

Strategic, Legal, and Accounting Challenges for Social Enterprises

Robert Moussetis ^{1*}
Thomas Cavenagh ¹

¹ North Central College, Naperville, IL, USA

* Corresponding author, rcmoussetis@noctrl.edu

Abstract

Purpose – This study is to trigger an integration of strategic, legal, and accounting issues relating to the formation and operation of social enterprises (SEs). It provides a conceptual model to facilitate debate, research, and practical approaches to aspiring social entrepreneurs.

Design/Methodology/Approach – The study utilizes a secondary research method. It reviews literature from classical business and entrepreneurship to law and accounting journals and overcomes the complexity of topics to create a holistic approach to social entrepreneurs' challenges and opportunities.

Findings – It provides a vantage point of the distinctive nature of social entrepreneurs and entrepreneurial motivations. It explores the advantages of legal and accounting challenges in forming a Low-Profit Limited Liability Company (L3C). In particular, it delineates the intricacies between an L3C, a limited liability company (LLC), and not-for-profits. Finally, it offers a conceptual model for further research and a set of practical implications.

Research limitations/implications – This study invites further investigation of the strategic formation of SEs. Specifically, exploring the external environment in conjunction with strategic behavior, capabilities, law, and accounting challenges. In addition, it provides a conceptual model for further investigation of the significant dynamics of SEs.

Practical implications – The creation of the conceptual model provides a guiding start for research, debate, and practical guidelines for aspiring entrepreneurs by integrating strategic, legal, and accounting challenges and opportunities.

Social implications – The proliferation of SEs provides solutions to social challenges while entrepreneurs generate profit. It provides a dimension to a socially conscious person to engage in enterprises. Finally, it may provide a new paradigm for new capitalism that deliberately combines social and financial benefits.

Originality/Value – This study develops a conceptual model to explain the complexity and dynamics of social entrepreneurship and provide exposure to SEs' legal and accounting challenges and opportunities.

Keywords: social entrepreneurship, strategy, L3C, law, accounting.

Reference to this paper should be made as follows: Moussetis, R. & Cavenagh, T. (2021). Strategic, legal, and accounting challenges for social enterprises. *Journal of Business and Management*, 27(1), March, 23-52. DOI: 10.6347/JBM.202103_27(1).0002.

Introduction

Since Borstein's seminal work (Bornstein, 2004) and Yunas' energetic follow-up (Yunas, 2006), social entrepreneurship has entered the mainstream media, captivating by its market-based approach to solving social problems. Arguably, Social Entrepreneurship provides the perfect convergence of two seemingly competing organizational aims: Profit and Societal Benefit. Yet, the definitional landscape of social entrepreneurship remains unsettled, with scholars continuously attempting to delineate its boundaries, form, and meaning. Are the definitions too exclusive (Light, 2006) or too inclusive? Where do pure-profit capitalism end and social enterprise (SE) begin (Hlady-Rispal & Servantie, 2018)? Understanding of the field remains largely vague until a prevailing paradigm begins to emerge.

There have been as many as 37 definitions of Social Entrepreneurship (Dacin *et al.*, 2010). Generally, those definitions focus on motivations, identifying opportunities involved in change, and inspiring leadership (Light, 2009), operating processes and resources, social wealth creation (Dacin *et al.*, 2011), or merely an initiative to help people (Yunus, 2008). Besides, attempting to define social entrepreneurship inevitably invites the question of how it differs from traditional entrepreneurial activities. Social entrepreneurship stems from different missions, drives, and challenges; hence, it requires

a different research approach. Moreover, training and educating social entrepreneurs requires a dedication to the management of accountability, the double (or even triple) bottom line, and, most importantly, the identity (Sliva and Hoefler, 2016; Yunxia, 2016).

In the past, business entities have attempted to remedy social problems through the lenses of social responsibility and ethical behavior. For example, corporate strategy expanded to include societal strategy (ethics, corporate social responsibility, and political strategy); however, Corporate Social Responsibility (CSR) is designed primarily to maximize the corporation's image. Under the CSR model, investors would continue to have a strong interest and influence over the types of corporate activities that would ensure optimizing return on investment and higher stock value and performance. Hence, we explore socially related projects through the lenses of the increased stock value under the CSR paradigm.

In contrast, social entrepreneurship seeks to create social value returning to investors with much less compensation, capital growth, or increased salary or wages. Surplus economic gains are targeting the beneficiaries of SE (Yunxia, 2016). Consequently, one may ask what drives an individual away from rational self-utility optimization (Licht, 2010) or profit-seeking behavior to a non-monetary sense of accomplishment, which is a characteristic of all entrepreneurs.

Some people have an innate drive to attain considerable cost to support a social benefit despite possibly conflicting values that are highly passionate in their decision approach. For such individuals, satisfaction derives from their range of values and benefits others (Dacin *et al.*, 2011; Licht, 2010). More recently, empathy may facilitate a process and willingness to accommodate multiple perspectives, commitment to lessening suffering, and emotional connection. Indeed, one might argue that personality characteristics and identity drive social entrepreneurship or entrepreneurial intentions

(Hockerts, 2017). Considerable research on personality traits drives entrepreneurial behavior on openness, conscientiousness, extroversion, agreeableness, and neuroticism. However, empathy and agreeableness are personality traits supporting social entrepreneurs, while extroversion and conscientiousness have no predictive value.

Social Entrepreneurship is emerging rapidly; however, there are still challenges (Dacin, 2011). This paper addresses the SE's strategic nature and highlights the legal, taxation, and financial challenges. Lastly, it provides a conceptual model to facilitate future empirical research.

The Strategic Nature of Social Entrepreneurship

A SE's primary strategic challenge is whether the social entrepreneurs can explore the essential fit between shifting societal needs and the behavioral orientation and capabilities to match the societal shifts (Farkas, 2016; Emery & Trist, 1965).

In a rapidly changing world, an organization's ability to compete effectively depends on the ability to anticipate future changes and "create" the future, hence, utilizing constantly entrepreneurial approaches. Entrepreneurial approaches are strategic since they involve entrepreneurial activities and, at their core, are external conditions to venture onto uncharted business territories with novel products and services previously untested. Historically, firms used relatively static approaches to respond to changes by extrapolating past success into the future or reacting to external changes with corresponding strategies (Porter, 1980).

