INCOME GENERATION TOOLKIT

A Practical Guide for Charities and Not-for-Profits

This toolkit has been developed to assist not-for- profit organisations to set up or transform into social enterprises. The toolkit reflects our experience and key legislation in the area, and has been developed into tables and diagrams for ease of use.

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1. Introduction

In today's economic climate, charities and not-for-profits (**NFPs**) are forced to face the challenge of creating and maintaining a steady source of income. It has become common for NFPs to have more than one source of income, to help them effectively carry out their objects. In an age where the supply of Government grants and benevolent donations are decreasing, and public dependence on charitable and other public services are increasing, NFPs are finding themselves having to do more with less.

It is, therefore, no wonder that NFPs are turning to other potential sources of income to meet their funding needs, outside of the traditional funding models.

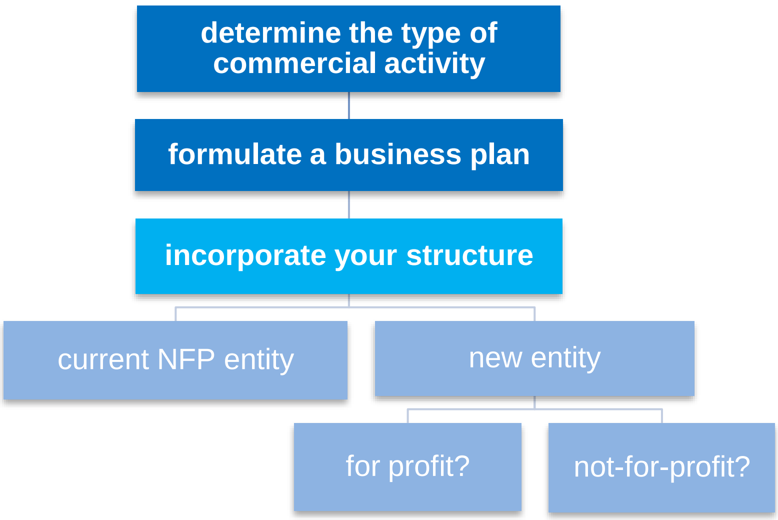
This toolkit aims to provide NFPs with some helpful information on:

- Commercialisation;
- Investment and Reserves;
- Collaboration; and
- Social Impact Bonds.

2. Commercialisation

2.1 Is commercialisation right for us?

Below is a summary of a decision making road map that your NFP may wish to utilise when deciding whether commercialisation is suitable. Each stage of the road map is expanded upon in the following sections of this toolkit.



We also recommend that you utilise the checklist located at the back of this toolkit.

2.2 General Rule – No Profit

One of the most important considerations when deciding whether to commence a commercial venture is the effect it might have on your NFP's tax status.

For example, at its most basic, a charity is an organisation that has an established charitable purpose, operated for the public benefit and which does not provide profit, gain or benefits to its members (subject to limited exceptions). The latter requirement is known as the "no-profit" rule, and underpins a charity's status. That rule applies equally to NFPs generally.

A common misconception is that an NFP cannot undertake a commercial venture, lest it be seen to be operating outside of its objects.

However, this is not always the case. It is well established and recognised by the law that an NFP may undertake a commercial venture, where it does so solely in furtherance of its objects.

2.3 What commercial activities can we undertake?

Provided that the general rule is adhered to, there are few limitations to the types of commercial ventures that an NFP may undertake.

Below are some examples of the types of commercial activities that are available to an NFP:

a. Sale of goods

b. Example: An organisation focused on promoting measures to prevent cancer sells sunscreen. The profits of sale are directed to fund a campaign aimed at reducing the risk of melanoma in the community.

c. Incidental or Ancillary Commercial Activity

d. Example: An organisation grows vegetables to use to feed the homeless. The organisation occasionally sells surplus vegetables when they are not needed to feed the homeless.

e. Direct Commercial Activity

f. Example: An organisation running a nursery selling plants, for the purpose of providing meaningful employment to people with disabilities.

g. Paid Not-for-profit Services

Example: School holiday programs for disadvantaged students where a nominal fee is charged to subsidise costs.

To the extent that the commercial venture is to be carried out within your NFP, or through the incorporation of a new separate NFP:

a. the subject matter of a commercial venture should, insofar as is possible, be directly related to your objects. This is to lower the risk that a third party (such as the Australian Taxation Office) questions the not-for-profit nature of your commercial activity; and

b. in any event, it is imperative that the proceeds from the commercial venture are applied towards the objects for which the organisation has been established.

