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Taxing Social Enterprise

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TAXING SOCIAL ENTERPRISE

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Since the first hybrid enabling law was passed in Vermont in 2008, the number of states offering hybrid forms has grown steadily, as has the number of entrepreneurs choosing statutory hybrids as a middle road between the for-profit and the nonprofit. Plaudits for and criticism of the hybrid form have also proliferated. Proponents have lauded their ability to facilitate socially conscious enterprise. Detractors have questioned the viability of the hybrid form and have suggested that they create more fiduciary conflicts than they resolve. To date, however, there has been no serious scholarly publication addressing the appropriate tax treatment of hybrid entities even though some supporters of hybrids have asserted that these forms deserve tax preferences.

In this Article, we close that gap by thoroughly examining the arguments for tax preferences and the likely consequences that would flow from offering such preferences. We conclude that hybrid entities should not receive tax preferences traditionally offered to nonprofit entities because such an extension of tax benefits would likely have a deleterious effect, not only on the charitable sector and the public fisc, but also on hybrids themselves. Such an extension would almost certainly require a much clearer and narrower definition of public benefit that would undermine the much-touted flexibility offered by the hybrid forms, shift the financial risk of a hybrid not providing significant public benefit from its investors and donors to the public at large, place a substantial and likely unsustainable burden on the federal government to ensure that profitmaking does not trump providing public benefit, and threaten to undermine public support both for hybrid forms and for the existing tax preferences enjoyed by nonprofits. At the same time, we also conclude that some modifications to existing tax laws are appropriate in that they would acknowledge hybrids' virtues while not exacerbating their potential weaknesses.

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INTRODUCTION

"Hybrid" legal forms have proliferated over the past half decade, seeking to combine the potential for profit with one or more public-benefitting goals.[1] These forms include the low-profit limited liability company (L3C), the benefit corporation, and most recently the flexible purpose corporation. The stated purpose of these entities is to marry the capital and innovation that results from the ability to generate a profit for investors with the public benefit goals that characterize most nonprofits. While academics have sharply criticized the

1. *See, e.g.*, Stephanie Strom, *A Quest for Hybrid Companies That Profit, but Can Tap Charity*, N.Y. TIMES (Oct. 12, 2011), http://www.nytimes.com/2011/10/13/business/a-quest-for-hybrid-companies-part-money-maker-part-nonprofit.html (detailing the rapid spread of hybrid companies and legislation).

emergence of these forms with respect to both their necessity and feasibility,[2] states continue to pass legislation permitting them and private parties have begun to take advantage of this legislation. To date, eight states currently allow the creation of L3Cs, nineteen states and the District of Columbia have authorized the creation of benefit corporations, and the most populous state, California, has authorized the creation of flexible purpose corporations.[3] The most current figures indicate that over 1000 of these new entities now exist.[4] Although this figure pales in comparison to the number of more traditional for-profit and nonprofit legal entities,[5] these new forms are now an established part of the legal landscape for those seeking to combine doing good with doing well.[6] Such efforts are commonly referred to as "social enterprise" and those engaged in them as "social entrepreneurs," although neither of these terms has a fixed definition.[7]

There is no single, representative example of the type of business that chooses to use a hybrid legal form. When Delaware recently permitted the creation of benefit corporations, one of the first entities to switch to this status was Plum Organics, a fast-growing company committed to providing healthy snacks for children and wholly owned by Campbell Soup Company.[8] When California

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2. *See infra* notes 39, 49 & 60 and accompanying text (summarizing criticisms of L3Cs, benefit corporations, and hybrids generally).

3. *See* DEBRA BOWEN, CAL. SEC'Y OF STATE, TWO NEW TYPES OF CORPORATIONS EFFECTIVE JANUARY 1, 2012 (2011), *available at* http://www.sos.ca.gov/business/be/forms/flexible-purpose-corp-and-benefit-corp.pdf; *Legislation*, B CORP., http://www.bcorporation.net/what-are-b-corps/legislation (last visited Feb. 1, 2014) (showing states that have enacted benefit corporation laws).

4. *See infra* notes 41, 50 & 61 and accompanying text.

5. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 491 (2012), *available at* http://www.census.gov/prod/2011pubs/12statab/fedgov.pdf (noting the existence of over three million partnerships and almost six million corporations based on 2008 federal tax filings); Paul Arnsberger, *Nonprofit Charitable Organizations, 2009*, SOI BULL., Fall 2012, at 169, 179, 181 (noting the existence of over 400,000 tax-exempt nonprofit organizations based on 2009 federal tax filings).

6. *See, e.g.*, Alyce Lomax, *Doing Good to Do Well Gets a Legal Boost in California*, DAILY FINANCE (Jan. 28, 2012, 7:00 AM), http://www.dailyfinance.com/2012/01/28/doing-good-to-do-well-gets-a-legal-boost-in-california (reporting on passage of hybrid legislation in California).

7. *See, e.g.*, Garry Jenkins, *Who's Afraid of Philanthrocapitalism?*, 61 CASE W. RES. L. REV. 753, 761 (2011) ("Both social enterprise and social entrepreneurship, however, are diffuse concepts that have been used and defined in a myriad of ways."); David Pozen, *We Are All Entrepreneurs Now*, 43 WAKE FOREST L. REV. 283, 294-300 (2008) (reviewing various definitions of social entrepreneurship); *see also Office of Social Innovation & Civic Participation*, WHITE HOUSE, http://www.whitehouse.gov/administration/eop/sicp (last visited Feb. 1, 2014) (providing information on a White House office dedicated to the named concepts).

8. *See* Anne Field, *Who's Who of Social Enterprises Registers as Benefit Corps. in Delaware*, FORBES (Aug. 3, 2013, 2:33 PM), http://www.forbes.com/sites/annefield/2013/08/03/whos-who-of-social-enterprises-registers-as-benefit-corps-in-delaware; Michael Kanellos, *Silicon Valley Food Boomlet Gets Its First Big Acquisition*, FORBES (May 23,

permitted the creation of benefit corporations one of the first businesses to switch to that status was Patagonia, a family-owned maker of outdoor clothing and gear that contributes at least one percent of its sales to grassroots environmental groups.[9] And one of the first L3Cs is Maine's Own Organic Milk (MOOMilk), which ten organic dairy farms formed to help promote local family farming, and which the farmers, outside investors, and two nonprofits, the Maine Farm Bureau and the Maine Organic Farmers and Gardeners Association, own.[10]

To date, supporters of these hybrid forms have focused primarily on encouraging states to permit the creation of these new entities, but there have already been calls for these forms to receive some or all of the tax benefits enjoyed by charities.[11] As was the case with the calls to create these hybrid forms in the first place, such calls for tax benefits have met much skepticism. For example, in Hawaii the initial legislation that would have created benefit corporations in that state included exemption from state income tax, but the governor vetoed the final version of that legislation—which would have merely created a task force to study the creation of benefit corporations—in part because of the tax exemption provision that had drawn public criticism.[12] Leading nonprofit policy organizations, such as Independent Sector, have also con-

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2013, 7:40 PM), http://www.forbes.com/sites/michaelkanellos/2013/05/23/silicon-valley-food-boomlet-gets-its-first-big-merger.

9. John Tozzi, *Patagonia Road Tests New Sustainability Legal Status*, BLOOMBERG (Jan. 4, 2012, 4:57 AM PT), http://www.bloomberg.com/news/2012-01-04/patagonia-road-tests-new-sustainability-legal-status.html; *see Our Reason for Being*, PATAGONIA, http://www.patagonia.com/us/patagonia.go?assetid=2047&ln=140 (last visited Feb. 1, 2014).

10. *See* Jessica Hall, *MOOMilk Attracts $3.9 Million in New Investment*, MORNING SENTINEL (Me.) (May 29, 2013), http://www.onlinesentinel.com/news/MOO-Milk.html; *Our Story*, ME.'S OWN ORGANIC MILK, http://www.moomilkco.com/index.php/moomilk-story (last visited Feb. 1, 2014).

11. *See, e.g.*, Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 322 (2010) ("Another option to increase access to capital is to buttress existing capital streams through the creation of tax incentives for L3Cs."); Rick Cohen, *L3C: Pot of Gold or Space Invader?*, BLUE AVOCADO (Sept. 30, 2009), http://www.blueavocado.org/content/l3c-pot-gold-or-space-invader ("An increasing number of commentators . . . advocate changing the tax code so that contributions to (or purchases from) socially minded for-profits would be tax deductable."); Strom, *supra* note 1 (stating that there is "a quiet push to get preferential tax treatment for [hybrids]").

12. *See* H.B. 3118, 23d Leg., 2006 Leg. Sess. § 10 (Haw. 2006); Linda Lingle, Statement of Objections to House Bill 3118 (July 10, 2006), *available at* http://archive.lingle.hawaii.gov/govgallery/leg/2006/Folder.2006-04-19.5231/SOBJ%20-%20HB3118.PDF/download (describing reasons for vetoing the bill, including "the bill's potential impact on tax revenues"); Editorial, *"Responsible" Firms Don't Merit New Prize*, HONOLULU ADVERTISER (Mar. 29, 2006), http://the.honoluluadvertiser.com/article/2006/Mar/29/op/FP603290318.html (expressing skepticism about the proposed bill's tax break).

sidered this idea and rejected it.[13] But some commentators have supported the extension of the tax benefits historically enjoyed by nonprofit entities to other types of entities that pursue the public good.[14] Of all the other types of legal forms available, the new hybrids are the most likely candidates for such an extension. It is therefore important to consider whether it would be sensible or even desirable to broaden the universe of entities eligible for such benefits.

More specifically, while for-profit entities or their owners are generally subject to federal and state income taxes, nonprofit entities are generally exempt from those taxes. Furthermore, nonprofit entities that are committed to pursuing charitable, educational, religious, or other public-benefitting purposes—commonly referred to as charities—also enjoy a host of other tax benefits, most prominently the ability to receive tax-deductible contributions and exemption from most other types of state and local taxes. The question raised by the emergence of these hybrids is therefore whether the fact that they pursue public-benefitting goals should entitle them to any or all of the tax benefits enjoyed by nonprofits that also pursue such goals.

In this Article we review the current tax treatment of for-profit entities—including the treatment of their charitable activities—and of charities, as well as the rationales for the different tax treatment of these two types of entities. Against this backdrop, we then consider whether hybrids should receive some or all of the tax benefits enjoyed by charities. Our conclusion is that the bare fact that hybrids have public-benefitting goals in addition to profit-seeking goals does not provide sufficient grounds for giving hybrids these tax benefits for four reasons, each of which arises from the difficulty of defining and policing "public benefit."

First, abrogating the requirement that in order to receive tax benefits an organization must be a nonprofit entity brings to the forefront the difficult issue of defining exactly what activities qualify as charitable or otherwise public benefitting. Current federal tax law, and most state tax laws, avoid this issue in significant part by providing only a vague definition that is backstopped by the inability of public-benefitting organizations to distribute excess funds to owners—if a private party's real motivation is to do well instead of doing good, the nonprofit form makes it difficult to satisfy that desire to the detriment of doing good. The lifting of that nondistribution bar, however, places much greater

13. *See Hybrid Position Statement*, INDEP. SECTOR, http://www.independentsector.org/hybrid_position (last visited Feb. 1, 2014) (opposing the extension of tax benefits to hybrid organizations).

14. *See, e.g.*, THOMAS J. BILLITTERI, NONPROFIT SECTOR RESEARCH FUND, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH? 6 (2007) (reporting on an Aspen Institute-convened conference where "many participants . . . advocated such steps as changing the federal tax code to accommodate new kinds of social enterprise vehicles"); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2022 (2007) (advocating "decoupling" tax exemption from the nonprofit requirement).

pressure on the definition of public benefit, especially since most if not all for-profit entities already create a public benefit in the most general sense by providing jobs, desired products or services, and other economic opportunities.

Second, providing tax benefits would effectively shift the not insignificant risk that hybrids will fail to consistently pursue public benefit from the relatively limited and informed group of financial supporters of each hybrid to the relatively broad and uninformed taxpaying public as a whole. To reduce this risk would in turn almost certainly require the government to impose additional restrictions on hybrids and to fund additional oversight of them. Although investors in hybrids choose to take on an additional risk by funding an entity not solely dedicated to making profits, it is far from clear why the public should share in that risk or bear the burden of providing additional oversight for hybrids. The imposition of additional restrictions would also undermine the flexibility that is one of the major benefits of these hybrid forms.

This risk of not sufficiently pursuing public benefit leads to the third reason: tax-exempt charitable nonprofits are subject to an extensive regulatory regime to ensure that they in fact pursue public benefit, of which the requirement of nonprofit status is a critical component. Hybrid statutes seek to make pursuing a public benefit only one of the goals of such entities and lack bright-line requirements (such as nonprofit status) to ensure that they in fact provide some minimum quantum of public benefit. Any attempt to modify the statutes to create a more extensive state regulatory regime or to impose other mechanisms to ensure that hybrids produce sufficient public benefit to justify any tax benefits they receive would again undermine the very characteristics that supporters argue make hybrids desirable—the ability to harness private funds for public good and to promote innovation in seeking public benefit.

Lastly, if even a small number of hybrids that enjoy tax benefits fail to provide the promised public benefit, this result could threaten to undermine the already limited support for the existence of hybrid entities. Even more troubling, such misuse of tax benefits could lead to questioning of the provision of tax benefits more generally to incentivize providing public benefit, including by charities. While such questioning would not be new, misuse of tax benefits by hybrids might lead to a reduction in tax benefits for all public-benefitting activity, whether conducted by hybrids or charities.

Part I of this Article describes the emergence of the new hybrid legal forms and their growing adoption by states even in the face of significant criticism. Part II explains the current structure of and rationales for the tax treatment of both for-profit entities and charities, and details how the existing rules treat these new hybrids for federal and state tax purposes. Part III brings together the previous two Parts to answer the question of whether any of the tax benefits enjoyed by charities should be extended to these new hybrids. For the reasons already briefly noted and developed in more detail in this Part, we conclude that the answer to this question is an emphatic "no." Part III does, however, suggest several modifications to the existing federal tax rules to accommodate hybrids and their multiple purposes.

I. THE NEW HYBRID FORMS

In the latter part of the twentieth century, a class of entrepreneurs emerged that was vocal in its desire to consider factors other than the bottom line in making business decisions. Well known within this class were the founders of Ben & Jerry's and craigslist.[15] Rather than concentrating solely on profit, these individuals wanted their enterprises to pursue some social mission, but in both cases, that goal was allegedly hindered by investors' appeals to traditional corporate fiduciary duties relating to maximizing profits.

The founders of Ben & Jerry's felt that they were forced to sell their company to the highest bidder, despite the fact that there was no assurance that the acquirer would respect their company's dedication to social causes.[16] Some critics point to the broad protection of the business judgment rule—a doctrine that establishes a presumption that directors and officers make their business decisions in an informed and good faith manner to further what they believe to be the best interests of the corporation, which is rebuttable only by showing that the directors or officers failed to act rationally[17]—however, and argue that the founders of Ben & Jerry's would have been vindicated if they had stood their ground.[18]

Enter Craig Newmark, the founder of craigslist, who found himself locked in battle with eBay, a minority shareholder in craigslist, over his desire to maintain the public-service orientation he envisioned for his company.[19] In court, the ruling went largely in favor of eBay:

15. *See* J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 14-15 (2011).

16. *See id.* at 14 ("[T]he founders claimed that they did not really want to sell the company to Unilever, and that 'corporate law made them do it.'" (citing Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211, 211 (2010))).

17. *See* Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy,* 16 STAN. J.L. BUS. & FIN. 1, 8-16 (2010) (summarizing the history and recent application of the business judgment rule).

18. *See* Page & Katz, *supra* note 16, at 241 ("It was not corporate law that inexorably pushed the company to subordinate its social mission to the financial bottom line. Rather, Ben & Jerry's board members preferred Unilever's offer and no risk of personal liability to testing Ben & Jerry's defenses . . . .").

19. *See* Murray & Hwang, *supra* note 15, at 15. The court prefaced its holding by emphasizing that "[p]romoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders." eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33 (Del. Ch. 2010) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986)).

> The corporate form in which craigslist operates . . . is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. . . . Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form.[20]

Some entrepreneurs and academics suggested constituency statutes as a possible safe haven from these concerns because such statutes allow for the consideration of the interests of stakeholders other than shareholders.[21] There were new problems with this solution, however. First, constituency statutes exist only in certain jurisdictions, and even in states where they could be used, the lack of clear precedent to demonstrate their protective ability made entrepreneurs nervous.[22] Furthermore, the overwhelming majority of constituency statutes are merely permissive—allowing, but not requiring, directors to consider interests other than generating profit for shareholders.[23] If a large number

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20. *eBay Domestic Holdings*, 16 A.3d at 34.

21. Constituency statutes were first introduced in the late 1970s and early 1980s simultaneously with antitakeover legislation, significantly in Rust Belt states concerned with declining employment. *See* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 23-24, 27 (1992). For example, the relevant portion of Pennsylvania's constituency statute reads:

> In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:
>
> (1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.
>
> (2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.
>
> (3) *The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation*.
>
> (4) All other pertinent factors.

15 PA. CONS. STAT. § 1715(a) (2013) (emphasis added).

22. Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 463-65 (2006) ("Significantly, Delaware—by far the most important state in terms of corporate law—has not adopted a constituency statute."); *Legal FAQ's*, BENEFIT CORP INFO. CENTER, http://benefitcorp.net/attorneys/legal-faqs (last visited Feb. 1, 2014) (noting that, in the context of a liquidity crisis, "[i]n any of the 31 states with a constituency statute, the lack of case law regarding those statutes leaves . . . a lack of clarity about how a court would rule if directors made a decision based on broader considerations than just the highest offer").

