The Evolving Form of Free Software Organizations

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The bad news: free software is in trouble with the IRS.

Free software as 501(c)(3)

To qualify for exemption, a project's purpose must be **exclusively**:

- Charitable
- Scientific
- Educational

Free software as 501(c)(3)

IRS defines these terms narrowly

- "educational": specific courses of instruction, journals, lectures
- "scientific": perform scientific research, publish results, non-commercial
- "charitable": benefit a "charitable class," e.g. the poor, distressed, elderly, infirm

Free software as 501(c)(3)

Two related objections:

- Private benefit (or the potential for it)
- Competition with commercial software

In short, the commercialization of free software has undermined the legal structure for nonprofit development.

Free software as 501(c)(3)

The fallout for community projects:

- Fewer projects will qualify
- Fiscal sponsors may be hindered

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Free software as 501(c)(3)

The worst case scenario is not inevitable . . .

- No negative determinations yet
- Opportunities for appeal
- Non-US nonprofits are not affected

. . . but we need to prepare for it.

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Why 501(c)(3)?

Many projects default to 501(c)(3). It feels right, because:

- volunteer community w/ no owners
- promoting public good
- most income from donations

Why not 501(c)(3)?

501(c)(3) is not always a good fit

- existing project management structure maps poorly onto corporate leadership
- heavy administrative burden
- tax benefits often minimal
- funding options restricted

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Evaluating alternatives

Other structures exist. Differences are:

- **Accountability** to serve community's interests
- **Flexibility** to pursue funding
- **Tax treatment**

Alternatives: 501(c)(3)

Accountability: moderate-to-high
- Board (and member?) managed
- IRS & attorney general oversight
- Donor-dependent

Flexibility: mixed
- Eligible for foundation & legacy funding
- Severely limited business opportunity

Tax treatment: favorable, within mission

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Examples: 501(c)(3)

- Single-project orgs: Django Foundation, Plone Foundation, PSF
- Multi-project orgs: GNOME Foundation, GNU (FSF), FreeBSD Foundation
- Fiscal sponsors: Apache, Conservancy, SPI
- Advocacy organizations: FSF, OSI, SFLC

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Alternatives: do nothing

Accountability: moderate/informal
- Poor leadership promotes forking

Flexibility: mixed
- Can operate as exempt at < $5,000/year
- No grant funding
- Uncertain legal status make deals difficult and liability uncertain

Tax treatment: dependent

Alternatives: 501(c)(6)

"Trade association" operated to advance the common business interests of its members

- Tax-exempt
- No deduction for donors
- Need not serve any public purpose

Alternatives: 501(c)(6)

Accountability: low-to-moderate
- IRS oversight: must operate non-for-profit, serve common business interest
- Member-dependent

Flexibility: low-to-moderate
- No foundation/legacy funding
- Decisions not independent of members

Tax treatment: somewhat favorable

Examples: 501(c)(6)

- Single-project orgs: Linux Foundation, Eclipse Foundation, Dojo Foundation
- Other: Outercurve Foundation, Open Health Tools

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Alternatives: for-profit corp.

Accountability: low
- Responsibility is to business & shareholder interests, not community
- Some indirect accountability via demand

Flexibility: moderate
- Can pursue any legal avenue for profit
- Little latitude to pursue other ends

Tax: fully taxable till Romney is elected

Contingency plans

If exemption under 501(c)(3) is no longer an option for most free software projects, what can we do?

There is no simple solution to the IRS problem, but some reshuffling is possible.

Plan #1: don't incorporate

Some projects incorporate for questionable reasons:
- reached a critical mass of activity
- "can't take donations"
- confusion about limited liability

Some avoid fiscal sponsors for egotistical reasons.

Most small projects shouldn't incorporate

Plan #2: increased 501(c)(6) use

Projects that support many businesses may do as well with a (c)(6) as with a (c)(3).

- Same (or better) ability to raise funds from corporate donors
- . . . but constrained from representing interests of community members with no business interest in the project

Plan #3: specialized 501(c)(3)s

Organize special-purpose vehicles around projects' common non-development needs (e.g. conferences)

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Plan #4: select 501(c)(3) projects

Projects that serve "classically" charitable, educational, and scientific purposes will likely continue to receive exemption.

Example: Sahana Software Foundation

Contingency plan summary

These options provide room for many (or most) projects who will be denied exemption, but leave unserved projects with:

- no IRS-approved function
- limited corporate involvement
- substantial funding needs (i.e. more than the occasional conference)

An interesting new hybrid

The **benefit corporation** is a new corporate form designed for socially beneficial businesses

- Fills a space between mission-based nonprofits and profit-seeking businesses
- Motivated by "green"/sustainable business movement
- Authorized in seven states

Benefit corporations defined

Differences between a benefit corporation and a for-profit corporation:

- must produce a "material positive impact" on society and the environment
- can & must consider non-financial interests when making decisions
- must publicly report its public benefit according to objective, 3rd-party standard

Stakeholders, not shareholders

Rather than maximizing **shareholder** value,
a benefit corporation's board must consider
the interests of <u>all</u> **stakeholders**, including:

- employees
- customers
- community
- the environment

Why FOSS benefit corporations?

Recognizes community stake in project via:

- Transparency: annual report shows real effort, discourages "greenwashing"
- Flexibility: can pursue community interests over profit
- Accountability to people with a stake in the project (shareholders and/or others)

Why bother?

Benefit corporation designation adds responsibility, but has advantages:

- Attract contributors who otherwise distrust corporate projects
- Prevent change of control from undermining founders' purpose
- Freedom to do business ethically

But the taxes . . .

Burden of exemption outweighs benefit for some projects:
- limited fundraising options
- strict regulatory control

Tax exemption is only useful if you have income.

How to make it work

1. Start talking about it (talk to me)
2. Define how a **good** free software company looks and operates
3. Produce a standard for free software benefit reports
4. Just do it: any company can become a benefit corporation

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