Entity Structure for Community Composters: Cooperatives, Nonprofits, For-profits, and more!

Explained with the help of cake!

Note:
Many of the notes below the slides may be informative or they may be irrelevant. Some are remnants of other presentations. Read them at your own risk.
Entity structure matters for your compost enterprise and, as it turns out, for the whole community compost movement!
We support a lot of cooperatives and nonprofits... And SO MANY things in between and beyond. (We spend a lot of time in legal grey areas.)
Quick poll! My compost enterprise is a:

- Sole Proprietorship (just one person owns it, no formal entity)
- Nonprofit
  - Fiscally-sponsored nonprofit
  - 501c3 nonprofit
  - 501c4 nonprofit
  - Not tax-exempt nonprofit
- Cooperative
  - Worker-owned cooperative
  - Consumer-owned cooperative
- For-profit
  - Partnership
  - Corporation
  - Benefit Corporation or Social Purpose Corporation
  - Limited Liability Company (LLC)
- It’s informal or we haven’t figured it out yet
(State level)

Entity

Tax Status

(Federal level)

Financial, Governance, & Operational Policies
What really gives flavor to our enterprises?

Financial, Governance, & Operational Policies

But everything I’m about to say about entity and tax status is still important because....
These are words policymakers and regulators understand!
Compost policy is being made RIGHT NOW!
YIKES! The trend is to make laws that privilege LARGE-SCALE waste haulers and facilities.

- Burdensome licensing and regulatory requirements intended for large scale operations
- Exclusive contracts (monopolies) for big haulers.
We can ask policymakers to give certain kinds of compost enterprises:

- **Exemptions** from some regulations and hauling restrictions
- Public **funding** and **preferential contracting**

...on the basis of their:

- Small size
- Composting methods and practices
- Entity structure oriented toward public benefit (nonprofits and cooperatives)

There’s not much else in the way of objective criteria….or is there?
Size and entity structure:

- **Backyard-scale composting**
  - Composting at schools and community gardens

- **Medium-scale for-profit composting enterprises**
  - Structured for profit (shareholder-oriented)

- **Large-scale composting**
  - Nonprofit with composting facilities for workforce training
  - Structured for community benefit (stakeholder-oriented)

- **Compost micro-enterprise**
Two key points:

1. A major determinant of your entity structure for a compost enterprise may be the potential to gain policy advantages.

2. So you might need to challenge your preconceptions about nonprofits and cooperatives, like:

   - Nonprofits spend all the time asking for donations.
   - Cooperatives spend all their time in meetings.
   - I don’t want a Board of Directors to be my boss.
   - But I need to make money.
Three general cake categories:

**Public Benefit**
Most 501(c)(3)s, charitable and social welfare nonprofits

**For Shareholder Profit**
Stock corporations, LLCs, Benefit corps, Social purpose corps

**Mutual Benefit**
Cooperatives and mutual benefit nonprofits
Poof!
A Sole Proprietor!
Law Office of Me & Them

Poof! A Partnership!
Some folks want to limit liability. What does that mean?

It doesn’t mean your enterprise is protected from getting sued*...

*Get insurance for that.
It means that you, as an individual will be shielded from liability….uh, maybe.
Corporations and things with "LL" provide a liability shield.
Debts your firm owes
Harm your firm causes

Liability Shield
It wasn't me!
It was my company!
Debt you guaranteed
Your negligence or malpractice

Liability Shield
LLC: Limited Liability Company

Benefits (compared to corporations) include:
● Fewer formalities
● Simpler documents
● You likely don’t need to treat yourself and other owner-managers like an employee
Corporations

Common types (it varies from state-to-state):

- General Corporation or Stock Corporation
- Benefit Corporation or Social Purpose Corporation
- Nonprofit Public Benefit Corporations
- Nonprofit Mutual Benefit Corporation
- Cooperative Corporation
Do you want to be an employee?
Other considerations:

Cost:

$800/year in California
for a limited liability
entity like a corporation

Formalities:

- Notice
- Meetings
- Minutes
- Records
Certified B corp

It's a Certification.