23. *See* Velasco, *supra* note 22, at 463-64. In another article, Velasco argues that constituency statutes pose a hazard, in that they "could allow directors to justify virtually any decision, even if entirely self-interested, by referring to one constituency or another." Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605, 678 (2007). The problem of the permissive nature of constituency statutes is compounded by the fact that even in states with constituency statutes shareholders are generally the only ones with standing to bring derivative suits and they may not reliably take issue with earning too much at the expense of other stakeholders. *See* J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 16-17 (2012).

of shareholders disagree with the directors' vision for a company, the directors may find themselves voted out or the company may be bought out, constituency statute or not, and the new directors or owners can abandon the company's social mission.[24] The factors discussed above led some to believe that the for-profit corporate form itself was a barrier to social enterprise.

The charitable nonprofit form was no more appealing, however, given its inflexibility. Charities usually must have a well-defined mission from which they may not deviate and must devote substantially all of their assets and activities to charitable projects.[25] In addition, charities are very limited in the sources of funding that they may attract, making scaling difficult as they grow to meet the demand for their services. To many ambitious social entrepreneurs, this is an unacceptable limitation.[26] While charities enjoy significant tax and other legal benefits,[27] these benefits often are not sufficient to offset the drawbacks of the charitable nonprofit form. The apparent shortcomings of both the for-profit and charitable models therefore engendered proposals to develop entirely new forms. Those forms include the low-profit limited liability company, the benefit corporation, and the flexible purpose corporation.

A. *Low-Profit Limited Liability Companies (L3Cs)*

The low-profit limited liability company was conceived of in 2005 and has been promoted since then in large part by Robert Lang, the chief executive officer of a small private foundation, the Mary Elizabeth and Gordon B.

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24. Velasco, *supra* note 22, at 466-67 ("[A]t least on their face, most constituency statutes are silent on the shareholder's rights to elect directors and to sell shares.").

25. *See* Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2454-62 (2009) (explaining that Google.org was formed as a for-profit subsidiary of Google to work alongside the nonprofit Google Foundation precisely to gain the flexibility that is denied to charities and private foundations).

26. Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 353-54 (2009). Some point to the microfinance industry—and the way microlending efforts in the United States have been hampered by lack of access to capital—as an example of what is lacking with the nonprofit model and where hybrids can make a difference. *See* Michelle Scholastica Paul, Note, *Bridging the Gap to the Microfinance Promise: A Proposal for a Tax-Exempt Microfinance Hybrid Entity*, 42 N.Y.U. J. INT'L L. & POL. 1383, 1384 (2010).

27. *See* Memorandum from Erika Lunder, Legislative Att'y, Am. Law Div., to Joint Comm. on Taxation (Feb. 16, 2005), *in* STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 195 (Comm. Print 2005) (providing examples of non-tax benefits provided to § 501(c)(3) organizations by the federal government, California, Florida, Massachusetts, New York, and Pennsylvania); Bazil Facchina et al., *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85, 85-86 (1993) (briefly reviewing the wide swath of statutory benefits available to nonprofit organizations).

Mannweiler Foundation.[28] Creation of the L3C form was prompted primarily by a desire to tap into funds flowing from private foundations, although it has also been hailed as a useful alternative to benefit corporations (described below) because it avoids the strictures of corporate law.[29] One of the earliest L3Cs is Maine's Own Organic Milk (MOOMilk), formed between late 2009 and early 2010 by ten organic dairy farms attempting to increase the financial returns on their locally processed milk and to educate the public about the value of preserving local family farms.[30] While the company's description of itself notes its ability as an L3C to receive grants like a nonprofit, it appears that the company's funding has come primarily if not exclusively from the participating farms and outside investors.[31] Two nonprofit organizations do appear, however, to have a small ownership interest in the company.[32] Due to federal tax reforms passed in 1969, private foundations are required to distribute at least five percent of their assets annually, but are allowed to fulfill that obligation through "program related investments" (PRIs) in nonprofit or for-profit entities that further the foundations' goals, as well as through traditional grants or direct expenditures.[33] A PRI is generally an equity investment or loan that a private foundation makes primarily to further charitable or similar purposes and not in significant part to realize a profit.[34] The recipient of the investment may be either a nonprofit or for-profit entity, but typically the recipient serves a needy community or otherwise furthers a charitable purpose and is unable to obtain financing from conventional sources.[35] L3C statutes—which have been grafted onto existing limited liability company (LLC) statutes—are specially

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28. *See* Robert Lang & Elizabeth Carrott Minnigh, *The L^{3}C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 15 (2010).

29. *See id.* at 17; John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 122 (2010).

30. *See Our Story*, *supra* note 10.

31. *See* Hall, *supra* note 10; *Our Story*, *supra* note 10.

32. *See* FLA. S. COMM. ON COMMERCE, AN OVERVIEW OF LOW-PROFIT LIMITED LIABILITY COMPANIES (L3CS) 8 (2010), *available at* http://www.flsenate.gov/Committees/InterimReports/2011/2011-210cm.pdf (noting that the Maine Farm Bureau and the nonprofit Maine Organic Farmers and Gardeners Association "will" each own half of one percent of the company); *About Us*, ME. FARM BUREAU, http://www.mainefarmbureau.com/about (last visited Feb. 1, 2014) (identifying the organization as a nonprofit); *Donations*, MAINE ORGANIC FARMERS & GARDENERS ASS'N, http://www.mofga.org/SupportMOFGA/Donations/tabid/271/Default.aspx (last visited Feb. 1, 2014) (identifying the organization as a nonprofit).

33. Lang & Minnigh, *supra* note 28, at 16. The term "program related investments" specifically refers to investments that would be so risky as to jeopardize the foundation's legal classification, but are allowed if they are made for qualifying purposes. *See* I.R.C. §§ 4942(g)(1)(A), 4944(c) (2012).

34. *See* I.R.C. § 4944(c); Treas. Reg. § 53.4944-3(a)(1) (as amended in 2009).

35. *See* Treas. Reg. § 53.4944-3(b) (providing examples); Prop. Treas. Reg. § 53.4944-3(b), 77 Fed. Reg. 23,429, 29,430-32 (Apr. 19, 2012) (same).

worded to track the regulatory language pertaining to PRIs.[36] This PRI language is intended to ease private foundations' investment in L3Cs by creating an entity custom tailored to the federal tax law requirements for PRIs.[37] The "out of the box" nature of L3Cs is also meant to simplify start-up for entrepreneurs seeking foundation funding who do not have the resources to invest in drawing up the often complex operating agreements required by the LLC form.[38]

Many commentators opposed the creation of L3Cs. The concerns they expressed included that L3Cs might divert needed funds from existing charities, that they would result in conflicting fiduciary duties for L3C managers, and that they simply represented a desire to trade on the cachet of government imprimatur.[39] Moreover, the Internal Revenue Service has refused requests to

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36. *Compare* VT. STAT. ANN. tit. 11, § 3001(27)(A)-(C) (2013), *with* Treas. Reg. § 53.4944-3(a)(1)-(2) (required characteristics for program-related investments).

37. Kelley, *supra* note 26, at 372-73. Promoters of L3Cs have also pushed for federal legislation or regulation to create a presumption that L3Cs qualify for PRIs but without success. *See* Lang & Minnigh, *supra* note 28, at 23.

38. *See* Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 899 & n.91 (2010). On the other hand, a number of practitioners and scholars, including Kleinberger, have noted that making an investment consistent with the narrow purpose of a foundation is not the same as making an investment in a company organized for the general purpose of advancing charitable causes. *See, e.g.*, Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 250 (2010); Kleinberger, *supra*, at 907; Murray & Hwang, *supra* note 15, at 27; *see also* Treas. Reg. § 53.4944-3(a)(2)(i) (requiring a PRI to advance the "*private foundation's* exempt activities" (emphasis added)). Because of the "expenditure responsibility" required of private foundations, *see* I.R.C. § 4945(h), improper use of funds or mission drift by the recipient of a PRI can result in serious consequences for the grantor, and prudence would dictate that L3C founders spare no expense to ensure that their operating agreements express a purpose and mode of operation that is clearly in line with the mission of any foundations whose funding they wish to target, as well as detailing the disposition of assets in case L3C status is terminated. *See* Kleinberger, *supra*, at 899-904; Murray & Hwang, *supra* note 15, at 31.

39. *See, e.g.*, Ashley Schoenjahn, *New Faces of Corporate Responsibility: Will New Entity Forms Allow Businesses to Do Good?*, 37 J. CORP. L. 453, 470 (2012) (arguing that "L3Cs could . . . hurt nonprofits"); Rachel Culley & Jill R. Horwitz, *Profits v. Purpose: Hybrid Companies and the Charitable Dollar* 2, 13, 19-20 (Mich. Law Sch. Public Law & Legal Theory Working Paper Series, Paper No. 272, 2012), *available at* http://ssrn.com/abstract=2055368 (underscoring the risk that the perception of governmental approval will mislead the public into believing that hybrids are subject to oversight akin to that of nonprofits on the one hand or for-profit companies on the other; questioning whether hybrids will increase or merely redirect charitable spending; and arguing that the L3C form creates irresolvable fiduciary duty conflicts); Letter from Linda J. Rusch, Chair, Am. Bar Ass'n Bus. Law Section, to Steve Simon, Assistant Minority Leader, Minn. House of Representatives (Apr. 19, 2012), *available at* http://open.wmitchell.edu/cgi/viewcontent.cgi?article=1228&context=facsch (writing on behalf of the Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and the Committee on Nonprofit Organizations of the American Bar Association Business Law Section urging opposition to the passage of L3C legislation, because, among other reasons, "it is inappropriate and unneces-

issue rulings that would deem an equity investment or loan to an L3C as a PRI automatically, and it appears few if any foundations have in fact made PRIs to L3Cs.[40] Nevertheless, according to an L3C that tracks the creation of these entities there are now more than 800 L3Cs organized under the laws of the eight states and one Native American tribe that have adopted L3C legislation.[41]

B. *Benefit Corporations*

Beginning operations in 2007, the nonprofit B Lab developed the concept of the "benefit corporation."[42] While B Lab also provides private "B Corporation" certification of for-profit businesses that meet certain standards for social and environmental performance, accountability, and transparency, the benefit corporation is a separate endeavor and represents a new type of legal entity created under state laws modeled on draft legislation developed and promulgated by B Lab.[43] B Lab promotes this legislation as an effort to overcome the difficulties posed by relying on constituency statutes and to create a uniform standard to facilitate the spread of social enterprise.[44] So far the most prominent benefit corporations appear to be existing businesses that converted to benefit corporation status once that option became available in their states of incorporation. For example, Patagonia and Plum Organics took this route in California

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sary to use state entity law to provide a new and potentially misleading 'brand' to mark private business ventures as socially beneficial").

40. *See, e.g.*, CHRISTOPHER REINHART, CONN. OFFICE OF LEGIS. RESEARCH, OLR RESEARCH REPORT: LOW-PROFIT LIMITED LIABILITY COMPANIES OR L3CS (2011), *available at* http://www.cga.ct.gov/2011/rpt/2011-R-0344.htm (opponents of L3Cs note that "no federal legislation or IRS ruling states that the L3C designation by itself satisfies the PRI requirements"); Rick Cohen, *L3C Proponents Eager for Proposed New Program Related Investments Regulations*, NONPROFIT Q. (May 3, 2012), http://www.nonprofitquarterly.org/policysocial-context/20331-l3c-proponents-eager-for-proposed-new-program-related-investments-regulations.html (noting that new proposed PRI regulations clarify and expand the examples of acceptable PRIs but do not explicitly address L3Cs); Rick Cohen, *Watching the Charity Watchdogs: Vignettes from the NASCO Annual Meeting*, NONPROFIT Q. (Oct. 5, 2012), http://www.nonprofitquarterly.org/policysocial-context/21120-watching-the-charity-watchdogs-vignettes-from-the-naasco-annual-meeting.html (noting that presenters at the annual meeting of the National Association of State Charity Officials reported that there have been no or almost no PRIs in L3Cs).

41. *Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, http://www.intersectorl3c.com/l3c_tally.html (last visited Feb. 1, 2014). Just prior to January 1, 2014 there were nine states that had adopted L3C legislation. North Carolina repealed its L3C law, however, effective January 1, 2014. *Id.*

42. Elsa Jagniecki, *B Corporations: Driving a New Ecology of Commerce*, NEW DREAM BLOG (Jan. 16, 2012, 3:40 PM), http://www.newdream.org/blog/b-corporations.

43. *See Legislation*, *supra* note 3 (explaining the difference between benefit corporations and "Certified B Corps"); Tozzi, *supra* note 9 (same).

44. WILLIAM H. CLARK, JR. ET AL., THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION 5 (2013), *available at* http://benefitcorp.net/storage/documents/Benecit_Corporation_White_Paper_1_18_2013.pdf.

and Delaware, respectively.[45] While for Patagonia the choice to convert appears to have been driven by the family-owned company's longstanding commitment to support environmental causes, for Plum Organics, which is wholly owned by Campbell Soup Company, it appears the motivation may have been more to burnish its credentials as a maker of healthy snacks for children.[46] It does not appear that either company receives significant funding from or is owned in part by nonprofit organizations.

In a similar manner to how L3C statutes are appended to existing limited liability company provisions, benefit corporation statutes piggyback on states' corporation codes by altering specific defaults within existing corporation law. The core provisions for benefit corporations include:

> 1) a corporate purpose to create a material positive impact on society and the environment; 2) expanded fiduciary duties of directors which require consideration of non-financial interests; and 3) an obligation to report on its overall social and environmental performance as assessed against a comprehensive, credible, independent and transparent third-party standard.[47]

Benefit statutes are meant to defeat the problems that Ben & Jerry's and craigslist faced by introducing statutory language that alters the fiduciary duties by which directors of benefit corporations are bound, giving them wider latitude to consider the causes for which they were founded without fear of liability. By incorporating under the benefit corporation form, entrepreneurs can also signal their intentions, which may serve both to discourage solely profit-oriented investors and to attract socially conscious investors, leading to a lower probability of conflict in the first place.[48]

Many of the same commentators who criticized proposals to permit L3Cs also criticized the proposed new benefit corporation form, for many of the same reasons. Those reasons included the risk that the new forms would divert needed funds from existing charities, that directors would face conflicting fiduciary

45. *See* Field, *supra* note 8 (referencing Plum Organics); Tozzi, *supra* note 9 (referencing Patagonia).

46. *See* Kanellos, *supra* note 8 (describing Campbell Soup Company's acquisition of Plum Organics); *Our Reason for Being*, *supra* note 9 ("For us at Patagonia, a love of wild and beautiful places demands participation in the fight to save them, and to help reverse the steep decline in the overall environmental health of our planet. We donate our time, services and at least 1% of our sales to hundreds of grassroots environmental groups all over the world who work to help reverse the tide.").

47. CLARK, *supra* note 44, at 15. For a summary of the differences between the various benefit corporation state statutes enacted in July 2013, see J. Haskell Murray, Benefit Corporations—State Statute Comparison Chart (July 17, 2013) (unpublished chart), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988556.

48. *Cf.* Kelley, *supra* note 26, at 372 (discussing the value of signaling in the context of L3Cs). There is, however, always the possibility that investors may change their outlook and vote out the directors; in fact, they may even vote to change the benefit corporation into a standard corporation, which is usually permitted with a two-thirds vote of shareholders. *See* Murray, *supra* note 47 (enumerating the various methods of adopting or terminating benefit corporation status).

duties, and that the creation of the benefit corporation form could be mistakenly interpreted by the public as government approval or oversight of the public-benefitting goals of the corporation.[49] Again, despite these criticisms the new form has proven relatively popular with both state legislatures and private parties, with almost 200 registered benefit corporations reportedly created as of late 2012 in the twelve states that had enacted benefit corporation legislation at that time (a number which has since grown to nineteen states and the District of Columbia).[50]

C. *The Flexible Purpose Corporation*

The impetus for the creation of the "flexible purpose corporation" in California, which is the only state that has adopted this form, came from the fact that several practitioners ran into difficulty when trying to use existing traditional for-profit and nonprofit legal forms for social enterprises interested in combining profit seeking with public-benefitting goals.[51] This led these practitioners to push for legislation that would explicitly allow the incorporation of entities with these multiple goals.[52] These efforts finally bore fruit in 2011, when California enacted flexible purpose corporation legislation along with benefit corporation legislation, both effective on January 1, 2012.[53]

The flexible purpose corporation is a sort of benefit corporation lite: the flexible purpose corporation enabling statute merely requires the disclosure of at least one specific "special purpose" in the articles of incorporation, and directors are thereby protected against liability for giving special consideration to that single purpose, even when it is detrimental to the bottom line of the corpo-

49. *See, e.g.*, Culley & Horwitz, *supra* note 39, at 2, 12, 19 (raising the risk that the public will mistakenly believe hybrid status equals governmental approval and questioning whether hybrids will increase or merely redirect charitable spending); Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 606 (2011) (pointing out that terse state benefit corporation statutes and a dearth of judicial interpretation make it "difficult to provide guidance to fiduciaries in situations where profit and social benefit goals conflict").

50. *See* Ben Schreckinger, *Virtue Inc.: Can the New "Benefit Corporation" Charters Give Companies a Conscience?*, BOS. GLOBE (Nov. 25, 2012), http://www.bostonglobe.com/ideas/2012/11/25/virtue-inc/sMNhJRcOIgZ0rqjpLTALrN/story.html (reporting B Lab's most recent estimate of benefit corporation creation); *supra* note 3 and accompanying text (providing the number of states that have enacted benefit corporation statutes).

51. W. DERRICK BRITT ET AL., CAL. WORKING GROUP FOR NEW CORPORATE FORMS, FREQUENTLY ASKED QUESTIONS: PROPOSED AMENDMENTS TO THE CALIFORNIA CORPORATIONS CODE FOR A NEW CORPORATE FORM 2 (2011), *available at* http://www.law.columbia.edu/null/Final+FAQ+on+Flexible+Purpose+Corporation+%2800312058%29?exclusive=filemgr.download&file_id=59229.

52. *Id.* at 4.