The concept of external turbulence provided a measure to develop appropriate response mechanisms. For example, scholars have postulated the dependence upon the environment. Others described it as a dynamic change (Wilden and Gudergan, 2015). Furthermore, the research typology has portrayed an environment as stable, uncertain,

complex, static, dynamic, discontinuous, and turbulent (Wilden and Gudergan, 2015; Emery & Trist). The variability is known as environmental turbulence. Furthermore, the strategy derives from environmental turbulence.

Entrepreneurship implies significant change and departure from experiences (Dacin, 2011). The change process involves acute external changes and opportunities and a broader set of variables (i.e., behavioral, cultural, among others) that are critical inputs to success. Does the entrepreneur have the mindset and capacity to venture into uncharted territory? Selected literature suggests a meaningful relationship between external conditions (environmental turbulence) and internal conditions (strategic orientation and adjusted capabilities) (Farkas, 2016) as they relate to performance. Often, we encounter individuals with a passion for a business or a cause but lack the behavioral or intellectual skills to navigate the new landscape.

Social entrepreneurship was a natural evolution for people who wanted to provide social value effectively and consistently. Peter Drucker indicated that a business exists to provide a product or service effectively and efficiently; therefore, it should always be cost-effective. Having said this, is Social Entrepreneurship a new capitalism model to create shared value creation? In the spirit of Drucker's approach, is Social Entrepreneurship becoming the new norm of business in general where shared value becomes the new norm (Dacin, 2011)? The social responsibility movement and the professionalization of corporate philanthropy (planned giving) have created conditions for a new business model where economic and social values are equally integrated. A conception of a broader societal strategy of the business firm has been emerging for some time now. Pursuing an economic benefit is congruent with the broader social benefit per the cultural and political climate. Hence, social entrepreneurship may be the mechanism by which we see a broad transformation of the business institution where profitability, greed, and shareholder value, instead of more comprehensive social value, transforms into a broader societal institution to provide social benefits (Dacin, 2011). Therefore, social

entrepreneurs are change agents since they provide social value and create a new approach to “business.” They must understand critical societal shifts and match them with the corresponding behavior and capability.

Discussion of business’s legal environment has been taking place in both higher education and industry for decades. Indeed, the general approach to teaching business students and counseling business practitioners has become formulaic in terms of content and approach. However, the landscape is changing as new business law supports new business purposes (Lane, 2015). It is no longer a new trend for charitable organizations to become involved in commercial activities. Thousands of nonprofit organizations have embraced the social entrepreneurial concept. They have created ‘commercial’ type ventures as part of their nonprofits, have created spin-off organizations or subsidiary organizations, or have moved into the new area of hybrid organizations (Cherry, 2012).

The relatively new but rapidly expanding field of social entrepreneurship challenges that formula because social entrepreneurs’ values and goals are different from those in any other business area. (Renko, 2013) Moreover, social entrepreneurs’ legal needs and opportunities are complex, distinctive, and, in many ways, reconfigure social entrepreneurship students’ needs and the practical needs of individuals operating social entrepreneurship enterprises (Lane, 2015). Beyond noting the potential for social entrepreneurship to revolutionize aspects of business education and business practice, it is noteworthy that a body of scholarship devoted to social entrepreneurship is emerging.

The following section explores the legal environment in which social entrepreneurship continues to grow. It first considers the distinct values, goals, legal needs, and legal opportunities present in social entrepreneurship. Second, a detailed review of the business entity’s choice illustrates the social entrepreneurship legal environment.

Characteristics of the Social Entrepreneur

Social entrepreneurs are a different breed of business students and businesspersons because they bring profoundly different values to business practice than those engaged in for-profit endeavors, whether large or small (Renko, 2013). We hence elaborate on the characteristics of the social entrepreneur as follows.

Distinctive Values and Goals of the Social Entrepreneur

The social entrepreneur is much more likely to be an altruist, more interested in social change than operating any particular business. Indeed, business is likely a means to an end for the social entrepreneur, addressing the marginalized needs, not an end in itself. These business practitioners may come from many studies and diverse levels and training; they may not seek or have a business degree (Zahra *et al.*, 2009). Accordingly, they are likely to know less about business operations and strategy than traditional business people are. Moreover, they may care less about business operations and strategy than traditional business people may (Zahra *et al.*, 2009). Social entrepreneurs are also very likely to have deeply held, non-business-oriented beliefs that affect their business practices and expect their business practices to conform. For example, the traditional businessperson ordinarily sees a business as a source of ongoing revenue and an avenue toward acquiring long-term wealth.

Conversely, the social entrepreneur may bring deeply held beliefs about income inequality to the workplace. These beliefs may affect the extent to which they see their business as a source of wealth generation for themselves instead of others (Zahra *et al.*, 2009). Finally, social entrepreneurs may be hostile to or frustrated with traditional profit-driven businesses, believing they cause some of the problems social entrepreneurship intended to cure.

Social entrepreneurs have different values, and, as a result, social entrepreneurship is definitionally different from other areas of business practice in terms of business goals and strategies. Social enterprises (SEs) are businesses that ordinarily direct all or some of their profits, not to the owner, but to a range of at-risk populations, such as low-income urban communities, underserved communities, or foreign businesses not capable of selling at prices that can sustain families (Hlady-Rispal & Servantie, 2018). Social entrepreneurs might also strive to offer training and opportunities for self-improvement to these at-risk populations. They may also have a goal of producing goods for these communities to consume at subsidized price levels. (Hlady-Rispal & Servantie, 2018).

Distinctive Legal Needs of the Social Entrepreneur

Social entrepreneurs possess different values and operate their businesses to different ends; their legal needs are also exceptional (Galera & Borzaga, 2009). It is true in at least four ways: first, social entrepreneurs often (but certainly not always) lack business sophistication, so legal counsel becomes much more critical. Second, the law of business operations in the social entrepreneurship area is relatively new and continually evolving, so even social entrepreneurs with some business expertise find a growing, changing, and sometimes conflicting set of laws and regulations with which to work (Dacin, 2011). Third, social entrepreneurship enterprises often serve their international constituencies by invoking international law and American federal trade law (Kaufman, 2012; Short, Moss & Lumpkin, 2009). For example, fair trade goods purveyors seek to purchase and resell goods from at-risk producers, foreign coffee growers. They do so at prices set not by market forces but by the economic needs of the growers. Buying and importing the goods and transferring the revenues generated by the goods may involve legal considerations far beyond simple state business operation laws. Fourth, social entrepreneurs are virtually always operating underfunded and understaffed businesses

and have no permanent legal staff. (Certo & Miller, 2008). Therefore, knowing when the required legal counsel is needed, from whom to obtain it, and what purpose is crucial (Galera & Borzaga, 2009).

