Incorporating your new Fair Trade organization…
for-profit or non-profit?

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You have a brilliant new idea and see a wonderful opportunity for social justice through commerce. A crucial step to transform your passion into an organization that makes an impact is deciding how to incorporate your new organization. Should you incorporate as a for-profit or a non-profit organization?

This brief paper from the founders of two different Fair Trade Federation member organizations will explore the pros and cons of for-profit versus non-profit incorporation and offer insight into the lessons learned during the initial startup year for both our organizations.

Before we take a look at our thoughts, let's get our bias stated right away (every author has a bias): we believe that a capitalistic organization <u>may</u> be constructed in a sustainable manner (for humans, for the earth, for the organization itself). Granted, this is not widely practiced today, but we believe the Fair Trade movement is contributing to the movement of for-profit businesses in this direction through the power of the marketplace. There are clearly pros and cons to either path – for-profit or non-profit. In the end, we both chose the for-profit path.

We are also both in full startup mode – Year 1 of our operations – and thus using the phrase "for-profit" as an aspiration we hope to soon reach. Fair Trade Sports is a simple Washington State S-Corporation – a for-profit entity that passes through all after-tax profits to children's charities. Trade as One is a California State LLC, a for-profit business, governed by a Board of Directors.

When deciding whether to be a for-profit or non-profit, consider the following three questions:

1. What is your primary goal?

If your primary goal is to serve a specific constituency – and the sale of products/services is a minor/side portion of your project – you might consider non-profit to be the incorporation of choice. However, if the income from those products/services (classified as unrelated business income or UBI) becomes significant, you may find yourself with the wrong incorporation status and lose your qualification for federal tax exemption. The rule of thumb for auditors is if your UBI is 20%+ relative to your other revenues (donations, grants, etc), then you are in jeopardy.

This is worth a discussion with your attorney; you could remain eligible for Federal exemption if the purpose is to benefit workers from underdeveloped countries, and those workers are employed at high wages with skill training – the goods they produce may not be considered UBI.

Example: A primary goal of Fair Trade Sports is to raise charitable dollars for children's charities through the sale of certified Fair Trade sports balls. We chose to incorporate as a for-profit because the focus on product sales would overwhelm the definition of unrelated income. Given our goal of maximizing the real dollars flowing to charity, we found the hybrid business models insufficient (e.g. a non-profit owning a for-profit). A Washington State non-profit can only deduct 10% of net income passed through to charity, while a S-Corporation can deduct 50% of adjusted gross income to charity. There is an enormous difference between net and gross income in terms of real dollars supporting charitable work.

Example: Trade as One's objective is to create a sustainable route to market for its producers. It wants to use the structure of capitalism for good, and so it would see success in 5 years as a) having created a significant and secure revenue stream for its producers, b) having demonstrated to the market that its model allows investors to get returns slightly higher than leaving their cash in the bank and c) it has proven a model for an attractive alternative career for high-caliber individuals who decide to chose Fair Trade over more lucrative industries.

2. What is your primary message for your customers or donors?

You have seven seconds to tell prospective customers what you do, and if your business model takes too much time to explain (e.g. a hybrid model), you risk losing the attention of your prospective audience. "Loaded" words can help or hinder that communication. The words "non-profit" and "for-profit" are loaded terms, complete with both positive and negative preconceived notions, so consider how your specific target market or constituency may react to those words. Sometimes, a straightforward "we're a non-profit" or "we're a for-profit" allows you to jump to what is important to the audience about your business, rather than waste their time explaining complicated organizational structure.

On the other hand, if the people you are pitching to those who think that "non-profit" automatically equals saintly do-gooder and "for-profit" equals greedy money-grabbing self-interested capitalist then consider moving on to more enlightened consumers. There are plenty of them; they just might not look like traditional people who purchase Fair Trade.