53. Tozzi, *supra* note 9.

ration.[54] Some business leaders felt that this new form was preferable to the benefit corporation because of worries that the benefit corporation form's broad obligation to advance social and environmental welfare "forces directors to weigh so many competing interests that it's unrealistic for publicly traded companies" concerned with shareholder lawsuits.[55]

One of the first, if not the very first, flexible purpose corporations formed under this new law was Prometheus Civic Technologies.[56] The company develops and sells software to increase civic engagement and reduce the burden of government.[57] According to the company's president, it chose this form over the benefit corporation form because benefit corporations must provide annual assessments that would not be easy to produce given the difficulty of measuring whether Prometheus Civic Technologies had accomplished its social mission.[58] The company is owned by a nonprofit, the Prometheus Institute, and received $1.2 million in initial funding from a foundation operated by a member of the nonprofit's board of directors.[59]

While the flexible purpose corporation has generated less attention both because it is relatively new even among hybrids and limited to a single state, it nevertheless merits discussion because that single state is the most populous one. At the same time, it is vulnerable to the same criticisms leveled against L3Cs and benefit corporations.[60] Still, since the flexible purpose corporation form became available at the start of 2012 at least fifteen such entities have registered under California law.[61]

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54. *See* Anne Field, *Why Prometheus Civic Technologies Is a Flexible Purpose Corporation,* FORBES (Sept. 7, 2012, 1:12 PM), http://www.forbes.com/sites/annefield/2012/09/07/why-prometheus-civic-technologies-is-a-flexible-purpose-corporation; *see also* CAL. CORP. CODE §§ 2513, 2602(b) (West 2013).

55. Tozzi, *supra* note 9. Proponents of the flexible purpose corporation also argued that the specific requirement to promote environmental sensitivity could be inappropriate for an entity with a more narrowly defined mission, for example, targeted economic development in low-income neighborhoods. *Id.*

56. *See* Field, *supra* note 54.

57. *Id.*

58. *Id.*

59. *Id.*; *see also About Prometheus*, PROMETHEUS INST., http://prometheus.org/about (last visited Feb. 1, 2014).

60. *See* Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TRANSACTIONS: TENN. J. BUS. L. 221, 257-59 (2012) (noting fiduciary duty concerns); Dana Brakman Reiser, *The Next Big Thing: Flexible Purpose Corporations*, 2 AM. U. BUS. L. REV. 55, 71, 77-78 (2012) (same).

61. *See* Kendall Taggart, *Corporations That Claim to Do Good Need More Oversight, Experts Say*, NBC BAY AREA, (Oct. 15, 2012, 8:45 AM PDT), http://www.nbcbayarea.com/news/local/Corporations_that_claim_to_do_good_need_more_oversight__experts_say-174140111.html.

D. *Other Hybrid Forms*

While the L3C, benefit corporation, and flexible purpose corporation have been the most prominent hybrid forms in the United States, four other existing hybrid legal forms are worth mentioning. Maryland, the first state to pass benefit corporation legislation in 2010, has added its own unique contribution to the mix with the "Benefit LLC."[62] The Benefit LLC is modeled after the benefit corporation and creates protections and obligations—including benefit-reporting requirements—for Benefit LLC managers that are similar to those imposed on directors of benefit corporations.[63] It differs from the L3C form in that there are no strictures on the purpose for which the Benefit LLC may be organized, including the unabashed pursuit of profit, albeit while taking into consideration general public welfare.[64] In addition, Washington State recently passed legislation authorizing the creation of "social purpose corporations," which are similar to California flexible purpose corporations.[65]

The other two significant hybrids are not found in the United States and actually predate all of the domestic efforts along these lines. The Community Interest Company or CIC (pronounced "kick") was introduced in the United Kingdom in 2004.[66] As with domestic hybrids, the goal was to blend attributes of for-profit and charitable forms. In order to qualify for registration as a CIC, an entity must be operated such that "a reasonable person considers that the activities being carried on are for the benefit of the community."[67] The CIC enabling laws also include a number of features meant to protect against the improper use of assets that go well beyond what are found in any of the U.S. hybrids: limits on the compensation that may be paid to managers and employees of CICs; a cap on the return that investors can earn, including a prohibition

62. *See* Gary Haber, *Businesses Register for Maryland LLC "Benefit" Law*, BALT. BUS. J. (June 1, 2011, 2:51 PM EDT), http://www.bizjournals.com/baltimore/news/2011/05/31/businesses-sign-up-for-maryland-llc.html; John Tozzi, *Maryland Passes "Benefit Corp." Law for Social Entrepreneurs*, BLOOMBERG BUSINESSWEEK (Apr. 13, 2010), http://www.businessweek.com/smallbiz/running_small_business/archives/2010/04/benefit_corp_bi.html; *see also* MD. CODE ANN., CORPS. & ASS'NS §§ 4A-1101 to -1108 (LexisNexis 2013) (providing for formation of Benefit LLCs).

63. *See* CORPS. & ASS'NS §§ 4A-1107 to -1108.

64. The L3C must be organized for "one or more charitable or educational purposes within the meaning of . . . [I.R.C.] § 170(c)(2)(B)," and the pursuit of profit may not be a "significant purpose." VT. STAT. ANN. tit. 11, § 3001(27)(A)-(B) (West 2013).

65. *See* 2012 Wash. Sess. Laws 1656-67 (codified as amended at WASH. REV. CODE §§ 23B.25.005-.150 (2013)).

66. Doeringer, *supra* note 11, at 312. A group including promoters of the British CIC and the American L3C are currently lobbying for the introduction in the United Kingdom of the "Social Enterprise LLP" (SELLP), which takes its inspiration from the American L3C form. Stephen Lloyd, *The Social Enterprise LLP—What Is It; and What Is It For?*, BARRISTER, http://www.barristermagazine.com/archive-articles/issue-48/the-social-enterprise-llp-%E2%80%93-what-is-it;-and-what-is-it-for.html (last visited Feb. 1, 2014).

67. Stephen Lloyd, *Transcript: Creating the CIC*, 35 VT. L. REV. 31, 34 (2010).

on the company repurchasing its shares at a higher price than that paid by the shareholder; a prohibition on the sale of assets for below market value during the life of the company or upon dissolution; a requirement that, upon dissolution, net earnings be dedicated to the same community purpose for which the CIC was operated; and oversight by a "CIC regulator" with broad powers.[68] The CIC regulator's authority includes the right to audit, to appoint and remove directors, and to appoint a receiver to take temporary control of a CIC's assets in the event that the directors are removed.[69] That regulator also tracks the creation of CICs, and in its most recent annual report it stated that 7670 entities were registered as CICs, although 766 registered CICs later dissolved.[70] The report also is silent regarding the aggregate financial scope of the existing CICs, whether in terms of revenues, assets, or employees.

Going back even further, the Belgian Federal Parliament created the Société à Finalité Sociale (SFS) in 1995. The SFS is one of the earliest attempts to provide a platform for social enterprise by bridging the gap between for-profit and nonprofit entities.[71] The SFS allows more flexibility in carrying out commercial activities than the Belgian nonprofit form allows, but, like the British CIC and unlike its U.S. counterparts, it caps the distribution of profits to investors, and upon dissolution the disposition of assets is controlled to ensure that net earnings remain dedicated to charitable purposes.[72] Unfortunately, the SFS form offers no significant advantages to offset its strictures, and so apparently has been largely eschewed by entrepreneurs.[73]

None of these hybrid entities, whether the L3C, the benefit corporation, the flexible purpose corporation, or the other forms in the United States and in Europe, currently enjoy any of the tax benefits or preferences that governments commonly extend to charitable nonprofits. Some supporters of these hybrid forms have proposed extending such benefits to these forms, however, even as the focus of these supporters has been primarily on enacting legislation allowing their existence in the first place.[74] Furthermore, when the domestic hybrid legal forms were still in their infancy, Anup Malani and Eric Posner argued for federal tax law to permit standard for-profit entities engaged in charitable activities to be exempt from federal income tax in the same manner as nonprofit charities, and Todd Henderson and Malani have argued for extending the charitable contribution deduction to certain socially beneficial purchases made from

68. *Id.* at 37-39.

69. *Id.* at 38-39.

70. REGULATOR OF CMTY. INTEREST COS., ANNUAL REPORT 2012/2013, at 19 (2013), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/243869/13-p117-community-interest-companies-annual-report-2012-2013.pdf.

71. Doeringer, *supra* note 11, at 308-09.

72. *Id.*

73. *Id.* at 309.

74. *See supra* notes 11-13 and accompanying text.

for-profit businesses.[75] Their admittedly bold proposals were met with significant opposition on numerous grounds, including the difficulty of providing sufficient government enforcement to ensure that "charitable" for-profits in fact engaged in the promised charitable activities.[76] Nevertheless, hybrids provide a more compelling case for extension of these tax benefits because, unlike typical for-profit entities, they explicitly combine public-benefitting goals with profit seeking. These criticisms will therefore be examined in Part III of this Article to determine if they are relevant to the proposals for extending tax benefits to hybrids. First, however, it is necessary to understand the current tax treatment of for-profit, nonprofit, and hybrid entities and why most nonprofits enjoy significant tax benefits as compared to for-profits before discussing how, if at all, the tax rules for hybrids should be changed.

II. TAXATION OF FOR-PROFIT AND NONPROFIT ENTITIES

The federal income tax system—and to a lesser extent the various state tax systems—treats entities organized to generate profits for the benefit of investors very differently from the vast majority of entities organized as nonprofits. For these purposes, a nonprofit entity is generally defined as an organization that is subject to the "nondistribution constraint," a term coined by Henry Hansmann that signifies that the organization retains any surplus funds to use for its stated purposes as opposed to distributing them to a shareholder or other private owner.[77] For-profit entities or their owners are subject to federal and,

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75. *See* M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 609 (2009); Malani & Posner, *supra* note 14, at 2065; *see also* DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 116-25 (2008) (arguing that removal of the nonprofit requirement would significantly increase the funds available to charities).

76. *See, e.g.*, Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1214 (2010) (raising concerns about diluting the power of the public's perception of charitable organizations and compromising the quality of core charitable activities that cannot be easily measured); James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1214-15 (2010) (noting the increased risk of tax arbitrage and the difficulty of only subsidizing the marginal increase in social value); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819, 877 (2012) (explaining that administrative efficiency requires there to be one standard for the government to enforce, and raising concerns that for-profit managers may cut quality to reduce costs when quality is hard to measure); Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 40 (2011) (objecting to the Pallotta and Malani & Posner proposals due to accountability and monitoring concerns); Victor Fleischer, *"For Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231, 231-32 (2008), http://www.virginialawreview.org/inbrief/2008/01/21/fleischer.pdf (discussing the difficulty of distinguishing between charitable and noncharitable activities solely based on § 501(c)(3) definitions).

77. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 56-57 (1981) ("A nonprofit organization is

generally, state income tax on their taxable income—gross income less permissible deductions (primarily expenses incurred to generate the income). Nonprofit entities are almost always exempt from taxation even if they generate profits—that is, even if their revenues exceed their otherwise deductible expenses. Furthermore, a subset of nonprofits commonly referred to as charities enjoys additional tax benefits, including the ability to receive donations that are tax deductible for the donors (and thus reduce the federal and sometimes the state income tax owed by those donors) and often exemption from other types of state and local taxes, such as property taxes and sales taxes. This Part briefly explains the different tax treatment of for-profit and nonprofit entities, including how that differing treatment applies to charitable activities by for-profit entities and profit-seeking activities by nonprofits. This Part also summarizes the commonly cited rationales for that differing treatment. It then explains how the newly created hybrids are treated under the existing federal income tax and various state tax laws, given that such entities currently do not enjoy a separate tax status.

A. *Current Tax Treatment of For-Profits and Nonprofits*

While Congress constantly changes the details, the basic structure of the federal income tax treatment of domestic entities has remained the same for decades.[78] In general, for-profit entities fall into one of four federal tax classifications: sole proprietorship; partnership; S corporation; or C corporation.[79] The shared characteristic of these four classifications is that someone—either the entity or the owner(s)—has taxable income if the entity's activities result in gross income that exceeds permissible deductions. For the first three classifications, the taxable income is attributed to the owner(s), although the rules for such attribution vary between the different classifications. Unless an owner has other deductions that may be applied to offset that taxable income, the owner

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not . . . prohibited from *earning* a profit . . . . All net earnings, however, must be plowed back into financing the goods or services that the nonprofit was formed to provide.").

78. *See* Armando Gomez, *Rationalizing the Taxation of Business Entities*, 49 TAX LAW. 285, 286-87 (1996) (tracing the federal tax distinction between corporations and partnerships to the late nineteenth century); *id.* at 303-04 (noting the creation of the S corporation category in 1958 and tracing its current form to 1982). It is beyond the scope of this Article to explore cross-border issues relating to hybrids, including, for example, how federal income tax law would and should treat foreign hybrids if they chose to engage in activities in the United States.

79. *See generally* MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R40748, BUSINESS ORGANIZATIONAL CHOICES: TAXATION AND RESPONSES TO LEGISLATIVE CHANGES (2009). There are also numerous special types of for-profit entities that have their own sets of federal income tax rules, such as insurance companies, regulated investment companies, and real estate investment trusts, but hybrids would rarely if ever qualify as such entities. *See, e.g.*, I.R.C. §§ 801-848 (2012) (relating to insurance companies); *id.* §§ 851-860G (relating to regulated investment companies and real estate investment trusts).

will then owe tax on that income.[80] For the C corporation classification, the entity itself owes tax on that taxable income.[81] Not surprisingly, state income tax treatment generally tracks federal income tax treatment, although there are some variations and several states do not impose an income tax at all.[82] Furthermore, for-profit entities and their owners generally owe the other types of taxes that states and localities commonly impose, including property and sales taxes.[83]

In contrast, the vast majority of nonprofit entities are exempt from federal income tax on all or almost all of their net income.[84] While qualification for exemption is limited to nonprofits that are organized and operated in a manner that fits within one the available categories of tax exemption, the number and breadth of these categories is such that almost all nonprofits fall within one.[85] State income tax exemption usually follows from federal income tax exemption, although there are exceptions.[86] Exemption from other types of state and local taxes is generally limited, however, to nonprofit entities that further charitable, educational, religious, or other public-benefitting purposes and so qualify as § 501(c)(3) tax-exempt organizations under federal tax law, although there may be further limitations.[87] Similarly, the ability to receive tax-deductible contributions is also generally limited to nonprofits that qualify as § 501(c)(3) tax-exempt organizations.[88]

To ensure that only qualified organizations receive these benefits, a number of significant limitations accompany them under federal tax law, particularly for charities that qualify under § 501(c)(3). These include requirements that

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80. Unless the owner is itself one of these types of entities, in which case the taxable income generally will flow through to the next layer of owners.

81. *See* I.R.C. § 11 (imposing a tax on the taxable income of C corporations).

82. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 7.02 (3d ed. 2012) ("The outstanding characteristic of state corporate net income taxes is their broad conformity to the federal corporate income tax."); *id.* ¶ 20.02 ("Most state personal income taxes conform closely to the federal personal income tax.").

83. *See id.* ¶ 12.01 ("[R]oughly 40 percent of state sales tax revenues are attributable to business purchases.").

84. John Simon et al., *The Federal Tax Treatment of Charitable Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 267, 268 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006) ("With some minor exceptions . . . what all inhabitants of [the nonprofit] sector have in common is . . . exemption from the federal income tax . . . .").

85. *See* I.R.C. § 501(c) (listing twenty-nine different categories of tax-exempt organizations); *id.* § 527 (granting tax exemption to political organizations); *id.* § 528 (granting tax exemption to certain homeowners' associations).

86. *See* Facchina et al., *supra* note 27, at 99.

87. *See* Mark J. Cowan, *Nonprofits and the Sales and Use Tax*, 9 FLA. TAX REV. 1077, 1079 (2010); Janne Gallagher, *The Legal Structure of Property-Tax Exemption*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD 3, 3-4 (Evelyn Brody ed., 2002). *See generally* Facchina et al., *supra* note 27.

88. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 27, at 155 (listing various tax benefits accruing to § 501(c)(3) organizations).

the organization be both organized and operated to further the purpose for which exemption is granted and various other limitations on activities.[89] For the purposes of this Article, the most important current limitation is that while a tax-exempt organization may earn a profit, it may not, consistent with state nonprofit laws, divert any such profit away from its mission to inappropriately benefit any private party.[90] This limitation prohibits a tax-exempt organization from both having owners who have a right to a share of the organization's profits and paying more than reasonable compensation for services to the organization's directors, officers, and other employees.[91] Nonincidental benefits running to insiders are commonly referred to as "private inurement" in keeping with the terms of § 501(c).[92]

A tax-exempt charity is also generally prohibited from operating for the private benefit of outsiders as well—other than the beneficiaries it is intended to aid.[93] This prohibition is subject to reasonable limitations in order that it may not hamper the organization's ability to procure goods, services, and financing through arm's-length transactions.[94] A tax-exempt organization may even enter into a joint venture with profitmaking entities in order to further its mission, so

89. *See* I.R.C. § 501(c)(3) (exempting entities "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals").

90. *See supra* note 77 and accompanying text (describing this "nondistribution" constraint).

91. I.R.C. § 501(c)(3) (describing the most common type of tax-exempt nonprofit as an entity "no part of the net earnings of which inures to the benefit of any private shareholder or individual"); *see also id.* § 4958(c) (defining "excess benefit transactions"); Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii) (as amended in 2008) (imposing a balancing test to determine whether organizations that engage in "one or more excess benefit transactions" will lose their tax-exempt status). Note, however, the development of "intermediate sanctions" in which certain key persons may be subject to penalties, but the organization itself may escape with its tax-exempt status intact. Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, *in* NONPROFITS & BUSINESS 83, 101 (Joseph J. Cordes & C. Eugene Steuerle eds., 2009).

92. *See supra* note 77 and accompanying text; *see also* I.R.C. § 4958(c)(4) (describing "private inurement" by reference to "excess benefit transactions" which involve persons having positions of influence within certain § 501(c) entities, or related persons).

93. *See, e.g.*, Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1078-79 (1989) (denying exemption to a school that trained campaign workers because most of the school's students subsequently worked for the Republican Party).