Distinctive Opportunities for the Social Entrepreneur

The good news is that the emerging social entrepreneurship law is prosocial entrepreneurship, both here and abroad (Galera & Borzaga, 2009). New business entities allow, among other things, entirely new ways to raise and use start-up and operational funding (Kelly, 2009). Also, they offer significant legal protection to owners while they provide meaningful flexibility in operation. Furthermore, because these entities are emerging quickly and broadly, and courts have shown them considerable solicitude, more comprehensive funding sources, such as foundations, trusts, and high-wealth individual donors, can be sought. The unique business values and goals drive social entrepreneurship's legal environment and present significant challenges but are rich with opportunities for the well-advised and agile social entrepreneur (Galera & Borzaga, 2009).

Social Entrepreneurship Entity Choice and Taxation Considerations

A 2007 poll showed that 71% of social entrepreneurs considered the choice of entity to be the single greatest challenge for their enterprise. Businesses may "exist" in American law as entities separate from their owners. They are subject to regulation but have many protections, speech, or due process, such as what a person possesses. State law governs this legal area in which there are generally some 50 different sets of business entity choices from which the practitioner may select. Moreover, tax dimensions add a very significant federal component. Moreover, while there are many similarities among those state offerings, no two are exactly alike, and each distinct entity offers different

rights and responsibilities to its owners. Thus, this is a complex area where legal counsel is essential (Galera & Borzaga, 2009).

As a general matter, there are three types of business entities: sole proprietorships, partnerships, and corporations. The sole proprietorship, an unincorporated form of business, ordinarily operates with one owner. They are transferred simply by a sale of the business assets. The entity offers little legal protection because the business and the owner are mostly indivisible. However, there are minimal creation and operation formalities, so they are tempting to entrepreneurs who may wish to avoid the expenses of a more formal business entity. In general, the law does not treat a sole proprietorship as distinct from its human owner.

The general partnership is simply an association of two or more individuals operating for-profit and ordinarily consistent with a negotiated partnership agreement. Such an agreement practically starts the partnership's operation, and, like a sole proprietorship, transferring the assets complete the sale of the business's selling. Thus, the law treats a partnership as distinct from its human owner(s).

The corporation is a distinct legal entity owned by its shareholders and run by its officers and directors. There are substantial creation and operation formalities, but those formalities provide a vastly increased liability protection level for owners. With even greater clarity, the law treats a corporation as distinct from its human owner(s).

A Limited Liability Company (LLC) is a business entity that merges the partnership and the corporation and has been taxed as a partnership under federal tax law since 1997 (Reg. §301.7701-2(a)). The Low-Profit Limited Liability Company (L3C) introduction has recently sparked discussion regarding the combination of for-profit and not-for-profit entity characteristics. One primary question relates to the taxation

characteristics of an L3C. The simple answer is that if an L3C has more than one investor, it is considered a partnership for tax purposes (IRC §761(a)); thus, it is considered a pass-through entity. On the other hand, if the L3C has a single member, it would be considered a disregarded entity for tax purposes. Thus, all income would be tax at the individual level. A partnership is not subject to tax at the entity level; instead, all partners are liable for the tax associated with income from an L3C (IRC §701). An L3C, identical to an LLC, can elect to be tax as a corporation by filing a Form 8832, *Entity Classification Election*, with the Internal Revenue Service (Reiser, 2010).

Although an L3C is driven by the desire to capitalize on social entrepreneur endeavors, it is not necessarily a tax-exempt entity. Therefore, it does not automatically qualify for IRC §501(c) (3) tax-exempt status. It is clear that an L3C, driven by social entrepreneurship initiatives, may meet the operation requirements for tax-exempt status. However, IRC §501(c) (3) also clearly states that: “no part of the net earnings of which insures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation... and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” As current federal tax law stands, the newly invented L3C is a taxable entity, taxed as a partnership, creating taxable income recognition to investors. Although this tax status may be unappealing, several other tax considerations concerning an L3C positively impact social entrepreneur endeavors from a tax standpoint.

Program-Related Investment (PRI) Tax Advantages

An L3C is classified as a for-profit entity, thus subject to income tax, yet the entity structure could benefit investor interest and earn capital. The merge of for-profit and not-for-profit characteristics in an L3C may be seen as a form of a program-related investment (Minnigh, 2009). A program-related investment (PRI) is classified as an

investment that does not jeopardize the carrying out of the exempt purpose of a private foundation (Reg. §53.4944(a) (1)). By definition, a PRI is an investment that possesses the following:

1. The investment's primary purpose is to accomplish one or more of the following: religious, charitable, scientific, literacy, or educational purposes, or to foster amateur sports competition or prevent cruelty to children or animals.
2. No significant purpose of the investment is the production of income or the appreciation of property; and
3. No purpose of the investment is to accomplish the influence of legislation, participate in any political campaign concerning an individual candidate for public office (Reg. §53.4944-3(a) (1)).

Private charitable foundations that qualify for exempt status must make minimum annual qualifying distributions of at least 5 percent of their income or be subject to additional excise tax (Vitello, 2010). Additionally, private foundations are limited in their investment decisions as they cannot invest in a manner that would be deemed risky or potentially jeopardize the foundation from fulfilling its tax-exempt purposes (IRC §4944(a) (1)). A risky investment, according to the IRS, is one that failed to exercise ordinary business care and prudence according to the facts and circumstances at the time of investing (Reg. §53.4944-1(a) (1) (i)). Based on these requirements, private foundations struggle to balance the need to complete required distributions that do not result in a risky investment that would jeopardize the entity's exempt purpose. In an attempt to walk the line between risky and necessary, the standard investment in Program-Related Investments (PRIs) evolved (IRC §4944(c)). The PRIs allow private foundations to mix the required five percent distribution with sound business investments.

