit will allow the company to obtain grants as operating subsidies to cover these costs. On the other hand, if an ASO has identified outside partners for support services, structuring as a for-profit could allow the staffing company to concentrate on selling business and filling job orders, while the nonprofit focuses on delivering supports and securing the associated funding.

Attracting Talent

In order to attract talented executives, for-profit corporations sometimes offer equity as compensation, which can create a big upside if the company does well.[2] Some ASOs have chosen a for-profit structure, versus a nonprofit that cannot offer equity, in order to attract experienced leaders from the traditional staffing industry. Recruiting high-quality talent early on can produce significant advantages for a startup ASO, from client connections and systems knowledge to best-in-class business practices. The ability to offer equity also allows the ASO to bring on investors with experience and connections to benefit the organization.

[2] Traditional and benefit corporations can both offer stock as equity-based compensation. Similarly, LLCs and L3Cs can offer investment opportunities through selling membership interests in the companies with terms and conditions that can act just like stock.

Appealing to Key Partners

Temporary staffing is an industry that can sometimes carry a poor image. As such, staffing businesses operating as benefit corporations, L3Cs, and nonprofits can signify high-road alternatives to traditional providers. Similarly, some ASOs have deliberately adopted for-profit structures, typically LLCs, to send a message to the traditional staffing industry that it is possible to run a successful for-profit firm that simultaneously is a positive asset for the community.

Additionally, some potential business partners (e.g., employer clients, strategic alliances, referral sources, community organizations, etc.) may believe for-profits are more fiscally responsible than nonprofits. They may see a for-profit structure as representing cost control, effective management, and long-term sustainability of the organization. Alternatively, other potential partners from the nonprofit sector may be put off by for-profits, and see them as representing an organization too business-like, and out of touch with their mission or the community.

Understanding the Options

While the vast majority of ASOs operating today are structured as nonprofit corporations, the sector increasingly includes LLCs and benefit corporations, among other structures. Below are intentionally brief descriptions of the different legal structures.

Nonprofit Corporation

- Typically tax-exempt entities operating for a charitable purpose under section 501(c)(3) of the Internal Revenue Code, again, representing over 70% of ASOs currently in the sector.
- All activities, including social enterprise programs operated by the nonprofit, must directly benefit the charitable purpose as stated by the organization.
- A nonprofit cannot be owned by or benefit any private interest, so it cannot offer equity to investors, and all profits must be reinvested in the organization to fulfill its purpose.

Traditional: LLC (Limited Liability Company)

- LLCs are typically not taxable entities, but rather pass-through entities, where the income from the business passes through to the owners, who then pay taxes personally.
- Depending on the number of members in the LLC, the IRS will treat the business like a sole proprietorship (i.e., single member) or partnership (i.e., multi-member), however, certain LLCs are automatically classified and taxed as corporations by federal tax law; LLCs not automatically classified as corporations can choose to be taxed as such. [3]
- In most cases, LLCs can have unlimited classes of shares and an unlimited number of owners; despite not being a 'corporation,' owners of an LLC retain the corporate shield against personal liability for corporate debts and liabilities.
- Like traditional "C" corporations, LLCs are also highly flexible vehicles for accepting investment, but they have far less rigorous requirements for shareholder meetings and recordkeeping.

[3] Most commonly, this is done to keep profits in the firm as retained earnings, either for reserves or to finance growth, at a tax rate lower than that of the LLC's members.

- While there is no legal structure called a "nonprofit LLC," a single-member LLC owned by a sole nonprofit organization member would be tax exempt; LLC must operate according to charitable purpose of nonprofit owner, or nonprofit would lose status.

Hybrid: L3C (Low-Profit Limited Liability Company)

- Simply an LLC with a social purpose embedded in its operating agreement and with the authorization for its managers to pursue goals besides profit.
- Operate as LLCs for federal tax purposes, with no current tax benefits; also, structure is for-profit, so not eligible for tax-deductible donations; only available in eight states: Illinois, Louisiana, Maine, Michigan, Rhode Island, Utah, Vermont, and Wyoming.
- Technically designed to attract program-related investments (PRI) from private foundations and investors by formally complying with IRS PRI requirements in the articles of organization; purpose is also to market the entity as an alternative for-profit structure doing business for good
- Many have been critical of the L3C structure for not actually attracting PRIs, as the IRS has not ruled whether private foundation investments in L3Cs qualify as PRIs, and state laws authorizing L3Cs do not bind the federal tax authorities.[4] [5]

Traditional: "C" Corporation

- Most common for-profit structure in the United States; is well understood by banks and investors for financing, and can raise capital in a wide variety of ways.
- Primary criticism is double taxation of profits distributed to shareholders, both at the corporate level and at the individual level; also, its directors' sole objective is to maximize profit for shareholders above any social aims.