94. Any transaction or agreement with a third party for the provision of goods, services, or financing is likely to provide incidental benefits to the provider in the form of normal profits on the transaction. So long as the terms of the deal are reasonable, however, these types of transactions are not questioned, even if the benefit to the third party is significant. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 21, 1991) ("Though the private benefit is compounded in the case of certain specialists, such as heart transplant surgeons, who depend heavily on highly specialized hospital facilities, that fact alone will not make the private benefit more than incidental." (citing Harding Hosp., Inc. v. United States, 505 F.2d 1068, 1076 (6th Cir. 1974)))

long as the activities of the partnership are not shown to confer a disproportionate benefit on any non-exempt partners.[95]

1. *Taxing between the lines of for-profits and nonprofits*

So what happens if the lines between for-profit and nonprofit entities are blurred? For example, what happens if an otherwise taxable, for-profit entity chooses to engage in charitable activities? In this situation, the tax treatment of such expenditures is governed by § 162, relating to business expenses, and § 170, relating to charitable contributions. According to the language of § 162(b), § 162 deductions for business expenses and § 170 contributions are mutually exclusive.[96] A number of revenue rulings dealing with the division between § 162 and § 170 have held that the allocation between the two sections is controlled by the extent to which the expense is connected with normal business activities.[97] In the case of corporations, the line between § 162 and § 170 has been defined by the benefit that is *expected* to accrue to the corporation as a result of the transfer.[98] Corporations do not necessarily need to show that the

95. *See* Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324, 1333-34 (1980) (holding that there was no impermissible private benefit conferred on non-exempt limited partners who entered into a partnership with a nonprofit theater company to provide funding for the production of a play in return for a reasonable share of any revenues), *aff'd*, 675 F.2d 244 (9th Cir. 1982). The IRS has approved of joint ventures involving § 501(c)(3) organizations when "participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners." Rev. Rul. 98-15, 1998-1 C.B. 718. The service has further clarified that there is no impermissible benefit to the for-profit partner so long as "[a]ll contracts and transactions entered into by [the partnership] are at arm's length and for fair market value, [the partners'] ownership interests . . . are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by [the partnership] are proportional to [the partners'] ownership interests." *See* Rev. Rul. 2004-51, 2004-1 C.B. 974.

96. I.R.C. § 162(b) ("No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section.").

97. Rev. Rul. 72-314, 1972-1 C.B. 44 ("Whether payments . . . are 'contributions or gifts,' within the meaning of section 170 of the Code, or are deductible as ordinary and necessary business expenses under section 162 of the Code depends upon whether such payments are completely gratuitous or whether they bear a direct relationship to the taxpayers' business and are made with a reasonable expectation of a financial return commensurate with the amount of the payment." (citing Treas. Reg. § 1.162-15(b)).

98. *See* Singer Co. v. United States, 449 F.2d 413, 423 (Ct. Cl. 1971) ("It is our opinion that if the benefits received[,] *or expected to be received*, are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely *incidental* to the transfer), then in such case we feel the transferor has received, or expects to receive, a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under section 170." (first emphasis added)).

expense was a result of "disinterested generosity," but only that it was not made in anticipation of some future return on the investment.[99]

As a result of these rules, direct spending on charitable activities—for example, buying lunch for employees who participate in a charitable event such as a Habitat for Humanity project—will generally be treated as a business expense based on the argument that such efforts enhance the reputation and so ultimately the profitability of the corporation.[100] Indirect spending—for example making a payment to a § 501(c)(3) organization to support a particular charitable effort such as a disaster relief program—will generally be treated as a charitable contribution.[101] The classification of some payments may, however, be less clear, such as when a for-profit entity makes a payment to a § 501(c)(3) organization for a charitable event in exchange for being publicly acknowledged as a sponsor.[102]

Generally speaking, businesses will prefer, and so will usually try, to deduct expenses under § 170(a) for two reasons. First, there is the advantage of appearing to be concerned with social responsibility, thereby garnering consumer goodwill.[103] Second, the forced capitalization of some expenses under § 263 may make it more advantageous to characterize expenses as charitable contributions under § 170 as long as the charitable contributions of the corporation do not exceed the ten percent of taxable income limit on C corporations with respect to deducting such contributions.[104] In practice it appears to be relatively rare for the IRS to challenge classification choices by for-profit corporations or other business entities for transfers to charities, absent a quid pro quo.[105]

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99. *Id.* ("[W]e feel that the subjective approach of 'disinterested generosity' need not be wrestled with and we are of the opinion that our approach coincides perfectly with our reading of section 162(b)."); *see also* Dockery v. Comm'r, 37 T.C.M. (CCH) 317 (1978) (detailing the movement away from the *Commissioner v. Duberstein*, 363 U.S. 278 (1960), disinterested generosity test for "gifts" toward the *Singer* quid pro quo test in cases involving corporations).

100. *See* Martin Hall & Jerry J. McCoy, *Setting the Stage for Charitable Giving*, SR011 A.L.I.-A.B.A. 1, § D.2 (July 2009) (noting that a business expense must be economically motivated as opposed to gratuitous).

101. *See* Treas. Reg. § 1.170A-1(c)(5) (as amended in 2013) (generally requiring that a business have a reasonable expectation of financial return commensurate with the amount transferred to a charity in order to treat the transfer as a business expense).

102. *See* Linda Sugin, *Encouraging Corporate Charity*, 26 VA. TAX REV. 125, 172-74 (2006) (discussing the tax treatment of corporate sponsorship payments).

103. *See* Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1, 43 (1994).

104. *See id.* at 43-44; *see also* United States v. Transamerica Corp., 392 F.2d 522, 523 (9th Cir. 1968) (disallowing charitable deduction and holding that expense must be capitalized).

105. Knauer, *supra* note 103, at 36.

What about the opposite situation, when an otherwise qualified tax-exempt organization engages in some modest amount of profit-seeking activity that does not further its exempt purposes? Here the unrelated business income tax (UBIT) applies. UBIT is levied on revenues from a "trade or business," "regularly carried on," that is "unrelated" to the purpose for which an exempt entity is organized and operated.[106] The introduction of UBIT in 1950[107] allegedly was motivated by dual desires to eliminate unfair competition between exempt nonprofits and taxable entities as well as to protect tax revenues.[108] Others have argued that those rationales are unconvincing because (1) UBIT does not apply to activities related to the exempt purpose which may be undertaken in direct competition with for-profit counterparts—think daycare centers and hospitals; (2) at the time, almost no one was actually complaining about unfair competition from charitable nonprofits; and (3) the entities actually benefitting from the abuse of tax-exempt status through various arbitrage schemes were for-profits that largely evaded Congress's scrutiny.[109] A better explanation may be that UBIT was intended to keep public-benefitting nonprofits from straying too far from their mission.[110]

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106. I.R.C. § 511 (2012) (imposing UBIT on "unrelated business taxable income" (UBTI)); *id.* § 512 (defining UBTI as "income derived . . . from any unrelated trade or business . . . regularly carried on," less deductions "which are directly connected with the carrying on of such trade or business"); *id.* § 513(a) (explaining "unrelated trade or business" as "any trade or business the conduct of which is not substantially related [to the] purpose or function constituting the basis for . . . exemption"). There are many exceptions written into the UBIT statute that allow "appropriate" investing or are tailored to the peculiarities of various nonprofits. *See, e.g.*, *id.* § 512(b) (excluding, inter alia, income from loans, royalties, rents, and most capital gains from the sale of property); *id.* § 513(a)(3) (excluding revenue from the sale of donated merchandise). There is also an automatic UBIT trigger for S corporation stock. *See id.* § 512(e) (characterizing income derived from the ownership or sale of S corporation stock as UBTI for most exempt organizations).

107. *See* Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947-53 (codified as amended at I.R.C. § 511). Prior to the enactment of UBIT, the IRS relied on the "destination of income" test, originating with the ruling in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924), which allowed for the exclusion from income of profits that were "dedicated to charitable purposes." Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 606 (1998).

108. Treas. Reg. § 1.513-1(b) (as amended in 1983) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."); Brody, *supra* note 91, at 97 ("One congressman, referring to the infamous ownership of Mueller Macaroni by New York University Law School, had complained that without reform, 'eventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry.'" (ellipsis in original) (quoting *Revenue Revision of 1950: Hearings Before the H. Comm. on Ways & Means*, 85th Cong., 2d Sess. 580 (1950) (statement of Rep. John Dingell, Sr.))).

109. *See, e.g.*, Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1545-53 (2005).

110. *Id.* at 1544-45 ("The UBIT created a tax gradient, taxing the income from certain types of investment activities, but exempting others. . . . The expressly intended result was

Active involvement in non-exempt activities will not threaten exemption so long as that activity "is in furtherance of the organization's exempt purpose . . . [and] the organization is not organized or operated for the primary purpose of carrying on" that non-exempt activity.[111] Courts have been willing to back up the IRS's denial of exempt status when there is evidence that any substantial purpose of an entity is non-exempt, however, and they will not avoid parsing the difference between activity and animating spirit.[112] An examination of the manner in which the activity is carried out under the commerciality doctrine complicates matters, and the more an entity's activities and business methods approximate those of a standard for-profit, the less likely it will be able to sustain exempt status.[113]

When it comes to joint ventures involving both nonprofit and for-profit entities, the activities of the partnership are attributed to the nonprofit both for purposes of assessing UBIT, as well as considering the effect of participation on exempt status.[114] If the assets dedicated by a tax-exempt nonprofit to a partnership are substantial and the activities of the partnership are a significant part of the participating nonprofit's overall activities, then involvement in the partnership may place the nonprofit's tax-exempt status at risk.[115] The nonprofit can avoid this result by demonstrating sufficient control over the activities of

that charities by and large would avoid taxable activities and concentrate their investment activities in the exempt activities.").

111. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 2008); *see also* S.F. Infant Sch., Inc. v. Comm'r, 69 T.C. 957, 966 (1978) (holding that substantial non-exempt purpose, if inextricably linked and necessary to exempt purpose, will not destroy exemption); I.R.S. Gen. Couns. Mem. 34,682 (Nov. 17, 1971) (ruling out a simplistic "comparison of the relative physical size and extent of organizational activities devoted to business endeavors and to charitable endeavors in which the ends to which the beneficial use of an organization's resources are applied are disregarded" and expanding upon the "commensurate in scope" analysis of I.R.S. Gen. Couns. Mem. 32,689 (Apr. 27, 1964)).

112. *See, e.g.*, Better Bus. Bureau of Wash., D.C., Inc. v. United States, 326 U.S. 279, 283 (1945) ("[T]he presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."); *id.* at 284 ("[E]fforts to cleanse the business system of dishonest practices are highly commendable and may even serve incidentally to educate certain persons. But they are directed fundamentally to ends other than that of education. Any claim that education is the sole aim of petitioner's organization is thereby destroyed.").

113. *See* Brody, *supra* note 91, at 93-94 (discussing the commerciality doctrine and stating that "[t]he particular manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits, are all relevant evidence in determining whether an organization has a substantial nonexempt purpose" (quoting Living Faith, Inc. v. Comm'r, 950 F.2d 365, 371 (7th Cir. 1991))).

114. *See* I.R.C. § 512(c)(1) (2012); Rev. Rul. 2004-51, 2004-1 C.B. 974 ("[T]he activities of a partnership, including an LLC . . . are considered to be the activities of the partners." (citing Rev. Rul. 98-15, 1998-1 C.B. 718)).

115. Rev. Rul. 2004-51, 2004-1 C.B. 974.

the partnership to ensure that those activities further appropriate exempt purposes.[116]

2. *Rationales for the differing tax treatment*

Given the amazing diversity of nonprofits, and even charities, that exist, it is hardly surprising that different theories have been put forward at different times to explain their emancipation from the burden of taxation.[117] The most widely promoted justifications for tax exemption fall into two general categories: the subsidy theory and the tax-base theory.[118] The subsidy theory is more widely accepted, but the tax-base theory has the merit of explaining the grant of tax exemption to a number of organizations for which the subsidy theory fails to offer a clear rationale.[119]

a. *Subsidy theory*

The subsidy theory in its most basic form posits that tax exemption and the other tax benefits provided to charities are the government's way "of subsidizing particular services—such as health care, education, research, and aid to the poor—that nonprofit organizations often provide," rather than providing them directly.[120] A general subsidy for eleemosynary activity broadly defined is a useful way for the government to offer both symbolic and substantive, albeit indirect, support for certain public goods, when the usual market for goods and services does not supply them and a lack of political will for direct support prevents government from filling the gap.[121] In the 1960s, the observation that tax subsidies can be analyzed more easily as direct government expenditures added to subsidy theory and created an increased interest in measuring the effectiveness of these so-called "tax expenditures."[122] The federal government prepares

116. *Id.*

117. It is hard to imagine a unitary theory that would equally well explain exemption for the National Football League, *see* I.R.C. § 501(c)(6), Harvard University, *see id.* § 501(c)(3), the International Brotherhood of Teamsters, *see id.* § 501(c)(5), credit unions, *see id.* § 501(c)(14), and neighborhood churches, *see id.* § 501(c)(3). *See also supra* note 85.

118. Brody, *supra* note 107, at 585-86. *But see id.* at 586-87 (proposing an alternative sovereignty perspective that is implicit in the subsidy and tax-base theories but is also distinct from both).

119. *See id.* at 590-91.

120. Hansmann, *supra* note 77, at 66.

121. *See* John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 698 (2001) (explaining one justification for subsidy as a solution to "both private market failure and the inability of government to respond to that failure due to the vagaries of majoritarian politics").

122. *See* Brody, *supra* note 107, at 595. This analysis—which dubbed deductions, exclusions, and other tax preferences as "tax expenditures"—was developed by Stanley Surrey, who served as Assistant Secretary of the Treasury for Tax Policy in the 1960s. *Id.* One of the

a budget annually to account for the tax revenue "spent" by the government for the benefit of the public through various provisions of the tax code, including the charitable contribution deduction.[123]

Another take on government subsidy, referred to as the "capital subsidy theory," posits that these tax benefits can compensate for the inefficiencies created in capital markets by the constraints imposed on nonprofit entities by federal tax law.[124] The inability of nonprofit organizations to distribute earnings to owner-shareholders limits external financing sources to debt instruments, grants, and donations.[125] Even recourse to debt instruments can be hindered by the fact that many nonprofits are not viewed as favorable investments by creditors concerned with the riskiness of investing in an organization lacking access to other reliable sources of capital.[126] Relief from income taxes thus allows nonprofits to more quickly build up retained earnings as a source of funds to promote their purpose.[127] Exempting donors from personal income taxes on

advantages of tax-expenditure analysis is its usefulness in formulating metrics of efficiency and equity when considering the effects of tax policy on tax-exempt entities. *Id.*

123. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, at 9-10 (Comm. Print 2012), *available at* https://www.jct.gov/publications.html?func=startdown&id=4385. Note, however, that exemption is only considered a tax expenditure when it applies to "organizations that have a direct business analogue or compete with for-profit organizations organized for similar purposes," *id.*, and so tax exemptions for many nonprofits are not included in this annual accounting. *See also infra* notes 131-32 and accompanying text.

124. *See* Hansmann, *supra* note 77, at 72-75.

125. *Id.* at 72.

126. *See* Kelley, *supra* note 26, at 354; *see also* Hansmann, *supra* note 77, at 73 & n.67 (discussing the "awkwardness of the control relationships involved with such high risk debt financing" and the possibility of the lender inappropriately influencing the nonprofit's activities).

127. Hansmann, *supra* note 77, at 73-74. Hansmann claims that retained earnings may be a good measure of the demand for a nonprofit's services and therefore a way to provide subsidy proportional to the need that the entity fulfills. *Id.* at 74. In the case of many charitable nonprofits there is a certain perverseness to this benefit, however, in that it is more valuable to entities that are successfully earning a return on their activities, while it is of no value at all to those that fail to show any earnings simply because they are directing a higher percentage of their resources into charitable services. *Cf.* Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 609 & n.304 (1990) (examining the question of proportionality and suggesting that "[i]t may be that tax exemption, with its coincidental link to retained earnings, is the only politically feasible or practically administrable form of subsidy" (citing Hansmann, *supra* note 120, at 71)). Additionally, it encourages nonprofits to accumulate retained earnings, which runs against the usual purpose of such entities (with the exception of pension plans): to expend their assets in pursuit of their mission. *See, e.g.*, Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 3 (1990) (discussing the enormous endowments of many tax-exempt private research universities). *But see id.* at 29-32 (explaining that, whether intended or not, endowments may allow for protection from the influence of major contributors).

contributions made to § 501(c)(3) organizations also helps to increase financial support through donations, in the absence of easy access to other capital.[128]

While the subsidy theory is intuitive and defensible, it has certain serious shortcomings. For example, if tax exemption is a de facto government subsidy, then are tax-exempt churches being subsidized by the government?[129] Further, can the government withdraw tax-exempt status from politically disfavored entities and grant it to politically favored ones?[130] Also, how much benefit does the subsidy—both exemption and deductibility of charitable contributions—generate as compared to the cost it imposes on the federal and state treasuries? Consideration of these issues is, however, well beyond the scope of this Article.

b. *Tax-base theory*

The tax-base theory approaches the issue of tax exemption by beginning with the assumption that corporate income taxes are rightfully levied on enterprises that exist to produce revenues for private benefit.[131] Under this assumption, entities that are not organized for private profit and whose net income is inherently indeterminate should fall entirely outside the realm of taxable organizations.[132] This explains tax exemption for entities that engage in activities

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128. *See* Hansmann, *supra* note 77, at 72 n.65. This benefit is also appealing because it does not suffer in the same way from the perverseness of tax exemption on the organization's earnings discussed in note 127 above.

129. *See* Brody, *supra* note 107, at 590 n.23 ("[E]xemption is granted for religious activities that the government itself constitutionally cannot undertake. As a technical matter, 'lessening the burdens of government' is only one route to federal income tax exemption as a charity." (quoting Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008))).

130. *See id.* at 590-91.