A commercial venture operated by an NFP that is an end to itself (i.e. not to further the NFP's objects), will not be not-for-profit in nature and will therefore be taxed (according to the tax principles that apply to tax paying NFPs).

2.4 What do we want to achieve and how are we going to do it?

Once you have determined what commercial activity your organisation will pursue, the following questions need to be addressed:

a. What does our organisation wish to achieve through a commercial venture?

b. How are we going to achieve it?

Simply having an idea to generate income is not sufficient. If you were looking at commencing a for-profit business, you wouldn't show up to a bank for a business loan with merely an idea. Rather, you would prepare a detailed business plan, addressing the key issues that will determine whether your commercial venture succeeds or fails.

Commercial ventures fail for multiple reasons, but the major factors that are usually involved are:

a. a lack of effective marketing strategies;

b. inadequate start up capital;

c. poor management of funds (especially cash flow); or

d. insufficient market research and targeting.

If an organisation wishes to commercialise as a way of generating income, then the organisation needs to adopt a business oriented mindset, and prepare a detailed business plan that addresses these and other issues.

Although the contents of a business plan will differ between commercial ventures, generally speaking, it should deal with matters such as:

a. the structure of the commercial venture;

b. target market;

c. KPIs for success and failure;

d. the likely financial and other risks that might arise, and how they could potentially effect your NFP's exiting operations;

e. start up and ongoing costs; and

f. required and forecasted income.

For more information on business plans and other useful information and documents, the Australian Government has compiled a helpful list of guides and documents for use by the public,[1] which may be adapted for use by NFPs.

2.5 Structure

There are a range of different options and legal structures that you can utilise to undertake commercial activities. To keep things simple, this section will introduce some structures that may be used for income generation. Bear in mind, an organisation may choose to utilise one or more of these structures depending on its individual needs.

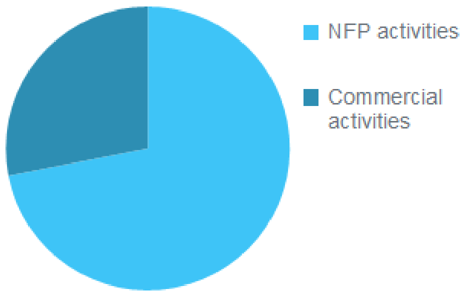
Broadly speaking, your organisation may:

a. integrate commercial activities into your organisation's current structure;

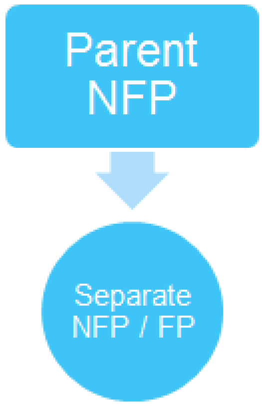
b. incorporate a separate NFP related entity; or

c. incorporate a separate for-profit entity.

[1] https://www.business.gov.au/info/plan-and-start/templates-and-tools



Integrate commercial activities within current structure



Set up a separate entity

Table 1: Outline of considerations for current structure

Type	Current Structure
Established Reputation	Your NFP may already have an established reputation that it can utilise to market its new services or goods If your NFP will be offering the commercial goods or services to its established membership, then it may be more appropriate to offer it "in house"
Establishment Costs	This structure avoids the establishment, maintenance, tax administration and compliance costs of anew entity
Skill Sets	Your NFP may not have the skill set necessary to operate commercial venture, both in terms of its Board and its employees Given the limits around director remuneration, it may be more difficult to attract the best candidates for the Board
Tax Concessions	Any income derived from the operation of the commercial venture will be subject to your organisation's existing tax concessions or exemptions
Capital Raising	Your NFP entity is limited in the way that it can undertake capital raising (e.g. it cannot issue securities such as shares/debentures in return for loaned capital) It may be easier to source debt funding within your established NFP, as compared with seeking the same debt funding in a new NFP entity
Risk	Operating the commercial venture within your NFP may significantly increase the legal liability and risk to your NFP Your NFP will be exposed to the market conditions of the industry within which you are selling your goods & services
Distribution of Profits	The profits will form part of your NFP's general income, and can be applied as per any other of its income