The PRIs are investments that uphold a private foundation's purpose and are not motivated by producing income (IRC §4944(c)). Tax law identifies that a private foundation can avoid additional penalties and tax by distributing at least five percent of its income that can be fulfilled through funding a PRI. Unfortunately, determining whether an investment qualifies as a PRI is not as straightforward as an investment "if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities" (Reg. §53.4944-3(a)(2)(i)). Because of these strict measures, the private foundation carries the burden to determine if the investment qualifies as a PRI and can be used as a qualifying distribution toward their minimum requirements (Flaherty, 2012).

Although an L3C is a taxable entity, paralleling the mission of an L3C with the requirements of a PRI can entice private foundations to fund social entrepreneurship initiatives through the use of an L3C. Private entities must analyze their investments on a case-by-case basis to determine if any would classify as a PRI. The L3C is structured to parallel the PRI defined in IRC §170(c) (2) (B) and Reg. §53.4944-3(a). The IRS does not explicitly acknowledge the L3C as an example of a PRI, but an L3C may take several steps to align it with the PRI definition. Aligning the L3C operating or partnership agreement with a PRI definition would create a minimal argument for the IRS to disallow individual L3C's PRI status (Minnigh, 2009). In April of 2016, the IRS denied L3C entities to be included explicitly as examples of a PRI (TD 9762). The treasury department's specific exclusion noted that an L3C status would not automatically determine PRI status; instead, an L3C status may still qualify as a PRI but not be given an automatic acceptance.

Using the L3C status as an organization can come with certain advantages, one of which is financing social entrepreneurship initiatives. L3Cs can give social entrepreneurs the chance to carry out their social missions as L3C organizations can attract different investors' forms to assist in funding (Thompson, 2012). The Tranche system of investment

can be utilized to create an L3C organization, allowing investors to dictate expected contributions and returns. Tranche investments separate investors by different layers of ownership and return interests, consisting of three categories: Equity, Mezzanine, and Senior Tranche (Vitello, 2010). More specifically, the Equity Tranche offers the lowest return rate (e.g., 1%) and is where most PRI investments would be categorized within an L3C. The Equity Tranche creates a path for tax-exempt private organizations to invest and fulfill their requirement to distribute five percent of their income, fulfilling PRI requirements (Reiser, 2010). Social entrepreneurs would utilize the Mezzanine Tranche and other corporations as this tranche offer an average amount of risk and return (e.g., 3%). Lastly, the Senior Tranche offers the highest return rate between the three levels (e.g., 6%). This tranche is reserved for various market investors or pension funds (Vitello, 2010). This Tranche system allows for a wide range of investors, creating several paths for an L3C organization to gain capital that may not have been available as an LLC.

Another advantage that L3Cs offer is the brand effect. The brand effect can be used as a marketing strategy to drive consumer sales by emphasizing the social impact. The brand effect is connected to each product manufactured by the L3C. The sales go to the L3C, a non-tax-exempt business driven by nonprofit motives (Thompson, 2012). The social impact connected to a product can incentivize consumers to buy, knowing that a portion of the sales may benefit society. It offers a sense of achievement to know that part of the proceeds will be returned with social impact. Buying products with a connected charitable mission does not offer the same tax advantages related to charitable contributions to consumers, but their purchase intent may be maintained. The sense of client fulfillment will drive the brand effect, potentially increasing L3C sales and funding. Table 1 contrasts the differences between L3C, LLC, and Not-for-Profits companies.

Table 1: Differences between L3C, LLC, and Not-For-Profits companies

Characteristic	L3C	LLC	Not-for-Profits
----------------	-----	-----	-----------------

Tax Exempt under §501(c)(3)	No, unless all the members are eligible under IRC §501(c)(3)	No, unless all the members are eligible under IRC §501(c)(3)	Yes
Operate at a Profit	Yes, but it cannot be a significant purpose	Yes	No
Easily Formed	Moderate	Moderate	No
Defined Charitable Purpose	Yes	No	Yes
Limited Liability for Owners	Yes	Yes	Yes
Contributions are Charitable Deductions	No	No	Yes
Distributions are T/E	No	No	Distributions are not given
Potential Rate of Return on Investment (ROI)	Between 0% and 5%	5% or more	Negative 100% to 0%

Disadvantages of L3C Structure

The main disadvantage that an L3C status brings to an organization is that under IRC §501(c)(3), an L3C does not automatically qualify as a tax-exempt organization. An organization pays income taxes based on its profits; thus, L3C organizations do not offer any tax advantage at the entity level in their current form. Additionally, the creation of L3Cs was to foster a more structured form of PRIs. Unfortunately, the process of qualifying an entity as a PRI is the same throughout any other type of business entity. Therefore, tax laws do not recognize the establishment of the L3C (Flaherty, 2012).

An L3C organization does not create a certainty that allows private foundations to regard it as a PRI like other business entities. TD 9762 expressly excludes L3C organizations from being listed as an example of an entity that qualifies as a PRI. The absence of specific inclusion in the PRI definition allows regulators to decide whether the

L3C can be considered an entity for PRI purposes (Hopkins, 2014). The lack of inclusion creates uncertainty for private foundations, and the investment may be considered a jeopardizing investment, leading to tax penalties (Vitello, 2010). In addition, the lack of apparent authority providing that an L3C is automatically considered a PRI has generated confusion. Private foundations and the general public lack education about the L3C structure and automatically assume that an L3C designation classifies it to be a PRI (Flaherty, 2012). Until there is a change to the tax code or granted preapproval, investments in L3Cs may be considered too risky for private foundations, and there is no decisive advantage an L3C holds over an LLC (Vitello, 2010).

The three-tranche systems previously discussed allow for creativity when structuring the capitalization of an L3C. However, it may also be challenging to find investors willing to forego a return on investment to foster social returns (Vitello, 2010). Outside investments are the primary source of funding for the L3C structure. Until the investors are willing to make minimal or no return on their investment, it could be cumbersome to gather capital for the organization (Flaherty, 2012).

Taxation Structure Strategies

An L3C's flow-through status would allow the members to include their proportionate share of the L3C items on their tax return, thus tax-based on their tax-exempt status. In addition, if an L3C member is considered a tax-exempt entity according to IRC §501(c)(3), the flow-through income from the L3C may not be subject to tax. Therefore, taxing an L3C as a partnership avoids the burden of paying tax at the entity level as L3Cs do not qualify for tax-exempt status.

