

Trying to Wriggle Out of Feeder Organization Status?: Not Easy

03.03.16 | Linda J. Rosenthal, JD



Three old hippies walk into a bar

*Well, they **were** former hippies, but they weren't at a regular bar. They were sipping cappuccinos at a trendy spot at Venice Beach – a **coffee** bar.*

Actually, one of them was a young lawyer, but the imaginary friends joining her were some famous former hippies.

Their discussion inspired the young lawyer to set up a special new business reflecting enlightened social philosophy. But it wouldn't be a business, exactly, because all the profits would go to charity....

Not this scene, but one like it, was what may have inspired the late Rick Cohen of The Nonprofit Quarterly to pen an article last year titled “IRS and Courts [Reject Hippie Redemption For-Profit Businesses as Public Charities.](#)”

He discusses the clever attempt to try to overcome the [“feeder organization” dilemma](#), but the Internal Revenue Service, then the United States Tax Court, and then again in May 2015, the [9th Circuit Court of Appeals](#), were having none of this creative legerdemain.

The Zag That Tried to Fly

In 2010, M. Renee Orth formed Zagfly, Inc., as a California Nonprofit Public Benefit Corporation.

The Articles of Incorporation read: “The specific purpose of this corporation is to establish Internet platforms that will enable the general public to direct the proceeds of their activities to charitable causes.”

“Zagfly is, or would be,” according to Rick Cohen, “a firm that sold flowers at market prices to online consumers ... [with a plan] to expand to marketing other goods and services.” It sought 501(c)(3) public charity status because its donation of its profits to charitable organizations would make it “akin to a public charity itself.”

“It struck us,” Cohen wrote, “to look into what Zagfly was and why it might have attempted to pitch its market-rate flower business as a 501(c)(3).” He discovered by Google search that the M. Renee Orth who is listed as the President, CEO, and attorney for Zagfly, Inc. –

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self-identified as a “Social Entrepreneur and Catalyst for Change.” Orth also appears as the co-author with her husband of Conspiracy of Dreamers: Capitalism at the Service of Humanity, published by Magnolia Lane Press in 2012. The book is a wide-ranging paean to what they describe as ‘economics,’ based on the values of thinkers as diverse as the Dalai Lama, Ron Shaich (Panera), Eckhart Tolle, and Bill Gates, to name only a handful of the people Orth cites for inspiration.

Good Try, Zagfly, But No Cigar

Straight out of the gate, the Tax Court made clear that the IRS had correctly denied the requested tax exemption under 501(c)(3) because merely donating profits to charity doesn’t turn a business into a charity itself. In a short opinion, the 9th Circuit affirmed.

After a lengthy description of the planned organization and operation of Zagfly, Inc., the Tax Court based its ruling on the grounds of Zagfly’s failure of the operational tests of 501(c)(3), but spent time as well on the organizational test, and added some bits about the unrelated business income tax.

The Court summarily swatted away Zagfly’s alternate argument that it would not be disqualified from tax exemption as a Section 502 “feeder organization.”

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Because we hold that petitioner will not operate exclusively for an exempt purpose and, therefore, is not an exempt organization under sec. 501(a), ‘we need not address the question whether petitioner is a ‘feeder organization’ under sec. 502(a).

The Business Plan That Didn't Make It

The unique twists and turns of Zagfly's business plan that its founders hoped would be successful arguments as exceptions to feeder-organization status weren't at all persuasive: "[Zagfly] plans to engage in an Internet-based business selling goods and services" but "[b]roking sales of flowers between consumers and florists is an activity ordinarily carried on by commercial enterprises." Moreover, "[Zagfly] acknowledges it will be 'a newcomer in a saturated market', and it will be in direct competition with commercial flower brokers."

Ouch.

Just so you know – if you want to take a stab at a feeder organization exception – here are some of the Zagfly features it hoped would fit into one of the established exceptions to Section 502 (paraphased here from the Tax Court's description of Zagfly's brief; Zagfly is the petitioner, by the way):

- "Initially, petitioner intends to create a Web site and sell flowers as part of an established network of florists;
- As a flower broker, petitioner anticipates that it will earn a sales commission of approximately 10% to 20% of the purchase price of the flowers it sells;
- Petitioner's Web site will feature approximately 40 different floral arrangements for purchase and delivery, and it expects to sell flowers at market rates, i.e., the price offered by other vendors participating in the florist network. When customers purchase flowers from petitioner, they will be able to designate a charitable organization, from a list of organizations approved by petitioner, to receive all of the profit arising from the transaction;
- Petitioner will approve an organization to receive a share of its profits only if the organization is exempt under section 501(c)(3);
- Petitioner plans to begin operations with an all volunteer workforce. However, assuming its business model is viable, petitioner intends to pay its employees reasonable salaries;
- Petitioner indicated it will begin operations with an all volunteer workforce. However, assuming its business model is viable, petitioner intends to pay its employees reasonable salaries.
- Petitioner indicated that it would 'suggest that our users allocate a small percentage (10% to 20%) of the profits (i.e., 1% to 2% of the purchase price) from their flower purchase to supporting our nonprofit. If we find that our users are not inclined to voluntarily elect to allocate funds to our organization, then we may need to include our operating expenses in determining the 'profit' that goes to the

- charitable cause of our users' choice'.
- Petitioner's goal is to cover all operating costs with philanthropic donations so that all user generated revenue * * * can be directed to the charitable causes our users wish to support.
 - Although it will fulfill its purpose by engaging in activities that others engage in for commercial gain, its primary motivation is charitable."

Conclusion

Of course, when this organization was formed in 2010, California had not yet adopted the social enterprise hybrid corporate model. That happened at the end of 2011.

"Economics" Zagfly's founder and her co-author wrote,

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is an alternative model for understanding and shaping the system with and in which we collectively and individually respond to and shape our material world, and are, in turn, shaped by it. Economics is based on the wealth of wisdom coming out of the science of systems...Capitalism is evolving, soulful and, most importantly, alive. The goal, rather than blind growth, is the collaborative expression of what it means to be a human being and the joyful celebration of the experience of life in its infinitely varied forms.

"Toward the end of the book," according to Rick Cohen, "Orth and her co-author talk about the concept of 'economics' as something of a 'Hippie Redemption' for the Baby Boomer generation that they align with Gates and Shaich in their work 'to shift from reaction (and, for many, from resignation) to creation and bring about the world of love and peace they imagined in their youth.'

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In the book's epilogue, Orth adds a page mentioning Zagfly as the intended 'platform for executing many of the ideas shared in this book,' albeit without explanation as to what Zagfly would actually do, though Orth acknowledged that the IRS found the entity 'too commercial.'

Sure sounds like a social enterprise to us.