Table 2: Outline of considerations for separate NFP

Type	Separate NFP
Established Reputation	Arrangements may be made between your current NFP entity and the new NFP entity, to utilise common established IP.
Establishment Costs	This structure will be subject to initial and ongoing establishment, maintenance, tax administration and compliance costs.
Skill Sets	Your NFP may not have the skill set necessary to operate a commercial venture, both in terms of its Board and its employees. Given the limits around director remuneration, it may be more difficult to attract the best candidates for the Board.
Tax Concessions	Any income derived from the operation of the commercial venture will be subject to the new NFP's tax concessions or exemptions.
Capital Raising	Your NFP entity is limited in the way that it can undertake capital raising (e.g. it may not be able to issue securities such as debentures). It may be more difficult to source debt funding through the new NFP entity.
Risk	If the commercial venture fails, the NFP can ordinarily be wound up or deregistered with little impact on the existing parent NFP.
Distribution of Profits	Ordinarily an NFP cannot distribute its income to a member. However, generally speaking, such a distribution will be acceptable where: • The transferring NFP's sole purpose is charitable; • Its constitution authorises it to distribute its surplus or profit to an NFP that has similar charitable purposes (including a member); and • Its constitution only allows distributions to organisations that have similar charitable purposes. The funds distributed to the NFP can be used at its discretion (as long as they are applied towards the receiving NFP's objects).

Table 3: Outline of considerations for separate entity (FP)

Type	Separate Entity (FP)
Established Reputation	Arrangements may be made between your current NFP entity and the new for profit entity, to utilise common established IP such as your NFP logo, to make the public aware that the for-profit supports your NFP.
Establishment Costs	This structure will be subject to initial and ongoing establishment, maintenance, tax administration and compliance costs.
Skill Sets	It may be easier to attract the best candidates to a special purpose for-profit organisation, given that it is likely able to generate more capital than an NFP, and given that it will be subject to less restrictions on director remuneration.

Tax Concessions	No tax concessions A for-profit will have to pay income tax on any profits made, and cannot utilise other tax concessions or exemptions that your NFP organisation might be entitled to (e.g. FBT rebate).
Capital Raising	A for-profit allows for greater freedom in terms of capital raising. For example, a Pty Ltd company can issue securities (shares and debentures etc.) to investors in return for capital, making it easier to attract them.
Risk	By incorporating a new separate entity, the risk involved in operating the commercial venture attaches to the new entity, as opposed to the established NFP. If the commercial venture fails, the for-profit can ordinarily be wound up or deregistered with little impact on the existing parent NFP.
Distribution of Profits	A for-profit can distribute its proceeds as it pleases, subject to the law generally.

3. Investments and Reserves

An NFP's not-for-profit status does not prohibit it from producing income through financial products and general passive investments (such as the purchasing of property).

However, NFPs should take into account the following when deciding whether to invest in financial products or other general passive investments:

a. NFPs should seek independent professional advice on what financial products and investment are suitable in their particular circumstances;

b. NFPs should be careful to avoid high risk investments;

c. NFPs should have consideration for how quickly investments can be liquidated, in case unexpected cash flow issues arise; and

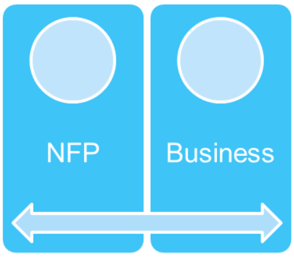
d. If your NFP has substantial money to invest, it might decide that some money can be invested in investments which can be liquidated quickly and others not as quickly.

Like investments, an NFP's not-for-profit status will not prohibit it from holding cash reserves, as long as they are reasonable taking into account the NFP's overall financial position. That is because the Australian Charities and Not-for-profits Commission and the Australian Taxation Office recognise that it is important for an NFP, like any other type of organisation, to have funds set aside to meet future liabilities and costs, both expected and unexpected.

For more information on reserves, charities should consult the fact sheet *"Charity reserves: financial stability and sustainability"* published by the Australian Charities and Not-for-profits Commission[2] and for NFPs generally, our article in last edition of 3rd Dimension.

[2] Available at http://www.acnc.gov.au/ACNC/FTS/Charity_reserves.aspx.

4. Collaborative Agreement



Enter into a
Collaboration

The commencement of a permanent commercial venture might not suit your NFP's needs for a range of reasons, such as:

a. your NFP may not have the capital to commence a permanent commercial venture, and may be unable to readily source it;

b. your NFP may not have the skill set to commence the commercial venture; or

c. your NFP may simply need a "one off" boost to its reserves to invest in a particular project or asset.