If the L3C elected to be taxed as a corporation, any potential tax would be based on the organization's total net profits for the tax year at the entity level. Since L3C uses the LLC taxation strategy, the organization can become tax-exempt. As previously

discussed, a single, sole, or multiple-member LLC can be considered tax-exempt if every member qualifies under IRC §501(c) (3). A qualifying member must not intend to be created to benefit the shareholders' private interests, as stated in IRC §501(c) (3), meaning the profits cannot benefit the shareholders. The law disqualifies any entity that offers dividends or a return on investment based on the profits made throughout the year. Individual investors are also disqualified because they are not tax-exempt eligible. This theory may be taken to the L3C level allowing L3Cs to be tax-exempt (Reiser, 2010).

Tax strategies that benefit an L3C organization are based on the members. Partnership elected taxation can be beneficial if at least one member does not qualify as tax-exempt under IRC §501(c) (3), creating a non-tax-exempt L3C. The pass-through nature of profits and losses under IRC §701, taxes would not be paid at the entity level, benefiting the L3C, while allowing the members to take losses based on their share of the partnership (IRC §704). Corporation elected taxation can only benefit the L3C if all members qualify under IRC §501(c) (3), creating a tax-exempt L3C. The same strategy can be taken at the partnership level to obtain the same results using IRC §701. To avoid taxation at the entity level, the L3C should structure the funding to accept only PRIs or donations since PRIs are only made by tax-exempt foundations (Reiser, 2010). If PRIs and donations are the sole sources of funding, it implies tax-exempt foundations would make up the members of the L3C, giving the entity tax-exempt status under IRC §501(c) (3). The L3C would not be able to utilize the tranche system of investment in order to maintain the tax-exempt status of the entity since tranches imply a return of an investment will be made, violating IRC §501(c)(3) (Vitello, 2010). Any contribution made to an L3C will be considered a charitable deduction under IRC §170(c) (2) if the requirements for IRC §501(c) (3) are fulfilled. Individuals and corporations can make uncompensated contributions to an L3C but cannot benefit from it. This issue can help an L3C decide whether to become tax-exempt or stay for profit. Taxation does not differ between a partnership or corporation if the entity holds tax-exempt status but should be taxed at the partnership level if the L3C does not qualify for tax-exempt status.

While an entrepreneur's choice of entity is not immutable, it is expensive, cumbersome, and time-consuming to change. Making the right business entity choice depends on thoroughly understanding one's objectives and priorities (i.e., business strategy) and carefully considers several crucial threshold questions: Who will be the owners? How many will there be? Does the business expect to make and distribute profits? Are early losses expected? What things of value will the entity own, and are they easily divisible? To what extent is a liability, either legal or economic, avoidance a priority for owners? What level of sophistication is present among the owners?

Social entrepreneurs benefit from some unique and very enticing business entity choices. Perhaps the most common one is the "Low-Profit Limited Liability Company" or "L3C," which is typically created as a for-profit venture subject to state and federal income taxes and property taxes, and with no limits on profit (Lang & Carrott-Minnigh, 2010; Smiddy, 2010). Vermont was the first state to enact the L3C; a handful of additional states have followed. Ordinarily, L3C laws amend a state's existing Limited Liability Company (LLC) statute to creating a specific type of charitable LLC. This L3C is designed to create a safe business entity for receiving in-state statutes a "Program Related Investment" or "PRI" from private foundations. Social Entrepreneurs often have difficulty raising capital, given that their bottom line is not purely profit-driven. In the L3C, not only does the social entrepreneur operating the L3C benefit, the foundation receives tax benefits and some degree of tax certainty from the gift (Lang & Carrott-Minnigh, 2010; Smiddy, 2010).

This L3C is an entirely new and innovative way to empower social entrepreneurs, and there is considerable excitement about it. An L3C's articles of incorporation must contain provisions identifying a charitable or educational purpose. The articles must also state that the L3C does not have a significant intent to produce income or a political or

legislative purpose. The benefits of this new form of an entity may be significant and are full of potential if Treasury Regulations are adapted to provide absolute clarity in determining which investments qualify as PRIs.

Several other states, including California, have authorized the creation of “Flexible Purpose Corporations.” The FPC may be either publicly traded or closely held like a family business. Its articles of incorporation must include a statement describing the FPC’s purposes, including charitable or social purposes like those nonprofits ordinarily carry out or promote activities that benefit their employees, suppliers, customers, creditors, the community, wider society, or the environment. These two broadly defined purposes offer an FPC substantial discretion to select its blended value purpose and accomplish a genuinely beneficial outcome. The “Social Purpose Corporation” is a moniker used by other states for a very similar business entity (see, e.g., California Social Purpose Corporation Act, Stats. 2014, Ch. 694, Sec. 13 (SB 1301)).

Another crucial development in the SE legal environment is the “Benefit Corporation.” As of March 2013, benefit corporations are authorized in twelve states and the District of Columbia. Like other social entrepreneurship entities, benefit corporations aim to accommodate social and financial goals by increasing the board’s discretion to consider social and environmental goals when making business decisions. In addition, they offer owner protection, government recognition, and a high degree of certainty about rights and responsibilities.

Finally, social entrepreneurial enterprises may seek “B Corporation” certification, and well over 200 have done so (Cherry, 2012). They do so by submitting a “B Impact Assessment” and additional required documents to a private entity called *B Labs*. Following a successful assessment process, B Labs certifies the business as a “B Corporation.” This designation comes with B Labs rules for operation, an agreement to

permit unannounced, on-site reviews by B Labs, and an annual public interest report evaluating the business's progress toward its charitable or social goals. The B-Corp status is privately granted and regulated, so it does not offer any particular tax treatment. However, like a Good Housekeeping seal, significant brand improvement potential is available (Lane, 2015).

Financing the Social Enterprise (SE)

A final area in which social entrepreneurs have a significant opportunity is the financing options available for such ventures (Buttice, Columbo & Wright, 2017). While it is beyond this paper's scope to fully consider all of the options for start-up and scaling investment available to social entrepreneurs, it is worth mentioning that it is ripe for exploration. In addition to the PRI option described *infra*, social entrepreneurs are uniquely situated to seek crowdfunding options because they present a clear picture to investors who might share their mission (Short *et al.*, 2017). Indeed, the social entrepreneur can make the pitch in a uniquely attractive way: they are both endeavoring to effect meaningful social change. Moreover, they are doing so in a fashion that (may) make a profit (Chan & Parhankangas, 2017; Young, 2017). The research on this area continues to expand, and social entrepreneurs would benefit from strategically considering the range of ways they can now develop financing options for their enterprises (Vismara, 2016; Buttice, Columbo & Wright, 2017; Chan & Parhankangas, 2017).