Financial, Governance, & Operational Policies
1. Cake:
Form the entity (i.e. corporation, LLC)
or register it (partnership)

2. Icing:
Choose tax status
Tax categories:

501(c)(3) - charitable, etc.
501(c)(4) - social welfare
501(c)(12) - energy coops, etc.
Subchapter T - cooperatives
Subchapter C - i.e. C corps
Subchapter S - i.e. S corps
Subchapter K - most LLCs and partnerships
Sole proprietors:

And it’s all self-employment income. (i.e. you pay FICA)
All other entities: file a separate tax return.
Partnerships and LLCs default to “partnership taxation” or Subchapter K taxation, unless they elect to be taxed as corporations.

**Note:**
It’s all self-employment income. (i.e. you pay FICA)

**Form 1065**
Allocates all profits and losses directly to partners/members. The entity doesn’t pay tax.
Corporate Taxation:

Money you pay yourself as a profit dividend.

Money you pay yourself as "salary."

Income tax

Medicare

Social security

Income tax
My tax person says it's time to incorporate.

I am earning too much money for this person.
C Corp (Subchapter C of Internal Revenue Code) pays taxes on profits (at corporate tax rate.) Then you pay taxes on it again when/if dividends are paid to you.

In essence: Double taxation
Corp tax benefits:

- More flexible for tax planning purposes.
- Lower tax rate for profits kept in smaller corporations.
S corp (Subchapter S of Internal Revenue Code)

All profits pass through to you. The corporation doesn't pay tax.
Favorable tax status:
You can combine pass-through and entity-level taxation as needed.

Only for entities “operating on a cooperative basis,” which means:
• **Democratic:** One vote per member
• **Equitable:** Profits distributed on the basis of value or quantity of services (not on the basis of equity share)
Cooperatives!
(That is supposed to be an elephant)

It's a tax category.

It's democratic and it distributes profits based on patronage.

It's a type of corporation.

It adheres to the Rochdale principles.
What Kind of Cooperative?

- **Worker cooperative:** Owned by the people who do the composting.
- **Consumer cooperative:** Owned by the people who generate organic material, or by the people who buy the finished compost, or both.
- **Producer cooperative:** Your compost enterprise probably wouldn’t structure this way, but you can join with other compost enterprises to market together, purchase supplies together, or sell compost together.
Nonprofits can be structured quite a bit like cooperatives.

A non-hierarchical nonprofit organization.
Pay is equal and governance is distributed among all staff.
Learn more: www.theselc.org/worker_selfdirected_nonprofits
We look more like this, though:
Board of Directors

Can hire, fire, decide your salary, etc.

But can delegate most other decisions to staff, with oversight.
Choose a cake:

Public Benefit
Most 501(c)(3)s and 501(c)(4)s nonprofits

Mutual Benefit
Cooperatives and mutual benefit nonprofits
Big $

Energy

Water

Land

Everything
Our sweet spot:

Public benefit
(with self-help and democratic management mixed in)
Communities organizing nonprofits to benefit their own communities.

Cooperative
(with systems-change and public benefit mixed in)
Movement-based, social change-oriented cooperatives, especially those designed for permanent community benefit.
Funding the sweet spot!
(With gift capital, risk-tolerant capital, etc.) We need:

1. More things to be 501c3s
2. Existing 501c3s to do more things
3. 501c3s to support non-501c3s \((\text{with PRIs, grants, partnerships})\)
501(c)(3): It’s not just about tax exemption and funding!

