Legal Considerations Relevant to Nonprofits Seeking to Support Small Businesses

Small businesses are often the lifeblood of local communities. In the wake of the economic stress of the pandemic, nonprofit organizations may at times want to support small businesses. By leveraging the community involvement of such businesses, nonprofits can further their charitable purposes. However, to do so without jeopardizing their tax exemption they must make sure to comply with various federal and state laws. Nonprofits that enjoy tax-exempt status under Section 501(c)(3) of the Internal Revenue Code and corresponding state tax laws must comply with especially strict federal and state laws. This Legal Alert outlines general legal considerations and principles that a nonprofit must keep in mind before providing financial or other support to a small business (which could be in the form of an LLC, corporation, partnership, or sole proprietorship) in its community. It then provides some real-world examples of nonprofit giving to for-profit endeavors that abide by legal restrictions, and details the specialized rules regarding nonprofit assistance to businesses in disaster relief situations.

1. General Principles

Any funds, grants, or partnership from a nonprofit to a small business cannot be ‘no-strings-attached.’ Rather, the nonprofit must do its best to maintain oversight, via reports or otherwise, over the usage of the funds provided to the business.¹ In addition, the arrangement must align with the following legal principles.

a. Maintain Primarily Charitable Purpose

A nonprofit interested in providing a business with financial or other support should start by asking whether providing such support is within the scope of the nonprofit’s mission. Nonprofits unsure of their legally defined mission should consult the “purposes clause” of their Certificate of Incorporation to see whether that document allows them to engage in the contemplated activity.² For example, a nonprofit whose purposes clause says that the organization will only engage in educational activities may not provide cash grants to facilitate activities that are not educational, even if the supported activities are otherwise charitable.

More broadly, a 501(c)(3) nonprofit must be “organized and operated exclusively” for one or more of the tax-exempt purposes specified in Section 501(c)(3), including charitable, scientific, literary, and educational purposes. Internal Revenue Service (“IRS”) regulations hold that a nonprofit will be deemed to operate “exclusively” for one or more of its tax-exempt purposes only if it engages primarily in activities that accomplish such purposes.³ Applying the IRS’s standards involves case-specific

² Every New York nonprofit’s Certificate of Incorporation is on file with the New York Department of State. Every organization should also keep a copy of its Certificate of Incorporation in its own corporate records.
³ Treas. Reg. 1.501(c)(3)-1(c)(1).
consideration of facts and circumstances, but if the facts show a consistent pattern of activities with nonexempt purposes, such as supporting private interests rather than charity, an organization may lose its tax exemption. Therefore, when a nonprofit considers helping a small business, it must be mindful of the fact that it could lose its tax-exempt status if more than an insubstantial part of its activities is not in furtherance of the charitable purposes for which it has received tax exemption.

b. Avoid Generating More than “Incidental” Private Benefit

Nonprofits with tax exemption under 501(c)(3) cannot simply advertise for private businesses. Rather, such nonprofits must “serve a public rather than a private interest.” This does not mean they are precluded from conferring any private benefit, but rather that they may not serve the private interests of any individual or organization more than insubstantially. Conferring more than insubstantial private benefit will jeopardize federal and state tax exemption regardless of an organization’s other charitable purposes or activities. IRS regulations place the burden on a nonprofit to demonstrate that it is not organized or operated to benefit private interests.

The test of whether a 501(c)(3) nonprofit “serves a public rather than a private interest” has both a qualitative and a quantitative component. The qualitative test is whether the private benefit is necessarily tied to a charitable activity that benefits the public at large, meaning the benefit to the public cannot be achieved without benefiting certain private individuals. Nonprofits should also consider the number of entities they are benefiting: If all of an organization’s business dealings are with a single entity (or group of related entities), or if the group receiving a benefit is small, there is a stronger case for finding private benefit, since these benefited entities are more clearly private, not comprising the public at large.