Conclusion

Increasingly for-profit and not-for-profit corporations face societal challenges, which routinely threaten profitability. Many corporate stakeholders exert social pressure on the corporation to address product safety, labor, human rights, excessive profitability,

education, and the environment. Subsequently, corporations have expanded the scope of strategy to include societal strategy. As illustrated in Figure 1, the societal strategy has become an integral part of the corporation in determining profitability. It reflects an effort to counter the mounting social pressure to address social issues. Therefore, for-profit organizations engage in innovative activities to build social capital; nevertheless, the bulk of social entrepreneurship is found among not-for-profits private and public service social entrepreneurship. Moreover, social services increasingly become scarce; hence, the need for Social Entrepreneurship.

Social Entrepreneurship receives so much current attention because citizens and corporations have lost faith in governments to solve social problems. Moreover, corporations are more comfortable with market-based solutions to social problems when considering that the U.S. extensively utilizes charities and non-for-profit solutions to social challenges. The prevailing assumption of a market-based society is that market forces will address social needs; however, the emergence of social entrepreneurship indicates failing to address social needs with market forces. The market-based system's natural tendency is to gravitate towards services and products that generate optimal short-term returns instead of more extended societal benefits. Theoretically, a society with minimal social needs offers a more robust consumer market; therefore, it seems that the market forces should have a vested interest in societal health as a practical business issue. Nevertheless, the market forces cannot close the gap between social needs and their own market needs; hence, the emergence of Social Entrepreneurship.

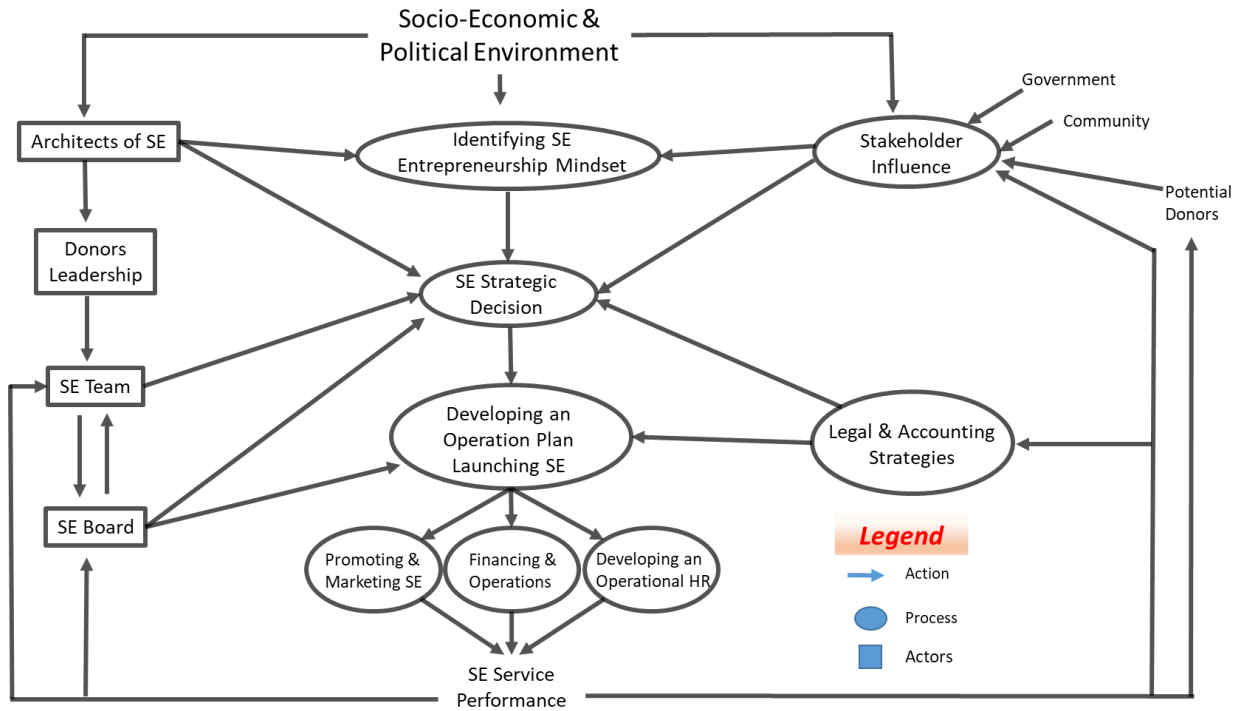


Figure 1: A conceptual model of a social enterprise (SE)

What is Next?

The design of a conceptual model can advance future research and assist those wishing to explore the various relationships among the actors and processes. As shown in Figure 1, the socio-economic and political setting generates the conditions for identifying societal needs, hence, the insertion of Social Entrepreneurs into the conceptual map. Moreover, we firmly believe that the social entrepreneur’s mindset is crucial for creating an SE successfully. The outcome of this process is the operationalization of the SE concept into a strategic decision. In short, we propose research that explores the relationship of the external environment as it shapes the design and mindset of a social entrepreneur, stakeholders’ influence, the relationship of design and mindset to decision and action, and the many unanswered questions on legal and accounting issues. We hope this model can advance the research on this emerging yet very critical field. Specifically,

we invite further investigation of the strategic formation of SEs by exploring the external environment in conjunction with strategic behavior, capabilities, law, and accounting challenges.

Practical Implications

In general, social entrepreneurship represents the relationship between social activities and economic wealth generation. Increasingly, organizations and businesses are interested in inclusive growth, social impact, and the need to create people-based reward systems and everyone's well-being. Therefore, businesses are shifting from pure profit-making to social impact performance measures. Considering the array of stakeholders, a socially-focused company understands the broader ecosystem operating beyond revenue and profitability. Moreover, social businesses have arisen as a sustainable and innovative means to resolve social problems. Social businesses become models for empowerment, quality of life, and economic growth. There is a movement to encourage a new generation of entrepreneurs to consider broader stakeholder interests and embrace socially responsible business models. A socially responsible business is good for business.