131. *See* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 302 (1976) ("In the early days of the federal income tax . . . the few lawmakers who commented on the issue [of exemption for nonprofits] suggested that an income tax could appropriately be imposed only on activities conducted *for profit*, and that crucial statutory notions like 'net income' and 'business expenses' do not ring true when applied to nonprofit organizations." (emphasis added)). Bittker & Rahdert discusses tax exemption in the context of federal income tax, but the tax-base theory is easily extended to other forms of taxation. *See, e.g.*, Peter Swords, *The Charitable Real Property-Tax Exemption as a Tax Base-Defining Provision*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD, *supra* note 87, at 377, 377-79.

132. *See* Bittker & Rahdert, *supra* note 131, at 307-12 (addressing the difficulties and paradoxes of applying various sections of the Internal Revenue Code to nonprofit entities); Brody, *supra* note 107, at 591. This seems to be the approach taken by the Staff of the Joint Committee on Taxation. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 123, at 10 ("With respect to . . . nonprofit organizations, such as charities, tax-exempt status is not classified as a tax expenditure because the nonbusiness activities of such organizations generally must predominate . . . ."). *But see* Hansmann, *supra* note 77, at 58-62 (describing ways to account for income that deftly respond to the arguments of Bittker & Rahdert).

that the government is prohibited from having a hand in, or towards which the government is simply indifferent.[133]

A slight variant of the tax-base theory also solves the paradox presented by the subsidy theory with respect to deductions for charitable contributions. These deductions seem disproportionately to benefit the wealthy and give donors—again, mostly the well-to-do—the ability to direct government subsidies.[134] Tax-base theorists argue, however, that personal income taxes are intended "to reduce private consumption and accumulation in order to free resources for public use."[135] Because donations are put to public use,[136] they should be excluded from the tax base if tax is only to be levied upon personal consumption.[137]

Roughly speaking, the subsidy theory therefore looks on tax benefits as a legislative grace that relieves tax-exempt entities of the taxes that they would otherwise rightfully owe, thereby rewarding them for the public benefit that

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133. *See supra* note 129. The sovereignty perspective articulated by Brody offers another compelling alternative. With respect to mutual benefit organizations that benefit primarily their own members instead of the public at large, they are more straightforwardly seen "as conduits through which the members pursue their own ends." Bittker & Rahdert, *supra* note 131, at 306 ("The activities of such an organization should be imputed to its members as though there were no intervening entity."); *see also* STAFF OF JOINT COMM. ON TAXATION, *supra* note 123, at 10 ("The tax exemption for certain nonprofit cooperative business organizations, such as trade associations, is not treated as a tax expenditure just as the entity-level exemption given to for-profit pass-through business entities is not treated as a tax expenditure.").

134. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 310 (1972) ("[T]he charitable contribution deduction has been described as a kind of government matching gift program for the support of taxpayers' charities[, and] . . . the distribution of matching grants is effectively skewed to favor the charities of the wealthy because of their higher marginal tax rates . . . .").

135. *Id.* at 313.

136. Even if the ultimate beneficiary of a charitable donation does use the funds for private consumption, it makes better sense to tax the donation at the donee's marginal rate—likely zero. *Id.* at 347 ("[T]he consumption or accumulation of real goods and services represented by the funds in question has been shifted to the recipients rather than the donor and should not be subjected to taxation at rates designed to apply to the donor's standard of living and saving."). Under the current law, however, a donee owes no taxes for receipt of a gift. *See* I.R.C. § 102(a) (2012) ("Gross income does not include the value of property acquired by gift . . . ."). Andrews rationalizes the taxability of donors and the nontaxability of donees of gifts—many if not most of which are intrafamilial—as being consistent with a taxation regime which primarily levies taxes as a function of household consumption and accumulation. Andrews, *supra* note 134, at 348-49. Contributions to charity, on the other hand, do not fit within this model. *Id.*

137. Andrews, *supra* note 134, at 351 ("[T]he charitable contribution deduction may be seen as eliminating from a taxpayer's return only that consumption which he shifts beyond the confines of his own household . . . ."). Earlier in his article, Andrews argues similarly that "[t]he personal consumption at which progressive personal taxation with high graduated rates should aim may well be thought to encompass only the private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others." *Id.* at 346.

they provide. The tax-base theory, on the other hand, adjusts tax liability according to a more nuanced consideration of what amount of income is appropriately included in the normative base upon which tax is calculated: earnings of—and donations to—public-benefitting entities are simply not a part of the base. Regardless of the exact rationale that one accepts for the tax benefits provided to nonprofits—and none of the explanations fit the existing scope of these benefits perfectly—the benefits and the continuing distinction between for-profit and nonprofit entities are a firm part of the federal and state tax landscape.

B. *Current Tax Treatment of Hybrids*

Because hybrids are not specifically addressed by existing federal or state tax laws, their current tax treatment must be discerned from the general rules governing for-profit and nonprofit entities discussed above. Since benefit corporations and flexible purpose corporations are formed under existing state corporation laws while L3Cs are formed under existing state limited liability company laws, and since these state law differences generally lead to somewhat different federal tax treatments, it is best to consider them separately.

1. *Benefit corporations and flexible purpose corporations*[138]

Both benefit corporations and flexible purpose corporations are formed under the corporation law of their respective states, although with the special provisions noted previously. Because they have owners with rights to share in the entities' profits, they do not comply with the nondistribution constraint. This means they are not nonprofit corporations and so are not eligible for exemption from federal income tax under any of the currently available categories. As a result, and since they are organized as corporations under state law, federal tax law requires that they be classified either as an S corporation or as a C corporation for federal tax purposes.[139]

As with other types of state law corporations, whether a benefit corporation or a flexible purpose corporation can choose S corporation status depends on whether it meets the eligibility requirements for that status. Those requirements include: having no more than 100 shareholders; having only shareholders who are U.S. citizens or residents, tax-exempt organizations, or certain trusts; having only a single class of stock such that ownership rights between shareholders vary only based on the number of shares owned; and filing the required IRS

138. The discussion in this Subpart applies equally to Washington State's social purpose corporation.

139. *See* Treas. Reg. § 301.7701-2(b)(1) (as amended in 2012) (providing that a business entity "incorporated" under state law is a "corporation" for federal tax purposes).

form to choose S corporation status.[140] If state law corporations, including benefit corporations and flexible purpose corporations, lack one of the required characteristics, then they will be classified as C corporations.[141] While it is certainly possible for benefit corporations and flexible purpose corporations to meet these requirements in theory, in practice it will not be possible to do so if such entities have different categories of investors with different rights, or if one or more investors are not eligible S corporation shareholders.

If a benefit corporation or flexible purpose corporation is required to be a C corporation because it does not meet one or more of the S corporation requirements, then the organization will be subject to the federal corporate income tax and its state equivalent, if any. The fact that the organization may have public-benefitting goals as well as profitmaking goals is currently irrelevant for federal and state tax purposes. Such organizations will therefore calculate their taxable income and the tax owed on that income in the same manner as any other C corporation, including with respect to any expenditures for charitable or other public-benefitting purposes.

If instead a benefit corporation or a flexible purpose corporation is eligible to choose S corporation status and in fact elects to do so, then the income and permissible deductions of the organization pass through the corporation to its shareholders. Taxable shareholders, such as individuals, then include their portion of that income and those deductions on their individual tax returns. If the income exceeds the deductions and the taxable shareholder does not have other deductions that she can use to offset the excess, she pays tax on that net income. Furthermore, shareholders that are themselves tax-exempt organizations also generally owe tax if the income allocated to them exceeds the deductions allocated to them from the organization. This result occurs because when Congress chose to include tax-exempt organizations in the list of eligible S corporation shareholders, it also classified the S corporation income allocated to such shareholders as unrelated business taxable income that is taxed at the corporate income tax rates.[142] This treatment applies regardless of the S corporation activity that generated the income.[143] It also applies to any gains that a tax-exempt shareholder might realize and recognize from the sale of its S corporation stock.[144] Congress's stated rationale for this automatic unrelated business taxable income treatment is that the relatively simple tax rules for S corporations are premised in part on the assumption that all income from an S corporation will be subject to shareholder-level taxation.[145]

140. *See* I.R.C. § 1361(b) (listing the requirements for S corporation status).

141. *See id.* § 1361(a)(2) ("[T]he term 'C corporation' means . . . a corporation which is not an S corporation . . . .").

142. *Id.* § 512(e)(1).

143. *Id.*

144. *Id.*

145. S. REP. NO. 104-281, at 61 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1535.

The bottom line is therefore that the net income earned by a benefit corporation or a flexible purpose corporation will be subject to federal income tax, and generally state income tax, either at the corporation level—if the organization is classified as a C corporation—or at the shareholder level—if the organization is classified as an S corporation. This result applies even if the organization is classified as an S corporation and the shareholder at issue is a tax-exempt organization.

2. *Low-profit limited liability companies*[146]

L3Cs are formed under state limited liability company statutes, although with the modifications noted previously. Domestic for-profit entities that are not corporations, including limited liability companies and partnerships of all types, may generally choose either to be classified as a partnership for federal tax purposes (the default option) or as a corporation and, if they choose corporation status, either to be classified as a S corporation (if eligible) or as a C corporation.[147] If such an entity does not choose corporation status and only has a single owner, however, it will be disregarded for federal tax purposes and its activities and income will be attributed to its single owner. If a single individual owns and operates a for-profit enterprise, either directly or through such a disregarded entity, then that enterprise is considered a sole proprietorship, with all of the income and deductions associated with that activity attributed to that individual and included on her individual tax return.

As with limited liability companies generally, the default federal, and usually state, tax rule is that L3Cs are treated either as partnerships or, if they have a single owner, as disregarded entities for tax purposes.[148] As a result of this treatment the income and permissible deductions pass through the L3Cs to their owners, who then include that income and those deductions on their tax returns and, if net taxable income results that is not offset by other deductions, the owners will owe tax. Unlike S corporations, however, those owners may include any type of individual or entity and the allocation of income and deductions between owners may vary significantly, and may even be different depending on the type of income or the kind of deduction at issue. This attribute of L3Cs may be particularly attractive, since L3C advocates promote L3Cs as being particularly amenable to a tranched finance structure whereby private foundations make high-risk, low-return PRI infusions into the L3C, thereby attracting socially minded and traditional market members who make lower-

146. The discussion in this Subpart applies equally to Maryland's Benefit LLC.

147. *See* Treas. Reg. § 301.7701-3(a) (as amended in 2006) (describing the choices available for such "eligible entities"); *id.* § 301.7701-3(b) (describing the default classification for domestic eligible entities).

148. *See* Treas. Reg. § 301.7701-3(b)(1); Susan A. Maslow & Timothy White, *Enlightened Capitalism and L3Cs*, N.J. LAW., Apr. 2010, at 64.

risk and higher-return investments.[149] L3Cs, like limited liability companies generally, can, however, also choose to be taxed as corporations (C or, if eligible, S), in which case the tax consequences are the same as noted above for benefit corporations and flexible purpose corporations.[150]

If an L3C is treated as a partnership or disregarded entity and one or more owners are tax-exempt nonprofit organizations, certain special rules apply. First, if the L3C is a disregarded entity with a tax-exempt organization as its sole owner, then the L3C's income, deductions, and activities are treated as those of the sole owner. The most important ramification of this treatment is that the owner's tax-exempt status can therefore be compromised by the L3C's activities. In general terms, this will occur if some or all of the activities of the L3C do not further the purposes that qualify the owner for federal tax exemption (the owner's "exempt purposes") and those activities are so significant when compared to all of the activities of the owner that they result in the owner having a substantial non-exempt purpose.[151] The creators of an L3C are unlikely, however, to limit the L3C to a single, tax-exempt owner because by doing so they are failing to take advantage of a hallmark of the L3C form—the ability to attract additional capital from a number of investors seeking to both do good and do well.

The more common form is therefore likely to be an L3C that is treated as a partnership and that has taxable and also possibly tax-exempt owners.[152] If an L3C has only taxable owners, the tax effects for the owners are the same as for any partnership. If some of the owners are tax-exempt entities, the activities of the L3C are attributed to the tax-exempt owners as well as their share of the L3C's income and deductions. The tax effect of this attribution depends on whether the L3C's activities are considered to be in furtherance of the tax-exempt owner's exempt purposes. Initially the IRS took the position that any activities conducted through a partnership with one or more taxable entities seeking a profit would be considered as operating for private instead of public interests, and so would cause that organization to lose its tax-exempt status because it was not operating exclusively for charitable purposes.[153] In the wake of court decisions to the contrary,[154] however, the IRS has developed a test that

149. *See* Lang & Minnigh, *supra* note 28, at 17-18.

150. *See* Treas. Reg. § 301.7701-3(c) (allowing partnerships to elect to be treated as corporations for federal tax purposes).

151. *See supra* note 112 and accompanying text.

152. Letter from Marcus S. Owens, Member, Caplin & Drysdale, Chartered, to Ronald J. Schultz, Senior Technical Advisor, Tax Exempt & Gov't Entities Div., IRS 2 (July 8, 2009), *available at* http://www.cof.org/files/Bamboo/programsandservices/publicpolicy/documents/schultzletter.pdf ("[I]t is anticipated that most, if not virtually all, L3Cs will be structured to qualify as recipients of PRIs, with both taxable and tax-exempt ownership interests.").

153. *See* I.R.S. Gen. Couns. Mem. 36,293, at 10-11 (May 30, 1975).

154. *See, e.g.*, Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324, 1333-34 (1980) (rejecting the government's argument that participation in a partnership with individuals and

turns on whether the participating exempt organization both receives reasonable compensation for its participation in the partnership and exercises sufficient control over the joint venture to ensure that the activities do in fact further the exempt organization's purposes.

For a tax-exempt organization that is part owner of an L3C classified as a partnership for tax purposes, this result means that whether the tax-exempt organization's share of income is taxable (as unrelated business taxable income), and whether its participation might threaten its tax-exempt status if the L3C's activities become sufficiently large as compared to the organization's overall activities such that they indicate the organization has a substantial non-exempt purpose, depends on a careful examination of the tax-exempt organization's role with respect to the L3C. The IRS has made clear that it is not enough to have certain, public-benefitting goal language in the L3C's governing documents. Rather, the IRS requires a measure of control by the tax-exempt organization as demonstrated by the ability to appoint a certain proportion (usually a majority, but sometimes half is sufficient) of the governing body's members; veto power over changes to the L3C's governing documents that would eliminate or limit either the public-benefitting goal or the tax-exempt organization's influence; limited influence by the taxable owners over the day-to-day activities of the L3C; and so on.[155] If, however, the tax-exempt organization exercises sufficient control over the L3C to ensure that the L3C will only pursue activities that further the organization's exempt purposes, then the organization's share of the L3C's income will generally not be taxable and those activities will not threaten the organization's tax-exempt status even if they become a significant part of the owner's overall activities.[156]

As noted previously, the supporters of the L3C form also hoped it could simplify the making of program-related investments (PRIs) by private foundations. To date, however, the IRS has not indicated any willingness to issue rulings that would treat investments in either L3Cs generally or any given category of L3C as automatically a PRI simply because of the recipient's L3C status

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a for-profit corporation for purposes of producing a play meant the nonprofit involved was operating for private, rather than public, interests), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

155. *See* Rev. Rul. 2004-51, 2004-1 C.B. 974-76 (ruling that, in a situation where only an insubstantial part of a tax-exempt organization's activities are housed in a partnership, it will be sufficient for the tax-exempt organization to only appoint half of the partnership's governing body if the tax-exempt organization has other means of controlling the substance of the partnership's activities to ensure those activities further the tax-exempt organization's exempt purpose); Rev. Rul. 98-15, 1998-1 C.B. 718 (suggesting that, in a situation where essentially all of a tax-exempt organization's activities are housed in a partnership, generally the organization's appointees must have voting control of the partnership's governing body as well as other powers sufficient to ensure the partnership's activities further the tax-exempt organization's exempt purpose).

156. *See* Rev. Rul. 2004-51, 2004-1 C.B. 974-76.

under state law.[157] Federal tax law therefore does not currently treat L3Cs differently even for this limited purpose.

3. *Conclusion*

As the above discussion demonstrates, the creation of these new hybrids does not create any new tax categories or treatments. The different types of hybrid corporations (including Washington's social purpose corporation) are treated the same as more typical state law corporations. The L3C and Benefit LLC are treated the same as any other state law entity that can be classified as a partnership (or disregarded entity) for federal tax purposes, and thus have the ablility to choose corporate tax treatment if that treatment is preferred. Although the L3C requirements could help support the case that the activities of a given L3C further the exempt purposes of a tax-exempt organization owner, nothing in the special provisions that exist for these hybrids automatically changes their tax treatment. At this point, therefore, new state law legal forms do not translate into new federal or state law tax treatment.

III. SHOULD HYBRIDS RECEIVE SOME OR ALL OF THE TAX BENEFITS RECEIVED BY CHARITIES?

To date, statutory hybrids have not been granted tax-favored status in any jurisdiction. The Hawaiian legislature included exemption from state income tax as an attribute of the hybrid form in its unsuccessful first attempt to pass benefit corporation legislation.[158] That idea met with public scorn, however, with an editorial stating "[t]he [tax exemption] proposal is, at best, silly and unproductive, and at worst, a loophole through which more business-paid tax revenue could leak needlessly," and ultimately the exemption provision was one of the stated reasons for the governor's veto.[159] Hawaii did eventually enact a benefit corporation statute, but without any mention of a tax preference.[160] The closest any jurisdiction has come to offering tax benefits to a hybrid is the tax credit offered by Philadelphia to local corporations certified by B Lab.[161] Nevertheless, and as media outlets have already reported, it is clear

157. *See supra* note 40.

158. *See* H.B. 3118, 23d Leg., 2006 Leg. Sess. § 10 (Haw. 2006) ("A company incorporated as a responsible business corporation under this chapter shall be exempt from [ ] per cent of all corporate taxes . . . ." (omission in original)).

159. Editorial, *supra* note 12; *see also* Lingle, *supra* note 12 ("I am not willing to force taxpayers to subsidize an experiment of this sort.").