Other benefits of 501c3 include, and are definitely not limited to:
- Educational debt forgiveness for staff
- Ability to engage unpaid volunteers
- Exemptions in various regulatory contexts:
  - Zoning
  - Securities
  - Health & safety law
  - Organics hauling
  - Many more we will likely advocate for!
- Access to discount programs like Google Nonprofits, TechSoup
501c3
Nonprofit
Corporation
tax exemption

501c4
Nonprofit
Corporation
tax exemption
Charitable & Educational
501c3
Nonprofit Corporation
tax exemption
With sprinkles!
Tax-deductible donations!
Social Welfare

501c4
Nonprofit Corporation
tax exemption
No tax exemption

“Public” purpose

Any lawful purpose

That’s not such a bad thing if you think about…

Pays tax like a corporation
Income Sources:

- Donations from people who don't take the standard deduction
- Foundation grants
- Donations from people who take the standard deduction
- Earned income

Which is hardly anyone, thanks to the Tax Bill

501c4 or No tax exemption

501c3
Primary Purpose:
Charitable & Educational
The boundaries of 501(c)(3) law move to accommodate our understandings of problems and their solutions.
We learn more about problems every day!

Planet has only until 2030 to stem catastrophic climate change, experts warn

By Brandon Miller and Jay Croft, CNN

Updated 6:54 PM ET, Mon October 8, 2018
More established boundaries of 501(c)(3)

Now eligible for 501c3: Game-changing solutions that we now realize are *paramount* to averting complete disaster?
How do the boundaries move?
FORM 1023
Your organization and all of its proposed activities, income sources, governance structure, etc...

IRS
We have questions.
Yep, that’s basically law getting made.

FORM 1023
Your organization and all of its proposed activities, income sources, governance structure, etc...

Send to: IRS

No.
Protecting "ecologically significant" land is a charitable purpose.

Farms aren’t ecologically significant.

Oh! Farms ARE ecologically significant.

Rough History of the IRS’ Reactions to Land Conservation

Things can change based both on what we know (about problems and solutions) and on what we value as a society:


See: William T. Hutton, Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384
Congress and various states recognized threats to farmland and passed laws to protect it.

Various ag land trusts have gained 501c3 recognition since the 1978 ruling. See: William T. Hutton, *Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384*


1967

Protecting land for educational purposes is cool.

Protecting "ecologically significant" land is a charitable purpose.

Farms aren't ecologically significant.

Oh! Farms ARE ecologically significant.

1975

1978

After that...
All of our organizations (and staff) can learn to explore the legal frontiers of 501(c)(3).

I sound like such a lawyer right now.
1. First, ask:

What are the threats we’re addressing? What is the need that is not being met?

Data helps!

Soil & Compost Fact Sheet
Does our activity have a substantial causal relationship to remedying the problems or meeting the needs?

Data helps!

Soil & Compost Fact Sheet
3. Then, ask all the time:

Does it cross any boundaries of 501(c)(3)?

Is it not larger in scope than is necessary to achieve our charitable or educational purposes?
Educational & **scientific** purposes hold possibility:

**Educational**: Every human needs to learn how to manage organic material. That will take practical and hands on experience!

**Scientific**: There’s still so much to learn about effective composting and soil stewardship. That will take actual composting and experimentation.

**But they could be limiting:**

Is our compost enterprise **larger in scope than is necessary** to achieve our **educational** or **scientific** purposes?
What are the boundaries we need to know about?

Charitable, Educational, Religious, Scientific, Etc.
Charitable includes a lot of things:

- Relief of the poor, distressed, & underprivileged
  - Lessening neighborhood tensions
  - Eliminating prejudice and discrimination
  - Combating community deterioration
- Lessening the burdens of government
  - Other stuff, too.
Is it too commercial?

Charitable, Educational, Religious, Scientific, Etc.
Is there too much private benefit?
Is there private benefit to insiders? (Inurement)
Is it too commercial?

Is there too much private benefit?

What if this is our sweet spot??

Charitable, Educational, Religious, Scientific, Etc.
Is it too commercial?

Charitable, Educational, Religious, Scientific, Etc.

Private Benefit
Major market failures

Commercial

Private Benefit

Charitable, Educational, Religious, Scientific, Etc.
Example of market failure!

Legislators say: We have to get all the organics out of landfills.