We believe that the paradigm of today's capitalism is shifting towards societally responsive practices. Hence, we attempt to provide a conceptual model for SEs that not only serves as a thinking pad but also triggers deliberate actions. The conceptual model in Figure 1 is designed to illustrate the range of critical forces of an SE and provide a launchpad for additional research and exploration. Therefore, this work's practical contribution is to recognize the shifting societal needs to a socially responsible profit-making activity. Moreover, SEs generate excellent brand value. Consumers are eager to participate in enterprises that create social and financial benefits. Hence, it is an alternative model from the current ways of doing business when considering the 2008-

2010 global financial crisis that demonstrated the high social cost of capitalism without scruples. Research in this area may also provoke a discussion on the social costs of business activities.

Furthermore, this paper explains the SEs' unique behaviors, characteristics, and typologies to advance research for creating broader and public wealth rather than just focusing on private profit-driven behaviors. It also adds to Schumpeter's entrepreneurship theory by providing social entrepreneurship theory on mobilizing resources to create a broader sustainable social impact. In addition, it demonstrates how a SE provides an avenue to a new range of venture capital from funding sources currently committed to social change. Another practical implication is prompt to redraw the boundaries of Entrepreneurship that more fully distinguish traditional entrepreneurship oriented toward profit-making from SE oriented toward social change. Finally, managers are aware of SEs' legal and accounting intricacies, such as the need to establish the legal standing of SEs and the importance of state-level SE laws on, *inter alia*, formation, operation, and liability of those entities. In addition, managers are aware of the need to clarify proper accounting approaches for SE's as well as the importance of federal and state law on, among other things, taxation, capital acquisition, and fund-raising for those entities.

References

- Baumol, W.J. (1990). Entrepreneurship: Productive, unproductive, and destructive. *Journal of Political Economy*, 98(5), 893-921.
- Bishop, C. G., (2010). The low-profit LLC (L3C): Program related investment by proxy or perversion? *Arkansas Law Review*, 63, 243-69.
- Bornstein, D. (2004). *How to Change the World: Social Entrepreneurs and the Power of New Ideas*. New York: Oxford University Press.
- Butticè, V., Colombo, M.G., & Wright, M. (2017). Serial crowdfunding, social capital, and project success. *Entrepreneurship Theory and Practice*, 41(2), 183-207.
- Cherry, J. (2012). Charitable organizations and commercial activity: A new era - Will the social entrepreneurship movement force change? *The Journal of Business, Entrepreneurship & the Law*, 5(2), 345-371.
- Certo, S.T., & Miller, T. (2008). Social entrepreneurship: Key issues and concepts. *Business Horizons*, 51(4), 267-271.
- Chan, C.S.R. & Parhankangas, A. (2017), Crowdfunding innovative ideas: How incremental and radical innovativeness influence funding outcomes. *Entrepreneurship Theory and Practice*, 41(2) 237-263.
- Dacin, P.A., Dacin, M.T., & Matear, M. (2010). Social entrepreneurship: Why we don't need a new theory and how we move forward from here. *Academy of Management Perspectives*, 24(3), 37-57.
- Dacin, M., (2011). Social entrepreneurship: A critique and future directions. *Organization Science*, 22(5), 1203-1213.
- Esposito, R.T., (2003). The Social Enterprise Revolution in Corporate Law: A Primer on Emerging Corporate Entities in Europe and the United States and the Case for the Benefit Corporation. *William and Mary Business Law Review*, 4(2), 639-714.
- Farkas, G. (2016). The effects of strategic orientations and perceived environment on firm performance. *Journal of Competitiveness*, 8(1), 55-65.

- Flaherty, M. K. (2012). A new vehicle for mission-driven work: Is the low-profit limited liability company right for Oregon? *Oregon Law Review*, 91(1), 274-95.
- Galera, G. & Borzaga, C. (2009). Social enterprise: An international overview of its conceptual evolution and legal implementation, *Social Enterprise Journal*, 5(3), 210-228.
- Haigh, N., Kennedy, E. & Walker, J. (2015). Hybrid organizations as shape-shifters: Altering legal structure for strategic gain. *California Management Review*, 57(3), 59-82.
- Hillman, A.J., Withers, M.C., & Collins, B.J., (2009). Resource dependence theory: A review. *Journal of Management*, 35(6), 1404-1427.
- Hlady-Rispal, M. & Servantie, V. (2018), Deconstructing the way in which value is created in the context of social entrepreneurship. *International Journal of Management Reviews*, 20, 62-80.
- Hockerts, K. (2017). Determinants of social entrepreneurial intentions. *Entrepreneurship Theory & Practice*, 41, (1), 105-130.
- Hockerts, K. (2015). How hybrid organizations turn antagonistic assets into complementarities. *California Management Review*, 57(3), 83-106.
- Kelley, T. (2009). Law and choice of entity on the social enterprise frontier. *Tulane Law Review*, 84, 337- 377.
- Keohane, G.L., (2013). *Social Entrepreneurship for the 21st Century: Innovation Across the Nonprofit, Private and Public Sectors*. New York: McGraw-Hill.
- Lang, R. & Minnigh, E.C. (2010). The L3C, history, basic concept, and legal framework, *Vermont Law Review*, 35(1), 15-30.
- Lane, M. J. (2015). *The Mission-driven Venture: Business Solutions to the World's Most Vexing Social Problems*. Hoboken, NJ: John Wiley & Sons.
- Light, P.C. (2009). Social entrepreneurship revisited: Not just anyone, anywhere, in any organization can make breakthrough change. *Stanford Social Innovation Review*, Summer, 21-22.