In circumstances such as those above, it may be more appropriate or beneficial for your NFP to explore the possibility of a collaboration agreement.

A collaboration agreement occurs when two pre-existing organisations form an agreement to work together for mutual benefit. This may, but will not necessarily, take the form of a joint venture relationship.

The most obvious example of a collaboration agreement is where a for-profit company sells products to the public, with a promise to donate a portion of the sale proceeds to your NFP.

Benefits	Disadvantages
Consumers feel a sense of satisfaction, and may be more likely to buy the product or service being offered benefiting both your NFP and your for-profit partner	Generally, collaboration agreements are short term arrangements, not allowing for long term income generation
Apart from offering a limited licence to utilise your NFP's logo on packaging and marketing materials, ordinarily your NFP's involvement will be minimal	If your objects or activities are controversial within some groups of the community, it may cause consumers to shun or avoid the good or services offered by your NFP's for-profit partner

5. Social Impact Bonds

As noted above, nowadays, many NFPs are turning to commercialisation and investment in order to meet their financial demands. This increased involvement has given rise to a new form of investment commonly known as Social Impact Investment. One facet of Social Impact Investment, is a type of security known as Social Impact Bonds (or, Social Benefit Bonds).

5.1 What are Social Impact Bonds?

In some ways, Social Impact Bonds are like any other form of investment. That is, investors invest money up-front, in the hope and expectation that there will be a beneficial return in the future. However, in addition to this financial motivation, Social Impact Bonds have an altruistic motivation, in that the funds invested by investors are used to improve social or environmental issues. The key difference between Social Impact Bonds and other financial investment products, is the way in which the returns to investors are determined.

5.2 How do they work?

A Social Impact Bond essentially involves a payment for results contract. Although the structure of each transaction will differ, broadly speaking, a Social Impact Bond involves the following:

a. **Benevolent Project** - A NFP (usually known as a Service Provider) proposes to undertake a project which addresses a pressing social or environmental issue (generally referred to as an intervention);

b. **Agreed Outcomes** - The Service Provider and government agree on agreed outcomes, formalised in a Service Agreement (or similar arrangement). Those agreed outcomes are designed to not only provide positive social or environmental outcomes, but also to reduce the costs of government associated with the subject matter of the project;

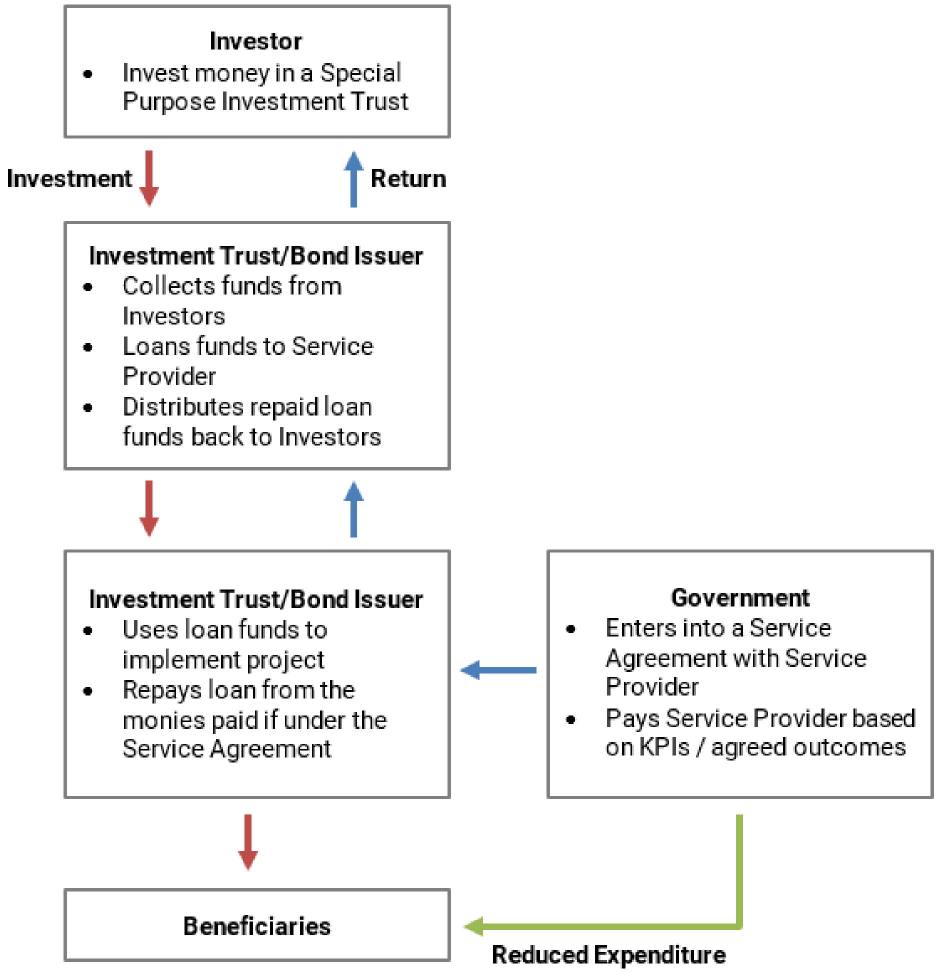
c. **Investment** - Investors are invited to contribute funds towards the project;