Hybrid: Benefit Corporation[6]

- Benefit corporations are a "new class of corporation that have a corporate purpose to create a material positive impact on society and the environment" and voluntarily meet different standards of accountability and transparency.[7]
- Operate and are treated just like traditional C corporation for all purposes (e.g., taxation, ability to offer equity, etc.), <u>**except:**</u>
    - Public benefit status or purpose is stated in the articles of incorporation
    - Corporate decisions consider impacts of actions on workers, community and the environment, in addition to shareholders

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[4] http://www.dmlp.org/legal-guide/low-profit-limited-liability-company
[5] http://nonprofitquarterly.org/2014/04/28/some-unanswered-questions-about-benefit-corporations-l3cs-and-social-enterprise-more-generally/
[6] As of August 2015, 31 states have passed authorizing legislation for benefit corporations. Similarly, Washington has authorized "social purpose corporations," while California has authorized "flexible purpose corporations" in addition to benefit corporations. Both social purpose and flexible purpose corporations give directors more flexibility on including a company's social purpose in decision making. Benefit corporations, on the other hand, are required to take their specific public benefit into account.
[7] See: http://benefitcorp.net/

    - Requires creation of a benefit report that assesses overall social and environmental performance against a "third party standard" (specific requirements relating to logistics and content of report vary by state)
- Primary benefits are associated with the marketing of the structure, in terms of appealing to potential customers, investors, and staff members, by representing a sort of 'middle ground' between the nonprofit and for-profit sectors.

Related to Benefit Corporation: B Corp Certification by B Lab

- A certification available to traditional corporations, benefit corporations, LLCs, and other legal structures (except nonprofits) to signify that an entity pursues a triple bottom line with profit, social, and environmental objectives.
- Often confused with the benefit corporation legal structure, which is promoted by the same group (B Lab) that certifies organizations as B Corps.
- In order to become a Certified B Corp and maintain certification, a for-profit business must:
    - Pass the B Impact Assessment with a minimum score,
    - Either incorporate as a benefit corporation in their state, or amend their articles with language to free their directors from a sole focus on profit,
    - Sign the B Corp Declaration of Interdependence and the Term Sheet
    - Maintain annual certification by completing a simple questionnaire and paying a renewal fee based on a sliding scale corresponding to gross revenue[8]

[8] For the typical ASO with revenues between $1-2M, the fee ranges from $500 to $1,000 annually.

Key Questions to Consider

Choosing the appropriate legal structure for an ASO is a strategic and multi-faceted challenge. Structure not only determines how the enterprise will be governed and financed, but also how it will be perceived by customers and partners. It is also a long-term consideration, with ramifications for how growth will be achieved and objectives will be pursued. While not necessarily permanent, an organization is generally difficult to restructure, so adequate planning and foresight is vital in charting a successful course for a new organization. Ask yourself the following strategic questions as you weigh the options:

What are your profit expectations or goals?

> It is important to determine the relative importance of profit and social objectives, and the degree to which these priorities should be formally required of your ASO now and in the future.

What is the anticipated scale and vision for growth of the ASO? Is it being created to employ a relatively small cohort of program trainees or will it recruit workers broadly within the target market, and potentially expand to multiple markets?

> Your growth strategy is based not only on how expansion will be financed, but also on if and how your ASO's scope and mission will change over time.

How do you expect to raise capital for startup, operations, and expansion? Are potential funders comfortable lending to nonprofits or businesses with a social purpose? Would you consider taking on investors?

> An ASO's structure both affects what types of funding it is likely to receive (e.g., most grants go to nonprofits), and how potential funders will perceive the efficiency and financial stability of your ASO in terms of repaying debts and achieving a return on investment.

Based on your market study, are your primary target clients private sector businesses, nonprofit organizations or government entities? How will these prospective customers perceive your nonprofit or for-profit status?

> An ASO's structure can open up or close doors for engagements with particular types of clients. Some clients will have formal guidelines on with whom they can contract, while others may only wish to partner with certain types of entities as a matter of preference or based on experience.

Will supportive services for workers be delivered internally or externally via partner organizations?

> This factor has significant implications for your cost structure and potential need for an ongoing subsidy.

How will you attract talented leadership to run the ASO? Will key executives require an equity stake in the enterprise to join your team?

> Depending on your ASO's sales and management needs, a for-profit structure allows for ownership interests to be included in the compensation packages for high quality internal staff.