- Mair, J., & Marti, I. (2006). Social entrepreneurship research: A source of explanation, prediction, and delight. *Journal of World Business*, 41(1), 36-44.
- Mair, J., & Marti, I. (2009). Entrepreneurship in and around institutional voids: A case study from Bangladesh. *Journal of Business Venturing*, 24(5), 419-435.
- Martin, R.J., & Osberg, S. (2007). Social entrepreneurship: The case for a definition. *Stanford Social Innovation Review*, Spring, 29-39.
- Minnigh, E.C., (2009). Low profit liability companies: An unlikely marriage of for-profit entities and private foundations. *Weekly State Tax Report*, 34(5), 209-216.
- Mishra, S. and Suar, D. (2010). Does corporate social responsibility influence firm performance of Indian companies? *Journal of Business Ethics*, 95(4), 571-601.
- Neck, H., Brush, C., & Allen, E. (2009). The landscape of social entrepreneurship. *Business Horizons*, 52(3), 13-19.
- Reiser, D.B. (2010). Governing and financing blended enterprises. *Chicago-Kent Law Review*, 85(2), 619-56.
- Sertial, H. (2012). Hybrid entities: Distributing profits with a purpose. *Fordham Journal of Corporate & Financial Law*, 14(1), 262-296.
- Renko, M. (2013), Early challenges of nascent social entrepreneurs. *Entrepreneurship Theory and Practice*, 37(5), 1045-1069.
- Short, J.C., Ketchen Jr, D.J., McKenny, A.F., Allison, T.H., & Ireland, R.D. (2017). Research on crowdfunding: Reviewing the (very recent) past and celebrating the present. *Entrepreneurship Theory and Practice*, 41(2), 149-160.
- Short, J.C., Moss, T.W., & Lumpkin, G.T. (2009). Research in social entrepreneurship: Past contributions and future opportunities. *Strategic Entrepreneurship Journal*, 3(2), 161-194.

- Skirnevskiy, V., Bendig, D., & Brettel, M. (2017). The influence of internal social capital on serial creators' success in crowdfunding. *Entrepreneurship Theory and Practice*, 41(2), 209-236.
- Sliva, S.M., & Hoefer, R. (2016). Social enterprise among university-based centers in U.S. schools of social work. *Social Work Education*, 35(1), 50-64.
- Smiddy, L., (2010). Symposium Introduction - Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship. *Vermont Law Review*, 35(1), 3-14.
- Stevens, R., Moray, N., Bruneel, J., & Clarysse, B. (2015). Attention allocation to multiple goals: The case of for-profit social enterprises. *Strategic Management Journal*, 36(7), 1006-1016.
- Thompson J. L. (2002). The world of the social entrepreneur. *International Journal of Public Sector Management*, 15(5), 412-431.
- Thompson, D. (2012). L3Cs: An Innovative choice for Urban Entrepreneurs and Urban Revitalization. *American University Business Law Review*, 2(1) 115-152.
- Vismara, S. (2016), Information cascades among investors in equity crowdfunding. *Entrepreneurship Theory and Practice*, 42 (3), 149-160.
- Vitello, C. (2010). Introducing the low-profit limited liability company (L3C): The new kid on the block. *Loyola's Practical Guide to Business Law*, 23(4), 565-79.
- Volkman, C., Tokarski, K., & Ernst, K. (Eds.), (2012). *Social Entrepreneurship and Social Business: An Introduction and Discussion with Case Studies*. Wiesbaden: Springer Gabler.
- Weerawardena, J., & Mort, G.S. (2006). Investigating social entrepreneurship: A multidimensional model. *Journal of World Business*, 41(1), 21-35.
- Wilden, R., & Gudergan, S.P. (2015). The impact of dynamic capabilities on operational marketing and technological capabilities: Investigating the role of environmental turbulence. *Journal of the Academy of Marketing Science*, 43(2), 181-199.
- Young, D. (2017). *Financing Nonprofits and Other Social Enterprises: A Benefits Approach*. Cheltenham, UK: Edward Elgar Publishing.

- Yunas, M. (2008). *Creating A World Without Poverty: Social Business and the Future of Capitalism*. New York: Public Affairs Books.
- Yunas, M., (2006). Social entrepreneurs are the solution. Paper presented at the *Skoll World Forum on Social Entrepreneurship* and included in Alex Nicholls (Ed.) (2006). *Social Entrepreneurship: New Models of Sustainable Social Change*. Oxford, UK: Oxford University Press.
- Zhu, Y., Rooney, D., & Phillips, N. (2016). Practice-based wisdom theory for integrating institutional logics: A new model for social entrepreneurship learning and education. *Academy of Management Learning & Education*, 15(3), 607-625.
- Zahra, S.A., Gedajlovic, E., Neubaum, D.O., & Shulman, J.M. (2009). A typology of social entrepreneurs: Motives, search processes and ethical challenges. *Journal of Business Venturing*, 24(5), 519-532.

About the Authors

Robert Moussetis, D.B.A.

*Professor of Strategic Management and International Business
School of Business and Entrepreneurship
North Central College
Naperville, IL, USA
Tel: +1-630-637-5475
E-mail: rcmoussetis@noctrl.edu*

Thomas Cavenagh, J.D.

*Professor of Business Law & Schneller Sisters Professor of Leadership, Ethics, and Values
School of Business and Entrepreneurship
North Central College
Naperville, IL, USA
Tel: +1-630-637-5157
E-mail: tdcavenagh@noctrl.edu*

Robert C. Moussetis joined North Central College in 1998 and is a Professor of Strategic Management and International Business involving Social Entrepreneurship. He received a degree in Electrical Engineering from San Diego State University. His graduate work was in International Business and Strategic Management. He taught as a visiting professor in China, Japan, Costa Rica, Greece, and Italy and has worked on several strategic management consulting projects around the world. He has published articles in *Journal of Management History*, *Competitiveness Review: An International Business Journal*, and *Journal of Happiness Studies*. He also received the best paper awards in the Academy of Management and Academy of International Business. In the last few years, he has worked with students to start two SEs.

Thomas D. Cavenagh joined North Central in 1989 and is the Schneller Sisters Professor of Leadership, Ethics & Values and Professor of Law and Conflict Resolution. He is the director of the Leadership, Ethics & Values Program at North Central College in Naperville, Illinois, and is the North Central College Dispute Resolution Center's founder and director. He graduated from Trinity College with a B.A. in Old Testament studies and philosophy, magna cum laude. His J.D. is from DePaul University College of Law. He is the author of *Business Dispute Resolution: Best Practices, System Design and Case Management*, and the co-author of *Alternative Dispute Resolution for Business* by West Publishing Company and *CyberJustice: A Guide to Online Dispute Resolution for E-Commerce* by Prentice-Hall. He has chaired the Illinois State Bar Association Section Council on Alternative Dispute Resolution and has been widely published in various professional journals, including *Mediation Quarterly*. He is the recipient of the North Central College Dissenger Prize for Faculty Scholarship and the North Central College Clarence F. Dissenger Distinguished Teaching and Service Award, and the