The commercial sector hasn’t made it happen.
Your nonprofit's activities:

Activities related to your exempt purpose.

Unrelated activities are OK if they are insubstantial in relation to your exempt purpose activities.
Is there too much private benefit?
(a bunch of community members composting for their own benefit?)
Enlarged charitable class:
(Workforce development and enterprise incubation for economically precarious communities)
“Charitable class” is context specific:

Older ruling:
“An organization formed to build housing for rent to moderate income families at cost was held to be not charitable within section 501(c)(3) since its program was not designed to provide relief to the poor.”

But what if it provides relief to the distressed, like moderate income people who are now:

- Threatened with displacement
- Rent-burdened (more than 30% of income goes to rent)
- Precarious: Moderate-income, but $0 in assets
- Live in climate-impacted area
Lessening the burdens of government?
Combatting community deterioration
501c3 tax exemption
Nonprofit Corporation

501c4 tax exemption
Nonprofit Corporation

Charitable & Educational
Social Welfare

With sprinkles! Tax-deductible donations!
Making the community better, just ‘cuz.

Making the community better, because if we don’t, things will be bad.

501c3
Nonprofit
Corporation
tax exemption

501c4
Nonprofit
Corporation
tax exemption

Making the community better, just ‘cuz.
Our intern’s assignment:
Gather data on how things are bad and especially about how things are getting worse. She produced these, which we encourage anyone to use:

- Soil & Compost Fact Sheet
- Jobs & Income Fact Sheet
- Food Systems Fact Sheet
- Housing Fact Sheet
The IRS staff aren’t soil scientists, so we can help educate them on we are all doomed if we don’t use compost to reduce or prevent:

● Soil toxicity
● Soil depletion
● Drought
● Malnutrition
● Starvation
● Disease
● Waterway pollution
● Methane and CO2 release
● The end of the civilization and the planet

We can point to:

1) Data
2) Public policies
Commercial

Charitable, Educational, Religious, Scientific, Etc.

Is there private benefit to insiders? (Inurement)
Self-help is empowering and necessary, right?

Hmm, but self-help has always been an awkward fit for 501(c)(3):
“A membership organization formed to enable its low income members to purchase decent housing is not exempt under 501(c)(3) because it serves the private interests of its members. Such an organization would be charitable if the low income families to which it provided decent housing had no relationship to the organization or those who controlled it, as in Rev. Rul. 70- 585, 1970-2 C.B. 115.”

To sum it up:
- You can help other people.
- Other people can help you.
- But you can’t join with others to help yourselves.
- Ugggh.
We WANT the community to bake the cake!
We NEED the community to bake the cake in order to combat community deterioration!

-- what Nobel Prize-winning economist Elinor Ostrom said (more or less)
We need self-help because smart Nobel Prize-winning university economists said so!

1. Clearly defined boundaries
2. Rules regarding the appropriation and provision of common resources that are adapted to local conditions;
3. Participatory decision-making
4. Monitoring by people who are accountable to resource appropriators
5. Graduated sanctions for exploitation of resources
6. Accessible conflict resolution methods
7. Recognition by the authorities of group autonomy and self-governance
8. For larger groups: Multiple layers of nested enterprises (to keep group sizes small)
What Wendell Berry feels for soil:

Affection!

Read his lecture “It All Turns On Affection”

What is the legal lesson in that?
Affection minus (Power) = Disappointment

Power minus (Affection) = Destruction

Affection + Power = Stewardship
Moral to that story? The people who are composting should have the power.

Our compost is clean and healthy!

Can we make the case to policymakers that worker cooperatives will be more responsible composters? YES!
So is there an ideal cake for composting? 

Maybe: Nonprofit (501c3) with participatory management by the people doing the composting.
We can ask policymakers to give certain kinds of compost enterprises:

- **Exemptions** from some regulations and hauling restrictions
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...on the basis of their:

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Thoughts?
Questions?
Let's learn compost law!

So fun!