The quantitative test is whether the private benefit conferred is insubstantial in amount, with the permissible amount of private benefit depending on the magnitude of the private benefit in relation to

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4 Nonprofits with 501(c)(6) status can act in such a promotional, chamber of commerce role.
7 See Private Benefit under IRC 501(c)(3), https://www.irs.gov/pub/irs-tege/eotopic01.pdf, and N-PCL Section 204 (a nonprofit “shall conduct no activities for pecuniary profit or financial gain, whether or not in furtherance of its corporate purposes, except to the extent that such activity supports its other lawful activities then being conducted”).
9 See id. One IRS publication, Rev. Rul. 70-186, 1970-1 C.B. 128, illustrates this concept with the following example. An organization is formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features. Although the organization’s activities clearly benefit the public at large, its work necessarily also confers significant benefit on the private individuals who own lakefront property. However, this private benefit was incidental in a qualitative sense, since the private benefits derived by the lakefront property owners do not lessen the public benefits flowing from the organization’s operations, and it would be impossible for the organization to accomplish its charitable purposes without providing some benefit to private entities.
the public benefit generated. The more precisely a nonprofit can quantify the private benefit conferred by its activity, the more likely it is to be non- incidental. Small businesses are therefore more appropriate for partnerships with a nonprofit than large businesses, because smaller dollar amounts are more likely to be involved.

2. Examples of Allowable Support to Small Businesses

While the abovementioned legal principles that nonprofits must abide by when providing support to businesses may seem both abstract and restrictive, there are in fact many ways that organizations can make an impact in their communities through for-profit grant making. The following scenarios illustrate how a nonprofit can both adhere to its mission and avoid conferring a private benefit when supporting local businesses.

a. Promoting Legal Resources to an Immigrant Population

Nonprofit X serves a local immigrant community through advocacy and educational programming. Nonprofit X plans to provide $100 cash grants to a number of neighborhood convenience stores so that the stores will then distribute immigration law resources to their customers and employees. The provision of the cash grants furthers Nonprofit X’s mission by educating and empowering the immigrant community on their rights. In addition, Nonprofit X’s actions serve the interest of the public at large more than they serve the interests of the individual convenience store owners, as the money will not be used at the owners’ discretion but will ultimately fund a community resource. As such, Nonprofit X’s provision of cash grants to local convenience stores adheres to the legal parameters discussed above and is likely allowable.

b. Providing Stipends to Minority Farmers

Nonprofit Y’s mission is to nurture the health and resiliency of a local minority community by supporting agricultural systems owned and operated by members of that community. Nonprofit Y plans to fulfill its mission by issuing $1000 cash grants as well as business mentoring to minority farmers. Nonprofit Y’s investments in for-profit farms furthers its mission by broadening minority access to the food system. Also, Nonprofit Y’s actions serve the interest of the public at large more than they serve the interests of the individual farmers, as the grants to each particular farmer are small in scope. The goal is therefore not to subsidize any individual farmer, but to be an ‘accelerator’ of the industry at large. Therefore, Nonprofit Y’s capital investment in minority-owned farms adheres to the legal principles discussed above and is likely allowable.

3. Disaster Relief Situations

In disaster relief situations, the prohibition on conferring private benefit is temporarily loosened, and the law provides more specific guidance on when nonprofits can confer private benefits to business entities. Cash assistance may be provided without as much ‘narrow tailoring’ to charitable purposes. Cash may be provided to businesses to achieve the following charitable purposes:

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11 Id., page 137.
12 Id.
1. To aid individual business owners who are financially needy or otherwise distressed,
2. To combat community deterioration, and
3. To lessen the burdens of government.

A tax-exempt organization can accomplish a charitable purpose by providing disaster assistance to a business if:\(^{14}\)

1. The assistance is a reasonable means of accomplishing a charitable purpose, and
2. Any benefit to a private interest is incidental to the accomplishment of a charitable purpose.

However, once a damaged business has been restored to viability or a newly attracted business is self-supporting, further assistance from a charity is no longer appropriate. Nonprofits that aid businesses should have criteria and procedures in place to determine when aid should be offered and discontinued.\(^{15}\)

Lastly, documentation and reporting for disaster relief activities are complex, as nonprofits that engage in disaster relief giving must maintain detailed records of payments as required by the IRS.\(^{16}\)

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\(^{14}\) Id.


\(^{16}\) Id., pages 13-14.