Example: Fair Trade Sports commits all profits to children's charities (we donate $1,000 annually to each charity until we reach profitability). It is difficult to get that message across in the first seven seconds with a prospect. Most of our North American prospects are still stuck on the definition of Fair Trade when we greet them with "Hi! We're the first Fair Trade soccer ball company in the US!" Slipping in the word "non-profit" might make our elevator pitch easier.

3. What is your primary source of funding?

Whether you are boot-strapping or launching with a full investor team behind you, your choice of incorporation will be crucial to how, when, and from whom you can raise capital. Both for-profit and non-profits can use debt as a finance tool, so the question you need to answer is whether you can achieve you objectives by raising money from donations or by surrendering a percentage of ownership in your company in exchange for the cash you need to grow.

We found it helpful to consider the following:

For-profit:

Pros:

a) The pool of capital available to you as a for-profit is orders of magnitude larger than as a non-profit. This means that, if you have a good plan that is sustainable (i.e. profitable), then it is possible to grow a lot faster than eking out growth from simple cash flow and donor funding.

b) Because the pool of money is larger, you can get the cash in larger denominations. This means you could reach your finance target with one or two investors vs. a typical non-profit model where people may cough up $1,000 and you have to get a lot of them to reach your target.

Cons:

a) Be very, very sure to whom you surrender even minority ownership. Chances are they will be savvier than you at putting in place clauses and tools that give them the ability to heavily influence the direction of the business if they decide at any point that they don't quite like the direction you are taking it. Be really sure that your investors really understand and believe in YOU and YOUR VISION.

b) If raising money at early stages, it is notoriously difficult to arrive at a realistic valuation of your company. The tool Trade as One used was a convertible note that took investor's money on as debt initially that then converts to equity at a later date when there is a first financing round and valuation is more easily defined.

Non-profit

Pros:

a) Donation funding comes with fewer strings than equity. The transaction is essentially: "You give me money and I give you a deduction on your tax return for the year."

b) Not only can you raise cash with your non-profit status, but it a lot easier to secure volunteer labor which effectively subsidizes your business.

Cons:

a) As a non-profit*,* getting donor funding is often non-trivial in itself, often requiring continual marketing efforts to keep the money flowing; then, once you have it, to maintain multiple rigorous reporting cycles to each of your major donor agencies. A high percentage of your overhead is spent on simply asking for and reporting on capital needs

b) As a non-profit, you cannot be as agile in your strategy as a for-profit can because of the restrictions that come with your non-profit status. Examples would be the ability to give away after-tax profits, or the fact that your tax exempt status is granted on the basis of your stated mission and plan. If that has to change for any reason, you have to accept that you cannot make that change as easily as with a for-profit.

To be a force that competes in the real world, Fair Trade must become a way of doing business that is sustainable and not propped up by donations, volunteer labor, or deep pockets of the individuals in it to feel like they are using their enormous wealth in a philanthropic way.

What's next in our incorporation adventures?

At the end of the day, whether you are for-profit or non-profit, you have to run a profitable enterprise or you won't survive. The question is, therefore, under what tax code do you operate and with what message do you market.

Once our for-profit companies succeed and begin to kick off cash in the form of after-tax profits, we will both pursue setting up separate non-profits to further advance our missions.

Example: Fair Trade Sports will continue to mirror the Newman's Own business model, setting up a foundation for distributing funds to a variety of children's charities.

Trade as One's model is closer to the one pioneered by Traidcraft, the leading Fair Trade company in the UK, who combines a publicly listed for-profit trading arm with a non-profit arm that builds capacity in its key producers in the developing world and campaigns to raise awareness among the public and influence public policy on issues of trade justice in the UK.

Further Reading

We recommend consulting with your accountant and attorney, as well as these websites:

- Management Library (www.managementhelp.org) – Legal advice about starting a for-profit business or non-profit
- AllBusiness.com (www.allbusiness.com) – Accounting advice about starting a for-profit business or a non-profit organization