160. *See* 2011 Haw. Sess. Laws 682-88 (codified as amended at HAW. REV. STAT. § 420D-1 to -13 (2014)).

161. *See The B Corporation: A Business Model for the New Economy*, CAPITAL INST., http://www.capitalinstitute.org/node/171 (last visited Feb. 1, 2014); *see also* sources cited *supra* note 44 (explaining the difference between B Corporations and benefit corporations). San Francisco recently approved a non-tax benefit for benefit corporations, giving them bid

that at least some supporters of these hybrid forms plan to lobby for tax benefits once these forms are an established part of the legal landscape, a goal they are close to achieving.[162]

For the reasons detailed in this Part, however, granting the tax benefits that nonprofits and particularly charities currently enjoy to these new hybrid forms would be a mistake that would harm not only the public fisc, but also charitable nonprofits, and even the very hybrids that proponents of such benefits support. The arguments in favor of granting such benefits are attractive on their face: what should matter is not legal form but providing public benefit; investors in hybrids are taking on a risk for the benefit of society and so should be supported by society in doing so; and state law provisions governing hybrids ensure sufficient public benefit. The problem is that upon closer examination it becomes clear that either the federal government would not be able to ensure that the recipient hybrids would in fact provide the public benefits that justify providing these kinds of tax benefits in the first place, or the restrictions the federal government or state governments would have to impose to ensure such public benefits would undermine the very flexibility that is the main attraction of these hybrid forms. There are, however, other modifications that should be made to the existing federal tax laws in order to accommodate the unique characteristics of these hybrids. These modifications include either increasing the limit on deducting charitable contributions for hybrids classified as corporations for federal tax purposes, or permitting such entities to deduct more of their charitable spending as business expenses. They also include eliminating the automatic classification of S corporation income as unrelated business taxable income for tax-exempt shareholders when the income arises from ownership in a hybrid classified as an S corporation.

A. *Arguments in Favor of and Against Tax Benefits for Hybrids*

Arguments have arisen from various quarters that hybrids, being formed explicitly for the purpose of promoting a public benefit, should be eligible for tax exemption and possibly other tax benefits.[163] The idea of extending tax exemption to for-profit entities that pursue public-benefitting goals is not new, but the rise of hybrids has changed the legal landscape.[164] Hybrids—which are formed explicitly for the purpose of promoting a public benefit—present a particularly compelling case for tax preference. One of the main rebuttals to such a

preference on city contracts. James Temple, *Social Good Protected by State Law*, SFGATE (Dec. 15, 2012, 6:44 PM), http://www.sfgate.com/technology/dotcommentary/article/Social-good-protected-by-state-law-4120463.php.

162. *See supra* note 11 and accompanying text.

163. *See supra* note 11.

164. *See, e.g.*, Hansmann, *supra* note 77, at 66-67 (addressing the question, but rejecting such a policy); Malani & Posner, *supra* note 14, at 2023 (advocating "decoupling" tax exemption from the nonprofit requirement).

proposal used to involve citing the paucity of for-profit charities, but that counterargument is no longer effective in light of the existence of hundreds of hybrids.[165]

A deeper look, however, reveals fatal flaws that render the case for extending tax benefits to hybrids far from compelling. The heart of the problem is that it is difficult both to define "public benefit" and to enforce a public benefit requirement absent the type of limitations imposed on charitable nonprofits. More specifically, defining public benefit becomes problematic once it is no longer associated with a nonprofit legal form. In addition, there is insufficient justification for shifting the risk for seeking such public benefit from presumably knowledgeable funders to the generally uninformed taxpaying public absent strict limitations designed to ensure a resulting public benefit. Furthermore, other mechanisms, such as the hybrid enabling statutes, are insufficient to ensure that public benefit is indeed provided. Finally, there would likely be significant and negative ramifications for both hybrids and tax-exempt nonprofit organizations more generally if even a small subset of hybrids that enjoyed significant tax benefits failed to fulfill their public benefit promise.

1. *The difficulty of defining public benefit*

Hybrids are meant to create public benefits similar to those expected of other tax-exempt organizations. Benefit corporations must "create a material positive impact on society and the environment,"[166] and L3Cs must "further[] the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code."[167] Proponents of expanding the availability of tax benefits therefore argue that the business form chosen should not impact the decision to reward them for the public benefit they provide.[168] Or, phrased in a slightly different manner: subsidy through exemption and the ability to receive tax-deductible contributions should be based on a showing of public benefit, rather than nonprofit form.[169] Whether an entity is for-profit or nonprofit, it still lessens the cost to the gov-

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165. *See, e.g.*, Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 863 (1980) ("Donative nonprofits . . . rarely have proprietary counterparts."); Mitchell A. Kane, *Decoupling?*, 93 VA. L. REV. IN BRIEF 235, 236 (2008), http://www.virginialawreview.org/volumes/content/decoupling (noting "the current non-existence of 'for-profit charities'"); *supra* notes 41, 50 & 61 and accompanying text (listing the number of hybrids registered under state law).

166. CLARK ET AL., *supra* note 44, at 15.

167. *E.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(A) (2013).

168. *Cf.* Malani & Posner, *supra* note 14, at 2023 ("[T]here is no reason to condition the tax subsidy for charitable activities on organizational form.").

169. *See* James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1181 & n.6 (2010) (citing sources that debate "whether specific charitable acts should be required of organizations that enjoy tax benefits").

ernment of providing the same benefits, one of the basic justifications for tax preference under the subsidy theory.[170]

A number of scholars have pointed out the difficulties inherent in making the dividing line between taxable and tax-exempt activities exclusively a matter of function, however.[171] The broad language of § 170(c)(2)(B) and § 501(c)(3) guides the evaluation of organizational aim, but gives no guidance on operational matters or allocation of assets. The nondistribution constraint, voluntarily accepted, provides concrete evidence that the founders and contributors of a venture are not out for their own private good, but for the good of others. If the nondistribution constraint is eliminated, it is crucial to have a substitute that will objectively demonstrate the intent to seek public benefit first, and to seek personal compensation only incidentally.[172] Otherwise, almost any profitmaking venture could reasonably argue that it provides a public benefit even as its owners and managers conduct its activities so as to generate the maximum amount of profit for themselves; after all, economic activity generally benefits society in many ways, including by providing employment and desired products or services. Discussing the proposal to give hybrids the benefits of exemption, one commentator provocatively asks: "What would keep a coffee shop (community building), a soap company (health) or an insurance company (disaster protection) from becoming an L3C and thereby potentially getting tax exemption benefits?"[173] This risk is heightened for the other types of hybrids, as their enabling statutes do not require a purpose found in § 170(c)(2)(B) and § 501(c)(3) but instead impose vaguer and broader purpose obligations that are not limited to the creation of public benefit within the meaning of those sections.[174]

Those who propose tax benefits for hybrids are following a valid intuition: companies that want to do good should not be penalized because of their form. What these commentators fail to recognize is that they may be setting two separate baselines in the wrong place. The first baseline, which we will call the "taxability baseline," has to do with tax treatment: is the proper baseline set at "income is taxable" or "income is not taxable?" The second baseline, which we

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170. *See supra* note 120 and accompanying text. Some contend that for-profits are more efficient than nonprofits, as well. *See* Hines et al., *supra* note 169, at 1192 nn.56 & 58. This would make subsidies of for-profits a better use of public funds. This claim is hotly debated, though, and based more on theorizing than real-life comparisons of similar enterprises in the two sectors. *See id.* at 1192-203 (finding arguments and evidence inconclusive).

171. *See, e.g.*, Hines et al., *supra* note 169, at 1215-16 (discussing the value and widespread use of entity classification to govern treatment under tax law and law generally); *see also* Fleischer, *supra* note 76, at 231 (suggesting that "relying solely on Section 501(c)(3) to distinguish between charitable and noncharitable activities" would be an "administrative nightmare").

172. Fleischer, *supra* note 76, at 231-32.

173. Cohen, *supra* note 11.

174. *See supra* notes 47, 54 and accompanying text.

will call the "responsibility baseline," defines what level of corporate good citizenship is expected of a for-profit entity.

As for the taxability baseline, if it is set at "income is taxable," then granting tax-exempt status (and deductibility of contributions for donors) is a reward. On the other hand, if the taxability baseline is set at "income is not taxable," then withholding tax-exempt status is a punishment. The subsidy theory explicitly presumes the taxability baseline for all entities and individuals is set at "income is taxable" and views exemption and deductibility of contributions as extraordinary grants from the taxing authority to compensate either for a public benefit known to be conferred by an entity or for some market irregularity. The tax-base theory also places revenues from profitmaking entities—which hybrids admittedly are—within the realm of the normative tax base.[175] Under either theory, the taxability baseline for hybrids and their funders is therefore set at "income is taxable." Taxation is not a penalty. Whether hybrids guarantee a public benefit or suffer from market failure and so merit subsidy is a separate question treated below.

With regard to the responsibility baseline, the question may be phrased thusly: what must hybrids do beyond being responsible corporate citizens? If corporations are expected to be—and are generally viewed as being—impersonal, greedy, and irresponsible moneymaking machines, then a social enterprise that acts from motives other than the sheer maximization of profit is worth rewarding and could merit having tax benefits bestowed upon it.[176] On the other hand, if we expect more from our corporate citizens, if we feel that for-profit entities have an obligation to comport themselves in a way that reflects a responsible balancing of profit and social or environmental values,[177]

175. Even if the tax-base theory "accepts the challenge" to differentiate between the charitable and taxable activities of a § 501(c)(3) organization, Brody, *supra* note 107, at 591, this is hard enough to do in valuing the commercial activities of a charity, for example, for the purposes of applying UBIT. Imagine reversing the process to assign a value to the "general public benefit" of a for-profit; who will accept the challenge to define "Related Business Untaxable Income" for a hybrid? *Cf.* Leff, *supra* note 76, at 852 (arguing in the context of a for-profit charity that while one may conceive of a way to measure "dollars going directly to the beneficiaries, or count number of children benefitted, it is much harder to make such an evaluation when the donor wants to provide flexibility to enable the entrepreneur to use [assets] in the most beneficial way").

176. *See* Marcus Oshiro, *State Can Help Align Profit, Public Interest*, HONOLULU ADVERTISER (Apr. 4, 2006), http://the.honoluluadvertiser.com/article/2006/Apr/04/op/FP604040313.html (commenting that "the term 'responsible corporation' has become an oxymoron in society today" and advocating tax incentives for good corporate citizens).

177. This is by no means a new view of corporate responsibility. In 1932, E. Merrick Dodd, Jr. wrote that "public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function." E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932). Dodd's article was a provocative response to that of his colleague, A.A. Berle, Jr. *See id.* at 1147 & n.5; *see also* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) ("[A]ll powers granted to a corporation . . . are necessarily

then why should a social enterprise—which is merely living up to our expectations—be rewarded? There are laws prohibiting mistreatment of many stakeholders including employees, customers, and the community.[178] If companies fall short of their obligations under these laws they should be penalized.[179] Theoretically, companies could be rewarded for superlative performance with regard to these stakeholders, but neither benefit corporation nor L3C statutes actually impose specific standards for the requirement of heightened duty toward these stakeholders.[180] They are more akin to aspirational statements that merely require that other stakeholders not be completely ignored in the single-minded pursuit of profits.

Paradoxically, the statutory requirements may still leave existing stakeholder interests imperiled. Imagine a benefit corporation with a very popular product that has a strong concern for the environment. It reduces its ecological footprint by investing in new green technology, but compensates for the cost by reducing profit margin, product quality, and employee benefits. This course of action would seem to be consistent with the demands of the benefit corporation statute because solicitude for the environment has been placed before profit—as well as before the investor, the consumer, and the employee. It would be next to impossible to show that the board violated its duty to "creat[e] general public benefit" by balancing the interests of the stakeholders in such a fashion.[181] Every business decision involves a tradeoff between opposing values, and the permissive business judgment rule protects directors from liability ab-

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and at all times exercisable only for the ratable benefit of all the shareholders . . . ."). For more on the debate between Dodd and Berle, see Knauer, *supra* note 103, at 22-23.

178. Among the many provisions that protect these stakeholders are employee benefit laws, labor laws, safety regulations, minimum wage laws, consumer protection laws, product liability laws, environmental regulations, and zoning regulations.

179. "The better role for government here is not to hand out candy to its model children in this paternalistic fashion. It's to create laws that draw the parameters of ethical behavior and establish the consequences for failure to comply. And it's to police these laws and see that justice is done." Editorial, *supra* note 12 (reacting to the introduction of legislation in Hawaii to create tax-exempt "Responsible Business Corporations"). Many also argue that social responsibility is already an obligation of corporations in return for the benefits of limited liability. *See* Velasco, *supra* note 22, at 460; *see also supra* note 177. With a form like the L3C, which is designed to receive tax-exempt foundation dollars, there is an even stronger argument to be made.

180. Though the statutes impose accountability and reporting requirements, there is—not surprisingly—no benchmark for a contribution to public welfare. *See, e.g.*, VT. STAT. ANN. tit. 11A, § 21.14 (2013) (delineating requirements for the "Annual Benefit Report" to be made publically available after distribution to and approval by shareholders).

181. *See, e.g.*, *id.* § 3.01(a) ("Every corporation incorporated under this title has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation."); *id.* § 21.08(a)-(b) ("A benefit corporation shall have the purpose of creating general public benefit. . . . The articles of incorporation of a benefit corporation may identify one or more specific public benefits that are the purpose of the benefit corporation to create in addition to its purposes under subsection 3.01(a) of this title and subsection (a) of this section."). It is also unclear who could bring an action to challenge such a decision.

sent gross negligence, demonstrable conflict of interest, or intentional misconduct.[182] Hybrid statutes may actually exacerbate accountability problems by explicitly broadening directors' fiduciary duties and permissible considerations.[183]

The alternative to the existing structure would be to develop a much more specific public benefit requirement for hybrids to enjoy tax benefits similar to those enjoyed by charities, both in terms of what qualifies as a public benefit and what quantity of such public benefit would be required to obtain the desired tax benefits.[184] This arguably is what some states are already doing with respect to nonprofit hospitals that seek to maintain their exemption from property taxes.[185] As those state efforts demonstrate, however, developing such a requirement is no easy task under any conditions.

Moreover, such a requirement would undermine one of the much-touted benefits of hybrids, which is their flexibility to balance public benefit—broadly defined—and profit seeking as their leaders and funders choose. Hybrids are widely lauded for their ability to aid entrepreneurs seeking better solutions to social needs due to their simplicity and flexibility.[186] Social entrepreneurs are interested in investing their time and money in bringing their ideas to fruition, not setting up their businesses. They also desire the flexibility to seek nontraditional approaches in conducting their business and to access a broad range of capital. The hybrid forms they have turned to were relatively tricky to simulate prior to the passage of enabling statutes, and the "blessing" of tax benefits could turn into a "curse" of new complexities and constraints that would defeat the purpose of these new forms.

2. *Risk shifting and its problems*

Entrepreneurs and investors who accept the constraints imposed by hybrid statutes in order to ensure the continuity of their enterprise's mission are taking on additional risk directly related to their desire to provide a public good. Like

182. Even in the case of gross negligence, directors are usually protected by exculpation statutes. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2013) (limiting the "liability of a director to the corporation or its stockholders for monetary damages for breach of [the duty of care]").

183. *See supra* note 23.

184. One scholar has suggested that hybrids could be required to engage in a minimum level of corporate giving merely to maintain their status. Murray, *supra* note 23, at 46 n.213 ("Few things speak louder on the issues of corporate priorities than how corporations allocate their resources.").

185. *See* John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29, 37-40 (2005) (summarizing recent state government challenges to nonprofit hospital tax exemptions); Lawrence E. Singer, *Leveraging Tax-Exempt Status of Hospitals*, 29 J. LEGAL MED. 41, 46-48, 51-54 (2008) (same).

186. Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 182 (2010).

nonprofit organizations that are compensated for their acceptance of capital market constraints, particularly charities through the ability to receive tax-deductible contributions, supporters of extending tax benefits to hybrids can plausibly argue that these investors merit some compensation for their sacrifice.[187] In a sense, they are giving up legitimate profits by limiting the means they will use to pursue them to those that confer a public benefit.

It has been argued that the difference between the profits realized and the profits that could have been realized is not taxable, just as a charitable deduction for the same amount would not be available.[188] While this argument may be a valid point as far as the investor is concerned, it does not tell the whole story for the entity, however, because the cost of assets that will be used to produce revenues in future taxable periods must usually be depreciated over time.[189] Consider the price tag to invest in, for example, environmentally friendly improvements and equipment for a factory. Given the time value of money, there is a significant difference between a charitable deduction today and depreciation deductions over the life of the property. Providing tax benefits would help offset this voluntarily accepted burden.

Others object that the social enterprise shtick is just part of the business plan, a public relations investment that will reap rewards in better business, much like an advertising campaign.[190] Supporters of tax benefits respond that motive itself is really irrelevant to the granting of subsidy and that measurable public benefit flowing from an activity is the proper object of public subsidy, not benevolent motives regardless of their value.[191] Society should support the creation of such public benefits by extending the tax benefits enjoyed by charities to hybrids, which are especially designed to provide public benefits as well as profits. For example, if an entrepreneur has an idea for a hybrid enterprise that will have a positive public impact, but the market will not support the creation of such an enterprise due to either capital or profit margin constraints, then perhaps the enterprise should receive a boost through public subsidy. Presumably the subsidy would flow to the publically beneficial goals of the enterprise

187. Steven Munch, Note, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J.L. & SOC. POL'Y 170, 188 (2012) ("Some may argue that because the benefit corporation is subject to higher levels of service, duty, and liability, it should be entitled to some financial advantages.").

188. *See, e.g.*, Hines et al., *supra* note 169, at 1189-90 (stating that the low returns associated with social investing are similar to a tax deduction).

189. *See* I.R.C. § 167(a) (2012) (allowing a "depreciation deduction" for capital outlays); *id.* § 263(a) (denying deduction for certain capital expenses); INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 85-86 (1992) (discussing the difference between "current expenses and capital expenditures").