d. **Return** - Assuming the agreed outcomes are reached, the investors will receive a repayment of their principal investment plus a financial return, which is paid from the monies which the government would have otherwise spent if the project or intervention was not undertaken.

In other words, a Social Impact Bond is results focused, rather than profit focused.

5.3 What do they look like?

Although these transactions can potentially be structured in a number of ways, below is an example of how such an arrangement can operate.



5.4 What are the potential benefits?

Social Impact Bonds are an innovative way to fund social and environmental projects, and have the potential to give your NFP access to the amount of capital that traditionally it would not be able to access through conventional financial products and markets. Although Social Impact Bonds will not be suitable for every transaction, the model offered by them has the potential to inspire the type of creativity and entrepreneurship that was traditionally only seen in the for-profit sector.

6. Commercialisation Checklist

6.1 Know your organisation's purpose

Review the objects clause of your organisation's constitution and ensure it accurately reflects your organisation's purpose and activities.

It is common for organisations to depart from their originally determined path, and this often results in the objects, activities and operations practised by the organisation being out of sync with those stated in its constitution. You should consider:

- What sort of activities does your organisation engage in? ☐
- Who are the members and/or beneficiaries of your organisation? ☐
- Does your organisation's objects clause accurately reflect these? ☐

If your objects clause does not accurately reflect your organisation's purposes and activities, your organisation may need to consider revising its constitution. If it does, proceed to 6.2.

6.2 Consider different commercial legal structures

Consider entering into a collaborative arrangement with an existing organisation.

Some useful matters to consider include:

- Are there other organisations or businesses with a similar purpose and social concern? ☐
- What products or services does your organisation rely on to survive? ☐
- Would it be possible to enter into a collaborative arrangement with current suppliers? ☐
- What can your organisation offer other businesses and/or organisations? ☐
- How can your organisation make the most out of a collaboration? ☐

Consider integrating commercial activities into your organisation's current structure.

Some useful matters to consider include:

- Does your organisation already provide products or services to its members/beneficiaries? ☐
- Would it be possible to start charging for these products or services? ☐
- Would charging for these products or services compromise your organisation's patronage or membership? ☐
- What skills or expertise does your organisation already have? ☐
- Is it possible to use these skills to start providing goods or services at a cost? ☐
- How can your organisation make the most out of its current structure? ☐

Consider starting up a separate entity.

See questions above in relation to Step 2(b). Some further matters to consider include:

- What type of legal entity should your organisation establish? ☐
- Will the new entity be a subsidiary company or a parent organisation? ☐
- What skills will be necessary to set up the new entity? ☐
- Can your organisation afford the start-up costs? ☐

- What relationship will the new entity have with your current organisation? ☐
- What services or products will the new entity provide? ☐

6.3 Understand the risks of commercialising

Understand the risks of commercialising and the impact on your organisation's current activities.

- What impact will commercialising have on current funding agreements? ☐
- What impact will commercialising have on your organisation's ability to obtain future grants? ☐
- Will commercialising affect your organisation's current tax endorsements? ☐
- Does your organisation already possess the requisite skills for new commercial activities? ☐

6.4 Determine the costs of commercialising

Determine the various costs involved in commercialising your organisation.

- Will your organisation need to hire new employees? How will they be renumerated? ☐
- Where will your organisation need to conduct its activities? ☐
- Will your organisation be able to cover the start-up costs? ☐
- How might the use of your organisation's surplus affect its current operations? ☐
- What are the financial and other risks involved? ☐

If your organisation loses patronage, will the new commercial activities make up for the loss?

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