190. *See* Malani & Posner, *supra* note 14, at 2064.

191. *See id.* ("It does not matter whether [the entity] (or its managers or shareholders) acts from altruistic or selfish motives; what matters is that the resulting activity produces social benefits.").

since it cannot survive initially without them.[192] A more sophisticated argument is that while social entrepreneurs will create (and in fact are already creating) some hybrids even in the absence of tax benefits, the level of creation is below the economically optimal level because some of the benefits from hybrids are captured by the public as a whole and not by the social entrepreneur.[193] Providing tax benefits that increase the returns to investors will therefore encourage the creation of more hybrids (and greater investment in hybrids) and so bring the level closer to the optimal one.

One significant problem with this risk-taking argument is that if the entity turns profitable—which is obviously the hope of anyone who invests in a hybrid—the profits (and the subsidy) will flow to investors, providing a private benefit. Perhaps it will be enough to have some mechanism to turn off the subsidy once the organization stabilizes. Then again, maybe not. Why should the government "prime the pump" while investors sit by and wait for the funds to start flowing?[194] The government should not be cast in the role of venture capitalist to seed any number of daring projects for private investors to pick up when they turn out well.[195]

Though at first glance tax-exempt bonds seem to serve a similar function, the differences are significant. The range of activities that can be funded with tax-exempt bonds that support private, as opposed to governmental activity, is sharply limited, as is the overall amount of such bonds that each state can issue.[196] For example, such financing is generally limited to either receipt by certain types of facilities (some of which must be government owned) or use for certain types of purposes, including providing mortgage funds for veterans or purchasers of below-average-cost, owner-occupied residences, providing student loans, funding specific types of redevelopment, or funding property owned

192. Leaving aside the possibility that the organization is simply inefficient, in which case the subsidy is simply supporting a failed or outdated business model. *See* Culley & Horwitz, *supra* note 39, at 17 (pointing to the fact that L3Cs were first proposed to prop up North Carolina's furniture industry and highlighting the example of MOOMilk, which "converted to an L3C when it was unable to survive in the competitive market").

193. This is essentially a version of the capital subsidy argument development by Hansmann. *See* Hansmann, *supra* note 77, at 72-75.

194. Even having a special tax to recapture the subsidy previously provided by the government is probably not a workable solution for two reasons. The entity may end up regularly returning a small profit, but any extra burden would sink it. On the other hand, some enterprises may never turn profitable and investors may walk away, leaving the public holding the bag until the company folds.

195. Governor Laura Lingle of Hawaii alluded to this when she vetoed legislation that would have set up a task force to determine, inter alia, how to "provide incentives for the creation of 'responsible' companies." Lingle, *supra* note 12 (describing reasons for vetoing the bill, including "the bill's potential impact on tax revenues" and stating that the governor was "not willing to force taxpayers to subsidize an experiment of this sort").

196. *See* I.R.C. §§ 141-146 (2012).

by charitable nonprofits used to further those nonprofits' exempt purposes.[197] These limitations are designed to ensure sufficient public benefit to justify the subsidy provided by exempting the interest paid on these bonds from federal income tax, which in turn results in the borrowers having to pay significantly lower interest rates. At the same time, these limitations create such a complicated set of rules that the IRS itself has stated that "[t]he Code and regulations sections applicable to tax exempt bonds are quite complex" and therefore its own internal training materials "do not address many of the complex situations which might develop in a bond transaction."[198] Subsidy through tax exemption for hybrids would be similarly difficult to constrain without imposing crippling rules, which, again, would eliminate the flexibility that social entrepreneurs seek from hybrid forms.

Further, with the growing class of social investors to which many promoters of social enterprise point, a major justification for subsidy is rapidly disappearing. The capital subsidy theory dictates that tax benefits are meant to correct for broken capital markets, specifically the inability of nonprofits that can provide certain goods or services more efficiently than for-profit entities to access equity markets because of the nondistribution constraint.[199] Hybrid entities are not of course subject to this constraint and therefore should have at least some access to equity markets; evidence of increased investor interest in hybrids indeed suggests that is in fact the case and so new tax preferences are therefore unnecessary. Moreover, as Henry Hansmann has noted, providing exemption or other tax benefits is a very "crude mechanism" for offsetting a perceived inability to obtain the economically optimal level of capital even when access to the equity markets is completely foreclosed.[200] For hybrids, access to the equity markets is at worse only hindered to some extent, making it even more difficult to calibrate the tax benefits so as to achieve the optimal level of hybrid creation and growth without overcapitalizing them.

With regard to risk taking for the sake of public benefit, there is little evidence that risk taking, in and of itself, is usually rewarded. There are certain tax credits and deductions available for investments that could be classified as high risk, but they are targeted at very particular goals, not risk taking generally.[201] These traditional ways of extending benefits to for-profit entities, based on spe-

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197. *See id.* § 142(a) (listing eligible facilities); *id.* § 142(b)(1) (requiring government ownership of some facilities); *id.* § 143(a) (mortgages for owner-occupied housing); *id.* § 143(b) (mortgages for veterans); *id.* § 143(e)(1) (purchase price limitation); *id.* § 144(b) (student loans); *id.* § 144(c) (redevelopment); *id.* § 145(a) (property to be owned by a § 501(c)(3) organization or governmental unit).

198. *Tax Exempt Bonds Training Materials,* IRS (July 15, 2013), http://www.irs.gov/Tax-Exempt-Bonds/Tax-Exempt-Bonds-Forms-Publications-and-Training-Materials.

199. Hansmann, *supra* note 77, at 72-75.

200. *Id.* at 75.

201. *See, e.g.*, I.R.C. § 45D (offering a tax credit for investments that assist "low-income communities or low-income persons"); *id.* § 1202 (offering a "[p]artial exclusion for gain from certain small business stock," which is very restricted in availability).

cific criteria, are much more likely to be amenable to supervision and therefore to be an efficient and productive use of tax dollars.

Furthermore, the result of extending tax benefits to hybrids would in effect be to shift some of the risk from hybrid funders—who presumably are, or at least can be, well informed about the current and expected activities of such hybrids—to the taxpaying public as a whole. The latter group is unavoidably relatively uninformed about the activities of hybrids, including the extent to which any given hybrid is in fact pursuing public benefits.[202] To some extent this ignorance could be overcome by deploying some of the regulatory tools applied to existing charities: detailed and publicly disclosed information returns (IRS Form 990);[203] federal and state regulators with auditing ability and available sanctions, up to and including revocation of tax benefits; [204] and specific prohibitions on certain types of activities.[205] A prime example of the latter tool is the much stricter rules for private foundations, including prohibitions on certain types of transactions with insiders even if they could be beneficial to the foundation; Congress enacted these rules to address perceived abuses of the charitable form that arose because of the relatively small group of individuals who usually controlled a given private foundation and the lack of sufficient oversight by outsiders.[206] Similarly, foreign hybrid entities are distinct from our domestic versions because they are subject to restrictions relating to use of assets, returns to investors, and so on.[207] Again, however, imposing such regulatory requirements would significantly increase the burdens on hybrids and reduce the flexibility that distinguishes them from both traditional for-profit and nonprofit legal forms.

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202. While there are public reporting requirements in place for benefit corporations, there are no corresponding requirements for L3Cs, *compare, e.g.*, VT. STAT. ANN. tit. 11A, § 21.14 (2013) (detailing reporting requirements for benefit corporations), *with, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27) (including no reporting requirements), plus mere public reporting does not guarantee that the public will take advantage of such information.

203. *See* I.R.C. § 6033(a)(1) (requiring tax-exempt organizations to file annual returns); *id.* § 6104(b), (d) (requiring public disclosure of same).

204. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 305-14 (2004) (describing the authority of state attorneys general to investigate charities); *id.* at 417-20 (describing the IRS audit process).

205. *See* I.R.C. § 501(c)(3) (prohibiting inurement of net earnings to any private shareholder or individual, limiting attempts to influence legislation, and prohibiting political campaign intervention).

206. *See generally* Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52 (2000).

207. *See supra* notes 68, 72 and accompanying text.

3. *State hybrid statutes and other forms of oversight are insufficient to ensure public benefit*

Unlike constituency statutes, which are largely permissive, hybrid statutes seek to compel consideration of public purpose either in addition to or over and above consideration of profit.[208] A traditional for-profit entity, professing a desire to do good when the economy is good, may turn fickle when the economy changes and abandon its best intentions.[209] A hybrid, on the other hand, has public benefit locked in by virtue of the enabling statutes, so it should be trusted to stick to its mission in good times and bad. Furthermore, with L3Cs, the foundations that invest through PRIs should have a strong role in the governance of the entity to compensate for the risk involved in their participation.[210] These factors could provide the assurance that is needed to extend tax benefits to hybrids, without burdening them with the strictures and additional regulatory oversight that creates such inflexibility in nonprofits.

The problem with this argument is that given the well-publicized difficulty of traditional for-profit and nonprofit directors to look out for the interests of a single constituency, it is hard to believe that hybrid directors and managers will be able to keep the needs of multiple constituencies balanced.[211] Entity leaders have enough to think about aside from balancing the competing interests of private owners and the public.[212] This concern is sufficient reason to divide entities into two camps and to limit tax benefits to nonprofits: for-profit directors and managers are expected to keep owners' interests foremost while charity leaders are expected to keep public interests foremost.[213]

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208. *See supra* note 23 and accompanying text.

209. *See* Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. TIMES (Sept. 14, 2006), http://www.nytimes.com/2006/09/14/technology/14google.html ("There are skeptics, too, among tax lawyers and other pragmatists familiar with the world of philanthropy. They wonder whether Google's directors might be tempted to take back some of the largess in an economic downturn.").

210. *See* Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 628-29 (2010) (noting that granting primary or exclusive governance rights to a foundation member "would safeguard the mission of the L3C to pursue charitable or educational purposes"); Schmidt, *supra* note 186, at 196 (emphasizing foundations' strong incentives to enforce the mission of an L3C to which they have made a PRI); *see also supra* note 38 (discussing the concept of "expenditure responsibility").

211. *See generally* JAMES J. FISHMAN, THE FAITHLESS FIDUCIARY AND THE QUEST FOR CHARITABLE ACCOUNTABILITY 1200-2005 (2007) (discussing nonprofit scandals throughout history); Gregory A. Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 CONN. L. REV. 1073 (2003) (discussing scandals involving for-profits and the typical regulatory response).

212. *See* Velasco, *supra* note 22, at 634 ("[B]alanc[ing] the various competing interests . . . is a function that directors are not capable of performing."); *see also* Culley & Horwitz, *supra* note 39, at 21 ("[I]t might be difficult for charitable fiduciaries to attend to their nonprofit organizational duties rather than their for-profit goals.").

213. Even if investors are aware that profit is not the name of the game, it is unlikely that they and the directors collectively will have complete unanimity of opinion as to just

In addition, different protective regimes are in place to regulate charities and for-profits, designed to achieve their goals through methods appropriate to the entities they protect. The theory from which securities law has developed is that maximization of shareholder wealth is the goal and measure of a healthy for-profit entity.[214] The federal securities laws, state "blue sky laws," and the corporate common law—to which for-profits' everyday affairs are primarily subject—are intended to ensure that shareholders are able to look out for their own interests when they buy, vote, hold, or sell their stock.[215] Meanwhile, the hallmark of a successful charity is that it expends the highest proportion of its resources possible in pursuit of its public mission. Various, primarily federal, tax rules—e.g., UBIT, penalties for excess benefit transactions, and the threat of the loss of exemption—as well as the supervisory role usually given to state attorneys general, grant authority to public representatives to keep charities faithful in their service of public interests.[216]

For-profit enforcement mechanisms, which are designed to protect private interests, are inappropriate in the context of guarding against abuse of a public subsidy. There is a misalignment of incentives for the investors who under traditional corporate law would have the authority to challenge hybrid directors' or managers' failure to adhere to the charitable mission: investors reap profits that may be limited by charitable goals.[217] It is also hard to know how a court that is accustomed to framing shareholder suits in terms of liability for failure to maximize shareholder value would proceed with a claim that the company did not adequately protect other interests.[218] Moreover, just because investors have below market expectations, that "should not be confused with donative intent or lack of an investor mindset."[219] Some may be perfectly happy with the warm glow that comes from investing in a recognized social enterprise without worrying too much about precisely how much public benefit results.[220]

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how much other interests will prevail over the goal of generating revenues, if only to make the enterprise sustainable and forestall a constant need of new capital. As one student note commented: "While the benefit corporation legislation to date provides a strong, basic framework for social enterprise, it may not do enough to encourage mission fulfillment, to guide directors and officers, or to assist prospective investors." Munch, *supra* note 187, at 188.

214. *See* Velasco, *supra* note 22, at 409 ("[T]he law seems to have coalesced around the norm of shareholder primacy—that the main goal of the corporation should be to maximize shareholder wealth . . . ." (footnote omitted)).

215. *See* MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 363-65 (2011) (discussing investors' need for "a common pool of knowledge . . . to judge for themselves" how to handle their investments).

216. *See* Tyler, *supra* note 29, at 150-51 (mentioning other accountability mechanisms as well, including "donor vigilance" and "the media").

217. *Id.* at 155.

218. *Id.*

219. *Id.* at 152.

220. For investors who are not so relaxed, there are numerous ways for them to ensure that their investments have sufficient positive social and environmental impact. *See, e.g.*,

On the other hand, absent the nondistribution constraint, will nonprofit safety mechanisms work any better? At least one state has subsumed L3Cs into the charitable oversight of the attorney general.[221] Attorney general oversight could potentially hold a hybrid responsible for fraud or ultra vires acts. Similar to the quandary faced by a court in the context of a shareholder suit, claims for fraud depend on cooperation from shareholders and presuppose some injury to their financial interests, both of which may be lacking.[222] Pursuing a claim for ultra vires acts would also be an uphill battle when the directors or managers are not actually prohibited from making a profit for owners, as long as they do it in the pursuit of a charitable goal. As noted above, current hybrid statutes do not address the issue of how charitable is charitable enough, nor does it appear desirable for them to do so.[223]

Federal tax law controls like UBIT, penalties for excess benefit transactions, and threats of loss of exemption would be very difficult to apply to hybrids. Given their broad purposes and intentional flexibility, how would "unrelated business" be defined? Would there be a different standard for excess benefit transactions to allow for distributions to owners? For benefit corporations, pursuing commercial ends in a way that confers public benefit—rather than pursuing public benefit in a way that uses commercial tools to provide support and funding, as some charities do—completely negates the current judicial analysis of purpose versus activity and the use of tools such as the commerciality doctrine. On top of the substantive difficulties faced by these nonprofit enforcement mechanisms in dealing with hybrids, there is already criticism of their effectiveness in overseeing the traditional nonprofit sector due to a lack of resources at both the federal and state levels.[224] Expecting this overtaxed system to take on the additional responsibility of reliably overseeing the hybrid sector would be costly and likely unrealistic.

It is possible that this concern with oversight could be addressed by strengthening the regulatory scheme for hybrids.[225] For example, the creation

MONITOR INST., INVESTING FOR SOCIAL & ENVIRONMENTAL IMPACT: A DESIGN FOR CATALYZING AN EMERGING INDUSTRY (2009), *available at* http://www.monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf.

221. The Attorney General of Illinois has taken jurisdiction over L3Cs as charitable forms. *See* Reiser, *supra* note 49, at 616 n.132.

222. *See* Tyler, *supra* note 29, at 156. Tyler also points out that coming up with a remedy or fixing damages could be particularly difficult "because the failure to prioritize charitable, exempt purposes may not result in financial loss and could actually produce financial gain." *Id.* at 157.

223. *See id.* at 156-57 (noting that the "agency responsible for charities enforcement could have a different [interpretation] than the attorney general's office that pursues *ultra vires* acts" and suggesting that the two functions be consolidated).

224. *See* Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 493-95, 524-25 (2010) (summarizing criticisms of both state and federal oversight of charities).

225. Obviously, this solution is subject to the caveat that it would require finding new enforcement resources or diverting them from existing enforcement regimes. Considering

of the British CIC was accompanied by the establishment of a dedicated regulator solely for such entities.[226] Again, however, such a measure would run counter to the flexibility that is the hallmark of hybrids.[227] If § 501(c)(3)-like benefits are granted to hybrids, the push for protective regulations will only increase, if only in a well-meaning attempt to guard the public fisc.[228] As already discussed, neither of the regulatory schemes typically applied to for-profits or nonprofits fits very well with hybrid social enterprise. It is likely that some sort of "hybrid" regime might be concocted, and it is equally likely that it could spell an early demise for the hybrid project by regulating the benefits right out of the form.[229]

Relatedly, autonomy is a valuable feature of, and one justification for the existence of the charitable nonprofit.[230] Opening the door to investors through tax-exempt hybrids could significantly impact the autonomy of the charitable form.[231] Even if investors were only allowed into a limited sector of for-profit charities, their influence might easily be felt throughout the charitable sector. Extending tax benefits to their for-profit counterparts could have a destabilizing

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that there has been little push to strengthen the oversight of nonprofits in spite of widespread agreement that the sector is prone to abuse, *see supra* note 224 and accompanying text, it is even less likely that there is sufficient political will to come up with resources to support a new regime.

226. *See supra* notes 68-69 and accompanying text. Indeed, the British CIC is subject to regulatory oversight in spite of the fact that it does *not* receive preferential tax treatment. *See* U.K. DEP'T FOR BUS. INNOVATION & SKILLS, COMMUNITY INTEREST COMPANIES INFORMATION PACK 47-48 (2010), *available at* http://www.bis.gov.uk/assets/cicregulator/docs/leaflets/10-1387-community-interest-companies-information-pack.pdf.

227. As it is, even if tax benefits are not granted, one scholar warns that there will be a strong "temptation to regulate" the L3C form if only to "protect investors, customers, and . . . the L3C brand itself from misuse." Schmidt, *supra* note 210, at 196.

228. The CIC Regulator is expected to engage in "light touch" regulation, U.K. DEP'T FOR BUS. INNOVATION & SKILLS, *supra* note 226 at 10, but it is worth noting the CIC Regulator's comment on the relationship between tax treatment and regulation: "Charities have certain tax advantages that CICs do not have. In return for those advantages, charities are subject to *more onerous* regulation than CICs." *Id.* at 38 (emphasis added).

229. *See* Schmidt, *supra* note 210, at 196-97 ("Legislators and government officials . . . should keep in mind the dangers of too much regulation. . . . Too much regulation can stifle the social creativity we will need if we hope to encourage new approaches to solving problems."). Speaking in the context of federal L3C legislation to facilitate PRI qualification, Tyler also notes that

> subjecting L3Cs to unduly restrictive approaches that undermine the ability to earn and distribute profits and allow values to appreciate could impose artificial burdens on L3Cs. These burdens may discourage investors, create confusion for creditors, cause ambiguity among managers about fiduciary obligations, or otherwise interfere with the ability of legitimate L3C enterprises to succeed . . . .

Tyler, *supra* note 29, at 153.

230. *See* Lloyd Hitoshi Mayer, *The "Independent" Sector: Fee-for-Service Charity and the Limits of Autonomy*, 65 VAND. L. REV. 51, 54 (2012) ("For charities to be charities . . . the law must protect them from other societal actors who intentionally or inadvertently would damage or destroy [their distinctness and public benefit orientation].").

231. *See id.* at 94.

effect on charitable nonprofits. The effort to survive in this new milieu could precipitate changes in the practices of charitable nonprofits similar to those that would result from allowing investors direct access to them as they imitate the behavior of their for-profit counterparts.[232]

4. *The risk of broken halos*

Scholars often speak of the "halo effect" that comes with the nonprofit form, and with tax-exempt charitable status in particular.[233] The public perception that charitable enterprises are valuable and deserve subsidy is vulnerable, however, and attempts by hybrid promoters to tap into that sentiment[234] could have serious consequences. If tax benefits are extended to social enterprise based on appeals to charitable impulses, and hybrids' image becomes tarnished, the result could be a backlash against tax-based support for charity generally, and a growing reluctance to subsidize any charitable activity, whether nonprofit or for-profit.[235]

The microfinance phenomenon serves as a useful example of this risk.[236] From meager beginnings, the movement grew with great public acclaim, culminating in the award of the 2006 Nobel Peace Prize to its most well-known proponent, Muhammad Yunus, and his creation, Grameen Bank.[237] Soon after

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232. For example, it has been shown that the choice of medical services offered by nonprofit hospitals moves toward the mix of services more commonly offered by for-profit hospitals when the two types of hospitals share the same market. Jill R. Horwitz & Austin Nichols, *Hospital Ownership and Medical Services: Market Mix, Spillover Effects, and Nonprofit Objectives*, 28 J. HEALTH ECON. 924 (2009). *But see* Cory S. Capps et al., *Antitrust Treatment of Nonprofits: Should Hospitals Receive Special Care?* 32 (Univ. of Chi., George J. Stigler Ctr. for the Study of the Econ. & the State, Working Paper No. 232, 2010), *available at* http://ssrn.com/abstract=1594249 (finding no evidence, based on California data, that nonprofit hospitals are more likely than for-profit hospitals either to provide more charity care or to offer unprofitable services in response to an increase in market power).

233. *E.g.*, Kelley, *supra* note 26, at 364; Reiser, *supra* note 25, at 2453.

234. *See, e.g.*, Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, EMORY L.J. 681, 733-34 (2013) (discussing the use of hybrids to create an effective brand for social entrepreneurs); Schmidt, *supra* note 210, at 183 (reporting that many L3C founders "had chosen the L3C business form for its 'halo' effect").

235. *See* Galle, *supra* note 76, at 1214-15 ("[O]pening philanthropy to potential profiteering . . . would dilute the power of these perceptions for every firm . . . ."); *cf.* Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, *in* TO PROFIT OR NOT TO PROFIT 1, 12 (Burton A. Weisbrod ed., 1998) (discussing the importance of public perception and the costs and benefits involved when charities engage in commercial activities).

236. *See* Jenkins, *supra* note 7, at 802 & n.195, 803 (explaining how microfinance is intended to break the cycle of poverty and promote gender equality "[t]hrough the provision of financial services (microloans, savings accounts, insurance, etc.) in small amounts, usually without monetary collateral requirements, to low-income individuals, particularly in the developing world").

237. *The Nobel Peace Prize 2006*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/peace/laureates/2006 (last visited Feb. 1, 2014).

microfinance began to take hold of the public imagination, for-profit entities began to step in, with the promise of expanding such programs through increased access to capital.[238] These new ventures were liberally applauded and endowed with the social enterprise label.[239] This rosy picture turned significantly darker by 2008, however, as for-profit microlenders were increasingly criticized for an undue interest in profits.[240] This was accompanied by public skepticism and greater scrutiny of the movement.[241] If tax-exempt status had been granted to these institutions and accusations of predatory lending then came to light, there could have been an even more damaging backlash against the social enterprise movement more generally. There already has been an overt effort to brand and market hybrids based on a desire to capitalize on public goodwill.[242] Rather than channeling this positive sentiment into tax law changes, the invisible hand should be given time to play its role.

Giving hybrids the ability to receive tax-deductible donations could be even more problematic. Proponents of for-profit charities argue that dedicated entrepreneurs should be able to reap the rewards of the efficiency they will bring to the charitable arena by pocketing some of the "profit" created through their efforts.[243] The use of the term "profit" in the context of a charity that accepts public contributions can be misleading, when the term really seems to mean excess donations that go into the founder's or investors' pockets rather than toward the donor's desired goal. The "profit" that the entrepreneur takes

238. *See, e.g.*, Elisabeth Malkin, *Microfinance's Success Sets Off a Debate in Mexico*, N.Y. TIMES (Apr. 5, 2008), http://www.nytimes.com/2008/04/05/business/worldbusiness/05micro.html? (stating that the founders of Compartamos, a for-profit microlender, claimed that they could "help more poor people by tapping the boundless pool of investor capital rather than the limited pool of donor money").

239. *See, e.g.*, Jay K. Rosengard, *Banking on Social Entrepreneurship: The Commercialization of Microfinance*, 32 MONDES EN DÉVELOPPEMENT 25, 25 (2004) (calling microfinance "a dramatic example of the successful application of [social enterprise]").

240. Malkin, *supra* note 238 (noting that some "are vilifying [the founders of Compartamos and their lending and collection tactics] as 'pawnbrokers' and 'money lenders'"). The picture has not improved since. *See* Muhammad Yunus, Op-Ed., *Sacrificing Microcredit for Megaprofits*, N.Y. TIMES (Jan. 15, 2011), http://www.nytimes.com/2011/01/15/opinion/15yunus.html (stating that microfinance has "give[n] rise to its own breed of loan sharks" and calling for greater regulation of the industry).

241. Erika Kinetz, *SKS Launches India's First Microfinance IPO*, BLOOMBERG BUSINESSWEEK (July 28, 2010, 1:30 PM), http://www.businessweek.com/ap/financialnews/D9H86ICG2.htm (citing fears that for-profit microlending will pit shareholders against the poor).

242. *See, e.g.*, Lang & Minnigh, *supra* note 28, at 17 (stating that in seeking a name the creators of the L3C "wanted branding," and calling the L3C "the for-profit with the nonprofit soul"); *Business FAQ's*, BENEFIT CORP INFO. CENTER, http://benefitcorp.net/business/business-faqs (last visited Feb. 1, 2014) (stating that choosing the benefit corporation form "[c]reate[s] a marketing opportunity to differentiate the business as a new class of corporation required by law to benefit society as well as shareholders").

243. *See, e.g.*, Malani & Posner, *supra* note 164, at 2019 ("[I]f the charity raises $10 million from donors but manages to [fulfill its purpose] at a cost of only $8 million, the charity will make $2 million in *profits* for the entrepreneur to take home." (emphasis added)).

home is the difference between the actual cost of providing the public good in question and the overcommitment of resources to solving the problem. Donors may end up duped into feeling good about lining an entrepreneur's pockets because they received a tax break for donating to "charity," when what they really paid for was his Caribbean cruise and new Ferrari.[244] The deduction might stand, but when they find out where the funds really went the good feeling will likely fade, as will the willingness to make charitable contributions of any type.

Commentators have also noted that for some of the current hybrid forms it is relatively easy for the owners to convert back to a standard, for-profit legal form. For example, a L3C can convert into an ordinary LLC merely by ceasing to meet the L3C special purpose requirements without any filing or notification requirements, while benefit corporations can make such a conversion by a supermajority vote of shareholders.[245] If while in hybrid form the enterprise had received significant tax benefits, one price of those benefits arguably would need to be a requirement that they be transferred to an entity still eligible to receive them or repaid to the government if such a conversion occurs to prevent misdirection of those benefits (thereby further limiting the flexibility of the hybrid form).

As the above discussion makes clear, the combination of the current vague definition of public benefit, the risk shifting that providing tax benefits to hybrids would generate, and the difficulty of ensuring that all hybrids in fact provide meaningful public benefit creates a situation with significant potential for a substantial number of hybrids and their for-profit investors to take the tax benefits and leave the public benefit behind. While tax-exempt nonprofit organizations, including charities, are not free from such scandals, such occurrences among hybrids could have particularly troublesome results for two reasons. First, the hybrid legal forms are relatively new and not fully accepted—any such scandals could therefore easily undermine the limited support that these forms enjoy, and even lead to repeal of the existing statutes that permit their existence. Second, the tax benefits enjoyed by charities have had their share of critics and problems, so hybrids enjoying the same benefits could easily become fodder for broader criticism of those benefits being provided to all types of organizations, whether fair or not. Both supporters of hybrids and supporters of charities should therefore be wary of extending any of the tax benefits currently enjoyed by charities to hybrids.[246]

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244. *See* Leff, *supra* note 76, at 864-65 (explaining how contributors to donative nonprofits rely on government enforcement of the nondistribution constraint "to prevent the entrepreneur from pocketing their contributions when, in fact, there may be nothing in their agreement with the entrepreneur preventing such result").

245. Reiser, *supra* note 60, at 3-4.

246. There is also a very real danger that pressure from weakly regulated, newly exempt hybrids could push some traditional charities out of business altogether. Program-related investing, currently of limited interest due to strict expenditure responsibility rules, might become significantly more attractive to private foundations if tax-exempt L3Cs were able to

B. *Tax Benefits for Hybrids as Hybrids*

For all of the reasons detailed above, it would be unwise to extend the current tax benefits enjoyed by charities to hybrids. It would, however, also be unwise to simply ignore hybrids for tax purposes given that they are an increasing part of the legal landscape, and given that hybrids and the public may benefit from several modest tax accommodations that could be offered specifically for entities organized as L3Cs, benefit corporations, or their ilk. These accommodations would not be an attempt to extend the tax benefits enjoyed by charities to hybrids. They would instead be based on the unique character of hybrids as organizations with both profit-seeking investors and public-benefitting goals.

1. *Modifying the deductibility of charitable contributions*

The first accommodation relates to the deductibility of expenditures for charitable activities. Hybrids, like all for-profit organizations, are free to dedicate a portion of their profits to support charitable ends.[247] Unlike individuals who may generally take a charitable contribution deduction for up to half of their adjusted gross income, such deductions by corporations are usually limited to ten percent of taxable income in any given tax year.[248] One way to encourage hybrids formed as corporations[249] to act on their charitable impulses would be to raise the limit on the deductibility of charitable contributions for these entities in particular.[250] Investors in social enterprise are already committed to accepting a limited return on their investment—why not give hybrids more leeway in distributing their profits to charitable causes?

Alternatively, the sharp division between charitable giving and business expenses under § 162(b) could be softened for hybrid enterprises. As noted

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offer artificially high rates of return, and especially if those rates of return came bundled with automatic PRI status. *See* Culley & Horwitz, *supra* note 39, at 21 (arguing that "[a]utomating the PRI process" by itself could facilitate the misuse of private foundation funds); *supra* note 38. PRIs serve both to satisfy the minimum distribution requirements for a foundation and potentially to provide a substantial return on investment, something a charity cannot match. *See* Schoenjahn, *supra* note 39, at 460, 470.

247. *See* I.R.C. § 170 (2012).

248. *Compare id.* § 170(b)(1)(A), *with id.* § 170(b)(2)(A). The limit on the deductibility of charitable transfers for corporations was fixed at five percent from the time it was introduced in 1935 until it was increased to the current ten percent limit in 1981. *See* Knauer, *supra* note 103, at 19 n.93, 29 n.159. Both the original enactment of the deduction and the increase in 1981 were putatively motivated by calls for greater corporate social responsibility and to encourage corporate philanthropy. *See id.* at 29.

249. This would include C corporation-like benefit corporations and other similar forms. L3Cs and other partnership-like forms—including S corporations—are not limited by the ten percent cap, but their owners may run into other difficulties that are addressed below. *See infra* Part III.B.2.

250. In 2005, there were efforts generally to raise the ceiling on the deductibility of corporate charitable giving to as high as twenty percent. *See* Charitable Giving Act of 2005, H.R. 3908, 109th Cong. § 103(b) (2005).

previously, in most cases the line between § 162 and § 170 is relatively bright.[251] In the context of for-profit corporations, whose raison d'être is to make a profit for shareholders, such a rule dividing charitable expense and business expense is sensible. In the context of hybrid enterprises, however, which exist to promote both public and private benefit, there is less reason for such a sharp distinction. For a hybrid, it is possible for expenses to be "completely gratuitous" *and* "bear a direct relationship to the [hybrid's] business."[252] The language of § 162(b) could be modified to allow hybrids to deduct amounts expended in pursuit of their charitable ends over and beyond the ten percent limit of § 170(b)(2)(A). Additionally, hybrids could be allowed to expense, rather than depreciate, assets dedicated exclusively to charitable ends to avoid the trap of § 263.[253]

2. *Eliminating automatic UBIT for hybrid S corporations*

One probably unintended consequence of the fact that two of the prominent hybrid forms are corporations under state law is that even if those firms qualify for and choose S corporation status all of their investors are taxed on their share of the hybrids' taxable income. This includes otherwise tax-exempt investors regardless of whether the activity of the S corporation would pass muster as furthering the charitable or other exempt purposes of the tax-exempt investor.[254] While this tax treatment has the benefit of simplicity—a hallmark of the S corporation form more generally—it actually reduces the incentive for a tax-exempt investor in such an entity to ensure that the hybrid in fact pursues its stated public-benefitting goal or goals. Consideration therefore should be given to whether satisfaction of requirements similar to those applied in the partnership context should be sufficient to exempt a charity's share of income (and gain) from its hybrid S corporation ownership from the otherwise applicable unrelated business income tax.[255]

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251. *See supra* notes 96-99 and accompanying text.

252. *Cf.* Rev. Rul. 72-314, 1972-1 C.B. 44 (noting that the ordinary test for determining whether a payment falls under § 162 or § 170 is "whether such payments are completely gratuitous or whether they bear a direct relationship to the taxpayers' business").

253. *See supra* note 104 and accompanying text. This could be accomplished either through a modification of § 179 or an expansion of § 168. *See* I.R.C. § 179 (allowing a taxpayer to "elect to treat the cost of [certain defined] property as an expense which is not chargeable to capital account"); *id.* § 168 (containing several subsections which allow for accelerated depreciation of certain types of property).

254. *See supra* notes 142-44 and accompanying text.

255. *See supra* note 155 and accompanying text.

3. *Other possible modifications*

Given the concerns raised by extending existing tax benefits enjoyed by charities to hybrids, it may also be advisable to revisit the limitations on charities engaging in profit-generating activity as an alternate means of providing support for social enterprise activity. For example, Dana Brakman Reiser recommends relaxing the limitations on how much commercial activity a charity can engage in without risking the loss of exemption from federal income tax or state property taxes.[256] This would serve to bolster the autonomy and flexibility of charities as they determine "how best to achieve their missions."[257] Rather than discouraging the use of the nonprofit form in favor of hybrids, it might be wiser to address the issue of charitable nonprofit access to capital in this way and so better allow each sector to play its own unique role.

CONCLUSION

The innovation of social enterprise—merging the charitable ends of § 501(c)(3) charities with the equity financing means of for-profit entities—may make it possible to expand charitable efforts to address growing societal needs. The efforts of entrepreneurs to seek new solutions through the creation of new hybrid legal forms should be recognized and encouraged. At the same time, extending nonprofit-type tax benefits to these new entities would be a mistake in that it could threaten the very benefits that their creators sought through their development. Tax preference is not a panacea that relieves all economic problems, but rather a targeted cure that can bring unwelcome side effects if wrongly prescribed.

There are already a number of opportunities under the current tax code and revenue rulings that are open to social enterprises and could assist them in their missions. These include existing tax breaks and the allowance for joint ventures between for-profit and tax-exempt charities. Hybrids that seek to provide affordable housing solutions, promote the production of electricity from renewable energy sources, find cures for rare diseases, or invest in neglected communities—among other charitable ends—already have tax credits tailor-made to their purposes.[258] Further, for-profits may partner with nonprofits through joint ventures under the rules promulgated by the IRS, which have grown increasing-

256. Reiser, *supra* note 76, at 55. Reiser does not argue for an elimination of UBIT or existing property taxes on charitable property, only for the elimination of the threat of loss of existing exemptions. *Id.*

257. *Id.*

258. *See, e.g.*, I.R.C. § 42 (offering a tax credit for the provision of low-income housing); *id.* § 45 (offering a tax credit for "electricity produced from certain renewable sources"); *id.* § 45C (offering a tax credit for drug testing for "rare diseases or conditions"); *id.* § 45D (offering a tax credit for investments that assist "low-income communities or low-income persons").

ly flexible.[259] The L3C form in particular may prove to be a useful tool for joint ventures because of its built-in charitable purpose, which is closely aligned with the requirements for permissible collaboration between § 501(c)(3) organizations and for-profits. The modifications suggested at the end of this Article can further ease such collaborations without unduly placing either the public fisc or public acceptance of the hybrid forms themselves at risk.

259. *See supra* note 95 and accompanying text.